PART – II

Documentation Requirements in the Standards on Auditing

Documentation Requirements in the Standards on Auditing

Audit Documentation

"The skills of an accountant can always be ascertained by an inspection of his working papers".
– Robert H Montgomery, Montgomery's Auditing, 1912

What the noted authority on auditing said about the relationship between an accountant (read "auditor") and his working papers almost 85 years back is true even today and then no wonder that "audit documentation" is the buzz word among the professional accountants today. The fact that "audit documentation" has remained as one of the top priorities in the professional circles, importantly, the standard setters, and that messing with the same has cost one of the oldest accounting firms its very existing drives home the point how important is documentation for the auditors. Audit documentation normally includes, in sufficient details, record of the following aspects of an audit:

- audit programme and other planning documents, including documents relating to assessment of the acceptance or continuance of the client.
- copies of significant client documents.
- checklists and questionnaires.
- notes of discussions with the client and/ or within the audit team on various aspects of the audit.
- management representation letters, third party confirmations and other important communications.
- details of tests performed, documents examined, analyses undertaken and results thereof. Though it is neither necessary nor practicable to document all the aspects of an audit, it needs to be adequate and appropriate enough to provide evidence that:
  - ⇔ the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and
  - ⇔ the audit was planned and performed in accordance with Standards on Auditing and the applicable legal and regulatory requirements.

In addition, audit documentation serves a number of other purposes including:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 220.
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.

- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Thus, the objectives to be met by the auditor when preparing audit documentation are:

- A sufficient and appropriate record of the basis for the auditor's report; and

- Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Strong audit documentation, therefore, also comes handy in cases of professional negligence against the auditor. Appropriate and adequate audit documentation, containing proper linkages, is virtually infallible evidence to the fact that the auditor has performed his work in accordance with the requirements of the professional Standards. One of the leading contemporary authorities working for an international auditing standards setter recently noted at a workshop organized by the Institute that the normal human psychology is that one documents/ records what one does. And going by that, the third parties, especially, the regulators and the law enforcers, normally, whatever be the facts, *prima facie* drew an analogy that what has not been documented has not been done. He also noted that there was a general perception among the professionals that bigger/ leading auditing firms were normally able to smooth sail such cases whereas the smaller audit firms/ practitioners found their defense difficult even though they had committed no such negligence. The main reason for this, he felt, was probably the fact that the larger auditing firms normally had stronger and well organized audit documentation which helped them in providing evidence of the work performed by them, whereas their smaller counterparts, were normally found to be lacking on the audit documentation aspects and therefore, unable to provide sufficient appropriate evidence of the work done by them. Therefore, notwithstanding the depth of knowledge that a practitioner has about his client, it is essential that the same is appropriately documented.

Further, the Standard on Quality Control (SQC) 1, issued by the Institute, which lays down the fundamental principles for maintenance of quality by the firms/ practitioners in the assurance engagements provided by them, draws its strength from the documentation skills and techniques of the practitioners. The Standard envisages that the audit documentation would be adequate enough to enable an "experienced auditor" (term which has been defined in the Standard) to follow the audit progress, basis of the decisions taken by the audit team, etc.

Audit documentation has also gained ground due to the process of peer review initiated by the Institute. The peer reviewer examines adequacy and appropriateness of the audit documentation of the reviewer. At its initial stages, peer review has been propagated as a learning exercise for the practice units rather than being a fault finding one.

Above all, strong documentation repository in an audit firm, comprising information about the clients is vital for building up the knowledge bank for the future use of the firm/ practitioner – a legacy of the firm/ practitioner. Working papers containing the history of the client over the years would help the audit staff to enrich their knowledge of not only what the client has been but also what they can expect the client to be. The knowledge bank would also come handy in helping the audit staff to understand the audit methodology, charting the reasons necessitating changes thereto as also understanding how the firm/ practitioner deal with various types of situations using the knowledge bank as the precedence.

To help the auditors in preparing sufficient appropriate audit documentation, the Institute had issued the Standard on Auditing (SA) 230, *Documentation,* in 1985. The Institute, in 2008, issued the Revised Standard on Auditing (SA) 230, *Audit Documentation*, providing detailed guidelines on important issues such as timely preparation of audit documentation, documentation of audit procedures performed and audit evidence obtained, assembly of the final audit file, ownership of audit documentation, etc.

DISCLAIMER :	*These documentation requirements have been extracted from the requirements given in the individual Standards on Auditing under the specific head of documentation and are illustrative only. These documentation requirements may have been abridged or reworded. Accordingly, the readers are cautioned to refer to the text of the SAs for complete documentation requirements. Further, a mere compliance with these documentation requirements in this document does not imply compliance with the respective Standard on Auditing (SA). The members and other interested readers are also requested to peruse the respective SA to identify the various documentation requirements arising therein. Further, this document does not include all the SAs since some of the SAs are purely conceptual and per se contain no documentation requirements.*

SA	SA Title
220	Quality Control for an Audit of Financial Statements
240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
250	Consideration of Laws and Regulations in an Audit of Financial Statements
260	Communication with Those Charged with Governance
300	Planning an Audit of Financial Statements
315	Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment
320	Materiality in Planning and Performing an Audit
330	The Auditor's Responses to Assessed Risks
450	Evaluation of Misstatements Identified during the Audit
540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
550	Related Parties
600	Using the Work of Another Auditor
610	Using the Work of Internal Auditors

Background Material for Audit Training Workshops and Seminars

SA 220: Quality Control for an Audit of Financial Statements

Para Ref.	*Issue*	*Documentation Needed*
24.	• Compliance with the Relevant Ethical and independence Requirements. • Acceptance and Continuance of client relationship and audit engagements. • Consultations	• Issues identified with respect to compliance with relevant ethical requirements and how they were resolved. • Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions. • Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements. • The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement.
25	Engagement Quality Control Review- Timing and Procedures.	The engagement quality control reviewer document: • The procedures required by the firm's policies on engagement quality control review have been performed; • The engagement quality control review has been completed on or before the date of the auditor's report; and • The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.
A35	Documentation of Consultations.	Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of: • The issue on which consultation was sought; and • The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

SA 240: The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

Para Ref.	*Issue*	*Documentation Needed*
44	• Understanding the entity & its environment. • Assessment of risks of material misstatements.	• The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and • The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.
45	Responses to assessed risks	• The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and • The results of the audit procedures, including those designed to address the risk of management override of controls.
46	Communications	Communications about fraud made to management, those charged with governance, regulators and others.
47	Fraud in revenue recognition	Reasons for concluding the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement,

SA 250: Consideration of Laws and Regulations in an Audit of Financial Statements

Para Ref	*Issue*	*Documentation Needed*
29	• Non - compliance • Discussions	• Identified or suspected non-compliance with laws and regulations. • Results of discussions with : ▪ Management; ▪ those charged with governance (where applicable); and ▪ other parties outside the entity.

A21	Non compliance	• Documentation may include: ▪ Copies of records or documents. ▪ Minutes of discussions held with management, those charged with governance or parties outside the entity.

SA 260: Communication with Those Charged with Governance

Para Ref	***Issue***	***Documentation Needed***
19	Oral & written communications to those charged with governance	• Matters required by SA 260R to be communicated are communicated orally, document: ▪ The matter; ▪ When communication was made; and ▪ To whom communication was made. • Matters required by SA 260R to be communicated are communicated in writing, retain a copy.
A49	Oral communication	May include a copy of minutes prepared by client retained as part of audit documentation where those minutes are an appropriate record of the communication.

SA 300: Planning an Audit of Financial Statements

Para Ref	***Issue***	***Documentation Needed***
11	Planning	• The overall audit strategy; • The audit plan; and • Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.
A17-A20	• Overall audit strategy. • Audit plan.	• In respect of overall audit strategy, document: ▪ the key decisions considered necessary to properly plan the audit – scope, timing, conduct of audit; and

	• Significant changes in the above two.	▪ communicate significant matters communicated to the engagement team. • May summarize the overall audit strategy in the form of a memorandum. • Documentation of the audit plan is record of planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. • May use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances. • A record of the significant changes to the overall audit strategy and the audit plan should document: ▪ resulting changes to the planned nature, timing and extent of audit procedures. ▪ reasons for significant changes were made. ▪ overall strategy and audit plan finally adopted for the audit. ▪ Response to the significant changes occurring during the audit. • In smaller entities a suitable, brief memorandum may serve as the documented strategy for the audit of a smaller entity.

SA 315: Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment

Para Ref	***Issue***	***Documentation Needed***
32(a)	Discussion	• The discussion among the engagement team where required by paragraph 10 of SA 315, and the significant decisions reached: ▪ the susceptibility of the entity's financial statements to material misstatement; and ▪ the application of the applicable financial

PREVIOUS HOME NEXT

		reporting framework to the entity's facts and circumstances.
32(b)	Understanding of each of the aspects of the entity and its environment specified in paragraph 11	• Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. • The nature of the entity, including: ▪ its operations; ▪ its ownership and governance structures; ▪ the types of investments that the entity is making and plans to make, including investments in special purpose entities; and ▪ the way that the entity is structured and how it is financed. • Accounting policies selection and application of accounting policies, including the reasons for changes thereto. • Auditor's evaluation of whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. • The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. • The measurement and review of the entity's financial performance.
32(b)	Understanding of each of the internal control components specified in paragraphs 14-24	• Control environment – Auditor's evaluation of whether: ▪ Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior. ▪ The strengths in the control environment elements collectively provide an appropriate foundation for the other components of

		internal control; and ▪ Whether those other components are not undermined by deficiencies in the control environment. • Entity's risk assessment process for : ▪ Identifying business risks relevant to financial reporting objectives; ▪ Estimating the significance of the risks; ▪ Assessing the likelihood of their occurrence; and ▪ Deciding about actions to address those risks. • Management's failure to identify a risk otherwise expected to have been identified: ▪ Why that process failed to identify it; and ▪ Evaluation of whether the process is appropriate to its circumstances or determine whether it represent a significant deficiency in internal control with regard to the entity's risk assessment process. • If the entity has not established such a process or has an *ad hoc* process: ▪ Discussion with management regarding whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. • The information system, including the related business processes, relevant to financial reporting, and communication. ▪ Information system, including the related business processes, relevant to financial reporting, including the following areas: ➢ The classes of transactions in the entity's operations that are significant to the financial

		statements; ➢ The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements; ➢ The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form; ➢ How the information system captures events and conditions, other than transactions, that are significant to the financial statements; ➢ The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and ➢ Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. • Entity's communication of financial reporting roles and responsibilities and significant matters relating to financial reporting, including: ▪ Communications between management and those charged with governance; and ▪ External communications, such as those with regulatory authorities. • Control activities relevant to the audit: ▪ Understanding of control activities relevant to the audit; and

		▪ Entity's response IT risks. • Monitoring of controls: ▪ Entity's major activities to monitor internal control over financial reporting; and ▪ How the entity initiates remedial actions to deficiencies in its controls. • Understanding of the relevance of the Internal Audit Function: ▪ The nature of the internal audit function's responsibilities and how the internal audit function fits in the entity's organisational structure; and ▪ The activities performed, or to be performed, by the internal audit function. • Entities having uncomplicated businesses and processes relevant to financial reporting, documentation: ▪ Simple and brief. ▪ Not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. ▪ Document only key elements of understanding. ▪ Extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team. ▪ For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.
32(b)	Sources of information from which the understanding was obtained	• Sources of the information used in the entity's monitoring activities. • Basis upon which management considers the information to be sufficiently reliable for the

		purpose.
32(b)	Risk assessment procedures performed	
32(c)	Risks (in terms of para 25 of the standard)	• Risks of material misstatement identified and assessed: ▪ at the financial statement level; and ▪ at the assertion level.
32(d)	Risks requiring special audit considerations	The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27-30 of the Standard.

SA 320: Materiality in Planning and Performing an Audit

Para Ref.	***Issue***	***Documentation Needed***
14.(a) & (b)	Materiality for the financial statements as a whole or materiality level(s) for particular classes of transactions, account balances or disclosures.	• Materiality for the financial statements as a whole: ▪ For establishing the overall audit strategy • Materiality level(s) for particular classes of transactions, account balances or disclosures: ▪ Determine materiality level(s) to be applied to particular classes of transactions, account balances or disclosures, which could expected to influence the economic decisions of the users.
14 (c)	Performance materiality	• Determine performance materiality: • For assessing the risks of material misstatement; and • Determining the nature, timing and extent of further audit procedures.
14 (d)	Revisions as the Audit Progresses.	• Revise materiality for the financial statements as a whole or materiality level(s) for particular classes of transactions, account balances or disclosures: ▪ Aware of information during the audit that would have caused the auditor to have

		determined a different amount (or amounts) initially. • If the auditor concludes that a lower materiality than that initially determined is appropriate: ▪ Determine whether it is necessary to revise performance materiality, and ▪ Whether the nature, timing and extent of the further audit procedures remain appropriate.

SA 330: The Auditor's Responses to Assessed Risks

Para Ref	***Issue***	***Documentation Needed***
28(a)	Overall responses	Overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed.
28(b)	Linkages	Linkage of those procedures with the assessed risks at the assertion level.
28(c) & A63	Results	• The results of the audit procedures, including the conclusions where these are not otherwise clear. ▪ The form and extent of audit documentation is a matter of professional judgment, and is influenced by: ▪ nature, size and complexity of the entity and its internal control, ▪ availability of information, and ▪ audit methodology and technology used in the audit.
29	Operating effectiveness of controls obtained in previous audits	• Document the conclusions reached about relying on such controls that were tested in a previous audit.
30		• The auditors' documentation shall demonstrate that the financial statements agree or reconcile with the underlying accounting records.

Para Ref.	*Issue*	*Documentation Needed*
15 & A25.	Uncorrected Misstatements	▪ The amount below which misstatements would be regarded as clearly trivial. ▪ All misstatements accumulated during the audit and whether they have been corrected: ○ Communication with management to correct the misstatement. ○ Communication with those charged with governance: ▪ Uncorrected misstatements and ▪ Effect that they, individually or in aggregate, may have on the opinion in the auditor's report. ▪ The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion. Auditor should consider: ○ The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and ○ The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. ▪ The auditor's documentation of uncorrected misstatements may take into account: ○ The consideration of the aggregate effect of uncorrected misstatements; ○ The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and ○ The evaluation of the effect of uncorrected

		misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

SA 540: Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

Para Ref	*Issue*	*Documentation Needed*
23(a)	Auditor's conclusion	• The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks.
23(b) and A128	Management bias	• Indicators of possible management bias, if any. ○ Assists the auditor in concluding whether the auditor's risk assessment and related responses remain appropriate, and ○ Evaluating whether the financial statements as a whole are free from material misstatement.

SA 550: Related Parties

Para Ref	*Issue*	*Documentation Needed*
28	Related parties	• Names of the identified related parties. • Nature of the related party relationships.

SA 600: Using the Work of Another Auditor

Para Ref	*Issue*	*Documentation Needed*
18	Components and component auditors	• Components whose financial information was audited by other auditors. • Such components' significance to the financial information of the entity as a whole. • Names of the other auditors.

		• Any conclusions reached that individual components are not material. • Procedures performed and the conclusions reached. • Where component auditor's report is other than unmodified, document how principal auditor has dealt with the qualifications or adverse remarks contained in the other auditor's report in framing his own report.

SA610: Using the Work of Internal Auditors

Para Ref.	*Issue*	*Documentation Needed*
13.	Using the specific work of the internal auditors	▪ Conclusions regarding the evaluation of the adequacy of the work of the internal auditors. ▪ Audit procedures performed by the external auditor on that work to determine its adequacy.

PART - III

Case Studies and Technical Posers

This part is a collection of scenarios in practical implementation of Standards on Auditing. The objective of the case studies is to initiate the reader's mind to find solutions to the problems presented in the case studies relating to implementation of the requirements enunciated in the applicable Standard(s) on Auditing and to, accordingly, encourage brainstorming among the participants at the training session.

Case Studies

CASE STUDY – 1
M/s. JKN & Co.

Client Acceptance Considerations*

Mr. John is a partner with M/s. JKN & Co., a firm of Chartered Accountants, which has been invited by the Board of Directors of Trinca Ltd. to accept appointment as external auditors. Trinca Ltd. operates a number of car dealerships and has grown rapidly over the past three years through an aggressive take-over strategy. Mr. Johns is aware that the company's existing auditors, a much smaller firm, qualified their last auditor's report. During discussions, the CFO of Trinca Ltd. Mentioned that their existing auditors could not cope with audit of a company of their size and, in particular, were not equipped to audit the recently installed sophisticated accounting software. He communicated that their company needed a firm of reputation and caliber like M/s. JKN & Co., in order to reassure the market as they intend to seek a public listing within two years.

A background check on the prospective client by M/s. JKN & Co revealed as follows:

- Management gives insufficient consideration to developing an accounting system adequate and appropriate to the expanding business. In particular, there is a lack of concern as to control. A number of petty employee frauds as a result of control weaknesses have been reported. However, no action is taken against the employees identified as engaged in fraud. The management attitude seems to be to encourage risk taking employees, who, in turn, make money on the side, whilst securing good deals for the company.
- The newly installed accounting software is unreasonably complicated though Trinca Ltd. claims this is necessary because of the need to maintain records to justify the company's claims for volume rebates, and bonuses under the complex incentive schemes by which car manufacturers reward dealers.

On an enquiry from the existing auditors, the former have advised M/s. JKN & Co. against accepting the engagement on grounds, including, that though they have no evidence of deliberate misrepresentation by the directors of Trinca Ltd. but the audit staff was hindered in their audit work by a less than helpful attitude by senior management who adopted an aggressive stance whenever a query was raised. The CFO of Trinca Ltd. was constantly on the phone to the partner claiming the audit staff was incompetent and accusing them of wasting his time asking unnecessary questions.

Queries to the Readers

i) What factors should partners of M/s. JKN & Co. should considered for and against accepting the appointment?

ii) In the case of acceptance of appointment, what matters should be taken into consideration in obtaining the required knowledge of the business and in developing the audit plan?

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* Adapted from a Case Study published in Modern Auditing, Grahan W. Cosserat (Second Edition), John Wiley & Sons pg. 206.

CASE STUDY – 2
Mr. Vallabh

Audit of Inventories[#]

Mr. Vallabh is a senior auditor assigned to the Seasons Electronics audit. This is the first year his firm is conducting the audit for this particular client. In fact, although Seasons Electronics has previously engaged audit firms to perform limited-review services for the purpose of obtaining bank loans, this is the first year Seasons Electronics has contracted for a full-scale audit of its financial statements. The company is planning an initial public offering (IPO) of its stock in the next two or three years and has hired Mr. Vallabh's firm to conduct its first financial statement audit in preparation for the upcoming IPO.

Seasons Electronics is a medium sized company that buys copper rod and plastics materials used to make insulated copper wirings. Seasons Electronics operates from a single location totaling 600,000 square feet, which includes office space (4%), production area (56%), shipping and receiving (18%), and finished goods and raw materials inventory warehousing (22%). Seasons Electronics supplies insulated copper wiring in the southern parts of the country. The company has a good reputation for quality products and has had a good working relationship with its past audit firms over the past years. Mr. Vallabh has been assigned responsibility for auditing Seasons Electronics' inventories. He is in the planning stages of the audit and he is preparing to conduct some analytical procedures to help identify risk areas that may require further attention.

Mr. Vallabh's staff assistant assembled information relating inventories and other items, Including a brief description of Seasons Electronics production and inventory areas. The information provided by the assistant is listed below :

(Amount in Rs.)

Particulars	2005	2004
Sales	94,50,000	91,50,000
Cost of Sales	72,62,500	69,60,000
Finished Goods Inventory	27,58,500	21,72,500
Copper Rod Inventory	36,25,000	27,50,000
Plastics Inventory	5,50,000	5,25,000
Days purchase in Account Payables	45.8 Days	47 Days
Days sales in Account Receivables	57.6 days	48.9 days
Market Price of Insulated Wire (per foot)	Rs. 0.008	Rs. 0.009
Market Price of Copper Rod (Per Kg.)	Rs. 0.510	Rs. 0.510
Market Price of Plastics (Per Kg.)	Rs. 0.125	Rs. 0.185

[#] Adapted from a Case Study published in Auditing Cases Buckless, Beasley, Glower, Prawitt (2000 edition), Prentice Hall, pg. 130.

Seasons Electronics makes several different gauges and types of insulates copper wire for use in applications ranging from residential telephones and electrical wing to industrial grade, high-voltage power cables. The production area is divided into three areas, with each area specialising in a particular product group, including residential products, industrial products, and special-order products. Production is done in batches according to orders placed with the firm. For each batch, machinery is adjusted and calibrated according to the type and size of products to be manufactured, and the size of the batch depends on the amount of product needed. Average machine setup time from start to finish is approximately six hours, which is slightly below the industry average.

The different types of products Seasons Electronics manufacturers all use similar raw material, so raw material inventory is stored in a single location, divided only into copper and plastics materials. Finished insulated copper wire is stored on large, stackable spools of various sizes, with approximately 500,000 feet of wire spool. Copper rod inventory is stored on pallets, which are not stackable. Each pallet measures 6 feet by 6 feet, stands 5 feet tall, and holds 1,500 tons of copper rod. Plastics inventory is stored in 4-foot-balll stackable barrels, with approximately 350 kg of plastic per barrel. The raw material inventory storage area is located near the shipping and receiving area for convenience. Inbound and outbound shipments of inventory are trucked to the nearest rail yard, from which they are distributed around the southern region of the country. A single 18-wheeler can carry up to 15 pallets of copper rod, 40 barrels of plastics, or 24 spools of finished wire.

Seasons Electronics production process is semi-automated, but it still requires a relatively large amount of labour. Thus, conversion costs are fairly evenly divided between direct labour and factory overhead. Overhead consists primarily of the costs of production facilities and depreciation and maintenance on the machinery. Seasons Electronics uses a hybrid product costing system (i.e., a system that combines characteristics of both job-order and process-costing systems) to accommodate both the continuous and homogenous nature of the manufacturing process and the fact that production runs are performed in separately identifiable batches. In accordance with the relatively homogenous nature of Season's products, overhead is allocated from a single cost pool bases on a combination of machine and direct labour hours.

As wire product is completed, it is rolled onto large spools of various sizes, usually in lengths of about 500,000 linear feet. These spools of finished inventory are stored next to the raw materials inventory near the facility's eight loading and unloading docks. In many cases the inventory is produced in response to specific customer orders received, in which case the spools are tagged for shipment to customers according to date requested. Inventory that has been produced without a customer order to provide a "cushion" for rush orders is stored toward the far end of the finished goods storage area, away from the shipping area.

The inventory and production areas are well organised and seem to flow smoothly. Machines appear to be well maintained. A cursory visual examination of inventories reveal no problems. Two spools in the finished goods area were tagged as being of the type of residential wiring recently banned by government safety guidelines. These spools are clearly marked, and the inventories supervisor indicated that they are to be destroyed within the next week. Procedures and records for tracking materials upon arrival, through the production process, and into finished goods and shipping, appear to be well designed.

Queries to the Readers

What analytical procedures should Mr. Vallabh perform to help him identify risks or issues that indicate the need for further attention, if any, in case of the following management assertions:

i) existence of occurrence.

ii) completeness.

iii) valuation of allocation.

iv) rights and obligations.

v) presentation and disclosure.

CASE STUDY – 3

M/s. S.K. Lal & Co.

Auditing in a CIS Environment[β]

Millennium Stores, is a first-year audit client of M/s. S.K. Lal & Co. The audit partner, Mr. Raj obtained background information about the sales system after recently meeting with client personnel at the corporate office. The company's sales system is computer–based & with computerised cash registers on the floors of all of its stores. At the point of sale, the company's sales personnel enter product number, quantity per product, and indication of whether it is a cash sale or credit sale. Additionally for credit sales, the sales personnel must enter customer credit card agency approving the credit sale. Millennium Stores only accepts Master or Citibank cards and a copy of the credit charge slip is maintained in the cash drawer. The computerised cash register performs the following tasks:

- Identifies correct price based on product number.
- Notifies clerk if product number is invalid.
- Calculates total price of purchase (price* quantity).
- Extends totals, calculates sales taxes, and determines final transaction amount.
- Generates a customer receipt and a duplicate record of the transaction on a cash register tape that is locked inside the register. Cash register tapes indicate all inputted information. Only accounting department personnel have access to the tapes.

Stores clerks are allowed to operate any machine on the floor. If a cash register is not currently being used, all the clerk has to do is turn the machine on, and once the system is booted, the clerk begins by entering the product number. Generally, operation of the each register is self-explanatory although some problems have occurred previously. Millennium Stores has no formal training for cash register operation because management believes "on the job experience" is more effective.

At the end of each day, sales personnel count the cash in the drawer and list the total cash count on the Daily Deposit Sheet (a pre-printed blank form). In addition, the sales personnel summarize total credit sales on the Daily Deposit Sheet by listing total amounts from the credit sales slips in the register. The sales personnel takes the cash drawer, which includes credit slips, to the store cashier. The cashier verifies the Daily Deposit Sheet and initials the total cash and credit sales columns listed on the Daily Deposit Sheet. The cashier leaves Rs. 20,000 in each cash drawer to begin the following days. Cash drawers are stored overnight in the store's vault. The store cashier takes the cash plus credit charge slips to the bank at the end of each day. The bank immediately credits the store's cash account for all cash and credit and receipts presented. An independent person in accounting verifies that the sum of the cash and credit card slip totals on all Daily Deposit Sheets for the prior day reconcile to the validated deposit slip. After performing the reconciliation, the accounting clerk attaches the Daily Deposit Sheets to the validated deposit slip and files them together by date.

Accounting personnel close out the machines each night. As a part of this procedure, the machine prints subtotals of cash and credit sales for the day at the end of the cash register tape. Accounting personnel remove the cash register tapes from the machines each night, and the tapes are stored in the accounting department.

[β] Adapted from a Case Study published in Auditing Cases: Buckless, Beasley, Glover, Prawitt (2000 edition), Prentice Hall, pg. 134.

Overnight, the computer system processes all transactions for each cash register and summaries this information on a Daily Sales Report. The Daily Sales Report is generated for each store nightly. It summarizes total stores sales, as well as subtotals of cash and credit sales, by store cash register. These reports are filed by date at each store. In addition, the computer updates perpetual inventory records daily, which are stored on magnetic disk. No reports of this interface are generated daily by the computer.

At month's end, the computer generates a detailed Inventory Listing, which provides quantity information by product number. Also, the computer generates a Monthly Sales Report for each store. This report shows daily sales totals for the store for each day of the month. The computer also prepares and prints a consolidated General Ledger, which summarizes the postings of monthly sales totals from each store to the consolidated sales account.

Queries to the Readers

i) Describe the audit trail from the point of the sale to the general ledger posting of the consolidated sales and cash accounts and also emphasise whether the audit trail is in paper or electronics form.

ii) Develop a proposed strategy for auditing the existence of sales. Is there a sufficient appropriate audit trail to be able to audit that assertion without relying on IT specialists?

iii) What source should be used to select a sample of sales transactions to test the existence of sales at one store? Why this source is better than the other available sources?

iv) Develop a proposed strategy for auditing the valuation of the sales account. Is there a sufficient paper trail to be able to audit that assertion without relying on IT audit specialists?

v) What portion, if any, of the sales system will likely require the assistance of an IT systems auditor, who evaluates evidence existing only in electronic form?

vi) What control weaknesses are there in the existing sales system?

CASE STUDY – 4
M/s. Krishnan Menon & Co.

Audit Quality Control[λ]

The senior partner of Krishnan Menon & Co., L. Krishnan, glanced at the newspaper in disbelief. "This can't be true," he muttered. "How did we ever manage to remain unaware of this?" he asked R.K. Menon. With him was a small news item adorning the front page of a leading financial newspaper. It concerned their new client an upcoming textile manufacturer, the Rs. 220 crore Nataraj Ltd. The announcement stated in bold letters that Nataraj had violated provisions of the Foreign Exchange Management Act (FEMA), and had been booked by the Reserve Bank of India. It went on to say that of the Rs. 70 crore worth of yarn imported during the year, the company was found to have over–invoiced imports by Rs. 33 crore.

Menon, who was also a founder partner, looked equally nonplussed. "Let us call a meeting day after tomorrow," he suggested. "The other partners can also fly down." That evening, Krishnan settled in his plush room and let his thoughts go back some 35 years…

Krishnan Menon & Co., chartered accountants, was established in 1970 in Coimbatore. During the initial years, the audit work was closely monitored and supervised by its two partners. The list of clients included small scale industrialist and partnership firms of professional and traders. Most of these clients shared as associated with the city that went back several generations. They were men of repute well-known for their integrity, and their business dealings were straightforward. As a matter of fact, the perceived audit risk factor was quite low. Even then, each time before finalising an audit report, Krishnan & Menon would sit down and discuss the issues raised during the audit. This was regardless of who acted as the principal auditor. They kept up a lively interest in professional issues and kept track of all new developments.

This was not all. Once every week, Krishnan would hold a meeting in the office. The discussions would centre around the day-to-day queries and issues specific to each audit client. In addition, there were exchanges on the current developments affecting the accounting profession. Articles appearing in professional journals were dissected and debated. Taxation and corporate law issues, in particular, were subjects of some extremely painstaking analysis.

With the passage of time, the firm witnessed steady growth and the annual gross billings swelled. The client portfolio too registered an impressive horizontal and vertical expansion. Their operations now ranged across industries and, of course, their numbers also puffed up. By 1990, the firm had three partners and eight qualified employees, and a branch at Trichur. During all these years of practice, all the partners were well-acquainted with each other, and the staff kept track of all clients. In the next decade, the growth of practice was exponential. The firm's gross billings increased by more than five times. Two more branches (at Visakhapatnam and Bangalore) were opened. By 2001, with nine partners and all of 36 qualified chartered accountants, Krishnan and Menon had a formidable reputation to live up to.

The sound of the phone ringing shook Krishnan out of his reverie. It was his secretary with the message that all the partners had confirmed they would attend the meeting. Krishnan now braced himself for the meeting on Wednesday. The meeting was attended by all the partners. They shared Krishnan's concern and were unanimous on initiating an action plan. One of the significant conclusions that emerged was that the firm had no formal policies and procedures for assigning personnel to undertake audit assignments, or for hiring staff members. The situation called for a thorough investigation. Accordingly, Menon was assigned the task of identifying instances. If any, that could be

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[λ] Adapted from Case Study contributed by Mr. Vijay Kapur published in The Chartered Accountant, April 1997, pg. 82-83.

potentially embarrassing to the firm. A schedule was drawn up for his visit to all the branch offices, and they all agreed to meet again in a fortnight.

The report that was submitted two weeks later was a revelation. It was a replete with interesting findings. (See Menon's Report : Executive Summary) The founder partners were appalled. All this time, their constant effort had been to instill a work culture that would encourage professionalism and continuous learning. This was, after all, a pre-requisite for the growth of the firm. Obviously, the cracks were now beginning to show. What exactly were the implications of all this? We must do something fast, they concurred but what?

MENON'S REPORT: EXECUTIVE SUMMARY

- The Swamy Group of Industries accounts for about 28 per cent of gross audit billings for the year 1995-96.
- In 1995, three traders paid audit fees less than Rs. 5,000.
- The EDP in-charge of a branch was suspended for fraudulent transfer of funds to his saving accounts. The partner in-charge of the concurrent audit of the branch has admitted to lack of EDP knowledge.
- An audit manager accepted an expensive gift from an officer in the client company.
- Documentation was found to be woefully inadequate in the case of certain audits.
- One of the partners purchased a car, the finance for which was arranged by a finance company which is audited by the firm. Terms of credit extended are normal.
- A partner was assigned an engagement where a close relative was an officer in the company concerned.
- During the last two to three years, only 10 staff members attended seminars and workshops organized by professional accounting bodies.

Queries to the Readers

Views of the readers are invited on the shortcomings in the audit quality control system in Krishnan Menon & Co., and remedial measures.

CASE STUDY – 5
M/s. Verifiers & Co.

Audit Documentation*

Vikram Seth, audit manager of M/.s Verifiers & Co., chartered accountants, was all set for a week-long vacation in Bangalore the following morning when the telephone rang. It was Vishnu Gopal, senior partner in his firm, on the line. The tone itself conveyed the message. Seth was to change the venue of his visit. Instead of Bangalore, he would have to report to office the following morning. It was an emergency.

Seth reached office around 9.30 a.m. the next morning his disgust at the turn of events having abated considerably and headed straight for Gopal's cabin. Sonali, a senior articled trainee, was already closeted with him. It began with apologies. Gopal was sorry that Seth had to cancel his visit but the matter was urgent it was to do with the issue of audit report of Krashers Ltd. (Krashers). The previous evening, before leaving office, Seth had informed Gopal that he had reviewed the audit working papers of Krashers thoroughly and that there was nothing wrong in them. Seth had said a clean report could be issued to Krashers.

But Gopal had spent a couple of late hours in the office examining the audit working papers and had come round to the opinion that certain auditing procedures had not been followed, or even if they had been followed, the fact was not reflected in the documentation. Moreover, there was no evidence that Seth had really reviewed the working papers since he had not initialed at many places.

Gopal suggested that Seth must have forgotten to put his initials since he would have been pre-occupied with the Bangalore trip. But such slips could get the firm into trouble, he reminded the audit manager. And, more importantly, Gopal said, the working papers for quite a few significant transactions were not available in the file. The lapses were as follows:

- Bank reconciliations for two months had not been prepared and cash balances shown in the ledgers did not tally with confirmation received from the bank.
- No evidence was available to prove the authenticity of a transaction involving the sale of certain raw materials at a throwaway price to a sister concern of which the managing director of Krashers was a board member.
- A branch office of Krashers had been closed and let out to another company on lease for five years, and the properly had been classified as investment property.
- Krashers had purchased explosives for which the company could have no conceivable use.

Further, it was not clear whether the internal control system, particularly for inventories and debtors, had been reviewed since there was no documentation for such review. Moreover, in the case of investments, there were no records of third party confirmations, and apparently, no follow-up had been carried out on non-responses to confirmations regarding inventories held by third parties and debtors.

"Look Vikram," Gopal said, "I have always relied on your opinion on various audit assignments. But I do not understand how this time the documentation fails to reflect the work you have performed. You should have taken particular care in this case since you knew fully well that Krashers is a new client." Seth's reply was firm. He emphasized that a fairly good job had been done and all standard audit procedures of the firm had been followed meticulously. There was no compromise on this aspect, he re-iterated. The extent of documentation required was a

* Adapted from Case Study contributed by Mr. Vijay Kapur published in The Chartered Accountant, June 1997.

matter of professional judgement, Seth said, adding that it was neither necessary nor practical to have every observation, consideration, or conclusion documented by the auditor in his working papers. However it was quite possible that the working papers were not adequate, he said, and explained that he had relied on verbal assurances offered by the management of Krashers.

Seth said that Chakresh, the managing director of Krashers, had assured him on more than one occasion that there was no problem in this regard and that all relevant papers would be handed over to the audit firm. Seth said even Sonali would confirm that two such meetings had taken place with the chief accounts officer of krashers.

"You would also recall that Chakresh has been pestering us to submit an early audit report since the date of the annual general meeting has been fixed and Krashers is planning for its first public issue," Seth explained to Gopal.

Seth went on to say that the audit had been planned properly so that sufficient appropriate audit evidence could be obtained. The internal control was also reviewed and tested properly using a standard questionnaire. Further, lot of extra book-keeping work was done since the records of Krashers were not exactly up-to-date. As far as the issue of cash not being reconciled was concerned, Seth said that would not pose much of a problem since he did not suspect any fraud. "In any case, just because some prospective investors rely on financial statements audited by us, we need not be overly concerned. And we can always prove that the audit was conducted exercising reasonable care and skill, and following the standards of auditing procedures," Seth asserted. He added that he had spent a good number of days on the job, and nothing had come to his attention to arouse the suspicion that the accounts did not provide a true and fair view. "Your point that I had not reviewed the working papers is not correct," Seth told Gopal. Sonali agreed with Seth but felt that before issuing the audit report, it would be better to spend some more time on the assignment.

Meanwhile, the telephone rang. It was Gopal's secretary. He was holding a call from Chakresh. Chakresh reminded Gopal that the audit report, though promised, has not been delivered yet. He said the Board was meeting that evening and he needed the report by that time.

Gopal politely informed Chakresh of the problem with the report. But Chakresh insisted on getting the report and assured Gopal that in case there was any inadequacy in the working papers, Krashers would take care of it. Gopal was in dilemma and stared at Seth and Sonali. He asked his secretary to connect him to his legal adviser.

Queries to the Readers

What should Gopal do?

CASE STUDY – 6
M/s. Sparkle Limited

Going Concern*

Mr. Chris Xavier's entire schedule had suddenly gone awry. The Managing Director of Sparkle Limited, a Rs. 143 crore company engaged in the business of mining and processing of precious and semi-precious stones, was in the middle of a grueling series of meetings to finalise the bid documents for a new mining venture. Absorbed in putting the final touches to his presentation to the state government, He had not glanced at the lengthy fax message that he had received in the morning from Mr. R. Krishnan, audit manager, M/s. Tickers & Co., statutory auditors of the company. Finally able to grab a few minutes between meetings, Xavier retrieved the fax from under a pile of slides. The Initial cursory scan, however, was soon transformed to an intent scrutiny as Xavier read the fax with mounting alarm. At stake was the future of a company he had devoted over 30 years to.

Noted the fax, "During the course of audit of your company, it was observed that the company had acquired a tract of land in Zozila (Madhya Pradesh) and invested about Rs. 25 crore (representing about 30 per cent of total assets). Further, another Rs. 50 lakh was spent by the company in acquiring the mining licence and other sundry work preparatory to the mining of the mineral zelota form which the rare metal zinesium can be extracted. The viability of the investment is solely dependent on quantity and quality of ore. The audit staff observed that the investment was made on the basis of report submitted by Mr. M. Venkatesh, a fairly senior employee of your company known for his expertise in evaluation of precious and semi-precious metals/stones, and a subsequent report obtained from the General Manager (Analysis) of reputed mining consultancy firm. As was apparent from the internal audit report, the management itself is not very comfortable with the report of Mr. Venkatesh probably because of his lack of adequate experience in the field of geological surveys. On the recommendation of MR. K. Kumar, Chief Internal Auditor, the matter was referred to the General Manager (Analysis). The sample obtained by Mr. Venkatesh from the site was also sent for analysis.

We have been given to understand that the final report submitted by the General Manager (Analysis) indicates a high proportion of the metal zinesium in the sample. However, the complete report detailing the methodology followed, the data relating to geographical features, the estimated quantity of ore, etc., and other assumptions have not been made available to us. Under the circumstances, we have no option but to issue an audit report indicating doubt about the going concern status of the company, since we are of the opinion that such a substantial investment made by the company is nothing but a pure gamble. However, we would like to verify the detailed report including credentials of the General Manager (Analysis) for the purchase of land in Zozila before we issue our audit report."

Xavier immediately buzzed his secretary and ordered her to cancel all remaining appointments. He then summoned Mr. S. Singh, Director (Finance) and Mr. K. Kumar Sparkle Ltd.'s Chief Internal Auditor for an emergency meeting. In the stormy session that ensued, a clearly worried Xavier demanded an explanation. Kumar clarified that though Venkatesh had a wealth of practical experience, he did not possess a professional qualification. So, at the insistence of the internal audit department, the General Manager (Analysis) were called in to evaluate technical feasibility of the project.

Mr. Singh pointed out that though there was no harm in submitting the complete report to statutory auditors, there were unfortunately certain remarks appearing on the report which could prove to be damaging. For instance, the report expressed doubts about the safety of the mine after five years. Nor did it clearly spell out the cost of operations. When presented with this explanation, Xavier's initial reaction was to send the complete report (including supporting documents) for examination by the auditors. But both Singh and Kumar expressed their reservations

* Adapted from Case Study contributed by Mr. Vijay Kapur, published in The Chartered Accountant, February, 1997.

about submitting the complete report. It would unnecessarily reopen the entire issue and could even raise fresh questions about viability of the project. Moreover, not only had the auditors grossly exaggerated the situation, they had overstepped their bounds in demanding the full report.

Xavier was in a dilemma. If he provided the full report to the auditors, it could still create a controversy that could adversely affect Sparkle Ltd.'s negotiations with the State Government for a mining lease, which were at a particularly delicate state. On the other hand, not submitting the detailed report could have serious consequences. After all, casting doubt on the going concern status of the company is the single most serious objection an audit report can raise. Just what are the rights of the auditor in such a situation, wondered Xavier.

Queries to the Readers

Readers are invited to offer their comments on the situation.

CASE STUDY – 7

M/s. Steel Krafts Private Limited

Illegal Acts of Clients[Ω]

Mr. Arshad, a chartered accountant and senior employee of the auditing firm M/s. SAS & Associates, was in the process of finalising the audit report for Steel Krafts Private Limited for the year ended March, 31, 2006. Steel Krafts was in the business of manufacturing precision steel instruments since 1996, when it started off as a partnership firm. In the first year of its operations, the firm picked up a small turnover of Rs. 25 lakh. In 2002, it converted itself into a private limited company. The Steel Krafts had always focused on developing a captive market for its products, and supplied to various ancillary units both in the public and private sectors. In the financial year 2005-06. Steel Krafts' turnover jumped to Rs. 10 crore. About 30 per cent of this figure was accounted for by exports to Russia, Belgium, and Yogoslavia. Steel Krafts appointed M/s. SAS & Associates as statutory auditors for the first time in the financial year 2005-06.

While going through the working papers, Arshad felt that an unqualified opinion could be issued to Steel Krafts for the year ended Mach 31, 2006. But as he prepared himself for the meeting back in his own office with Mr. K. Kumar, partner in-charge of the audit, he noticed a flurry of activity in the cabin of Steel Kraft's managing director (MD). A few minutes later, he saw two police officials coming out of the cabin. Arshad felt curious. He enquired Girish, a senior audit assistant, about the commotion. Girish informed that in February (2006), the MD's driver had run over a person and the visit of the police officials, in all probability, had something to do with that accident. But then, Girish added, the matter had already been settled out of court and the company had cleared all legal claims.

Arshad was not fully satisfied with Girish's explanation and went on to check the date of the accident and the relevant accounting records. While scrutinizing the entertainment expenses, Arshad stumbled upon some figures booked around the date of the accident. He called for Mukesh, the accounts manager of Steel Krafts. Arshad had seen from the accounting records that Kumar had started off with a monthly salary of Rs. 15,000 but was now drawing a gross salary of Rs. 350000 a month (inclusive of car allowance.) During the last one year, there had been a noticeable change in Mukesh's lifestyle.

On persistent queries by Arshad about the car accident, Mukesh revealed that around Rs. 25,000 had been paid to the relevant authorities to hush up the case. The amount was camouflaged as an entertainment expense. "However, the two police officials visiting the Steel Krafts MD that day had nothing to do with the case", Mukesh said. "In fact, they were not from the police but from the Customs department. And, this time, it is a stickier case than the previous one", the accounts manager confided.

Arshad's curiosity had been raised again, and he would not let go without an explanation. After some persuasion, Mukesh gave in. He said the two customs officials had come in demanding a hefty sum since the boxes being air-freighted to Belgium actually contained rags instead of export material. "These things had to be done if one were to stay in business", he explained to Arsahd. "In fact, no business could be run without greasing the palms of the officials", Mukesh said, adding that such payoffs, to a large extend, were responsible for Steel Krafts' rise in fortunes.

Seeing Arshad's bewilderment, Mukesh said that too much importance should not be attached to the payments since they were routine and the amounts involved were not material. He confided that, initially, even he was not comfortable dealing with such situations, but now he was reconciled to reality. He said the MD's family which held about 70 per cent equity in Steel Krafts considered him as one of the most trusted employees and, in fact almost all

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Ω Adapted from Case Study contributed by Mr. Vijay Kapur published in The Chartered Accountant, April, 1997.

deals were routed through him. “Normally, these transactions were disguised as publicity or advertising expenditure”, Mukesh said. He was also quick to remind Arshad that as a professional accountant he should not share the information given to him with anyone else.

Arshad was confounded at the revelations. After much thought, he called up Kumar requesting him to postpone the meeting by at least two days in view of the new developments. The next day, he began a thorough scrutiny of the expenditure under various heads. He was astonished to note that Steel Krafts had paid for the air tickets of certain government officials and their families who visited two international trade fairs in which Steel Krafts had participated. The more Arshad thought of the information he had stumbled upon, the more his dilemma grew. He kept wondering as to how he should go about the entire matter. Equally disturbing for him were the instances in which Steel Krafts had violated the various provisions of the law. “These could well have an impact on the financial statements and above all, the going concern of the company”, he thought. Unable to decide the course of action that he should take, Arshad decided to place all the facts before Kumar and seek his advice. But Kumar, after going through the entire matter, was equally perplexed.

Queries to the Readers

Readers are invited to offer their views on the scenario.

CASE STUDY – 8
M/s. Great Champs

Using Analytical Procedures as Substantive Tests[Ψ]

Great Champs, an independent, minor football team, competes in the Southern zone. The team finished in second place in 2006 with a good record. The Great Champs cumulative season attendance of 5,45,459 spectators set a new record high for the team, up from 4,90,000 in 2005. Bank-loan agreements require the Great Champs to submit audited financial statements annually to the bank. M/s. ABC & Co. has been the Great Champs' auditors for the past five years.

One of the major audit areas involved audit of ticket revenues. Those revenues reached nearly Rs. 10,88,0000 in 2005. In the prior years, the audit plan called for detailed testing of revenue accounts to gain assurance that reported ticket revenues were fairly stated.

Mr. Abhi, a new audit manager, just received the assignment to be manager on the 2006 audit. He had worked previously on the Great Champs prior-year audits as a staff auditor. When he learned that he would be managing the current–year engagement, he immediately thought back to all the hours of detailed testing of ticket sales he had performed in earlier years. One some of his other clients Mr. Abhi had been successful at redesigning the audit plans to make better use of analytical procedures as substantive tests. He is beginning to wonder if there was a more efficient way to gather substantive evidence related to ticket revenues on this audit engagement also.

In his first meeting with the management of Great Champs for the 2006 audit, Mr. Abhi learned that the Great Champs now use an outside company, M/s. Chicklets, to operate ticket gates for home games. The terms of the contract required M/s. Chicklets to collect ticket stubs so that they could later report total tickets collected per game. Although M/s. Chicklets did not break down the total ticket sales into the various price categories, Mr. Abhi thought there might be a way to develop an analytical procedure using the independently generated total ticket numbers and data from prior audits. To investigate this possibility, he asked a staff person to gather some information related to reported sales. The information that the staff person gathered from the records of the client, M/s. Chicklets and prior-year working papers is as follows :

2006 Park Attendance	
Total park attendance	5,45,459
2006 Number of Games	
Weekday games	44
Weekend games	29

Information from prior-year audit working papers indicate that average per-game attendance for weekend games was 27% higher than average per-game attendance for weekday games.

2006 Per-Game Ticket Prices	
Club seats	Rs. 300
Box seats	Rs. 200

[Ψ] Adapted from a case study published in Auditing Cases: Buckless, Beasley, Glover, Prawitt (2000 edition), Prentice Hall, pg. 133.

General seats :	Adult :	Rs. 150
	Child :	Rs. 75

Sales Mix	Weekday	Weekend
Club seats	30%	25%
Box seats	40%	30%
General Seats		
Adults	15%	25%
Child	15%	20%

Comparison of 2005 ticket prices to 2006 ticket prices reveals an average increase of 12% between the two years.

Information from prior-year audit working papers shows that sales mix has remained fairly constant over the past several years.

2006 Promotion : Number of Games

Weekday	7
Weekend	10

Information from prior-year audit working papers shows that attendance generally increases by 10 percent when there is a promotion (e.g., free football cap, poster, or special entertainment).

Queries to the Readers

i) Using the information provided, what expectation for ticket revenue for the year 2006 fiscal year should be developed by Mr. Abhi?

ii) How close would the Great Champs reported ticket revenue have to be to your expectation for you to consider reported ticket revenue reasonable or fairly stated?

iii) If reported ticket revenues are outside the "reasonable range" what could explain the difference?

iv) If the engagement team decides to use analytical procedures for the Great Champs audit then how will the audit plan differ from prior years?

CASE STUDY – 9

M/s. Eduk IT International Ltd.

Accounting Systems and Internal Controls[∞]

Eduk IT International Ltd. runs four private colleges which provide education and training for people in the information technology industry. Its two–year course includes training in data processing, multimedia, animation, etc. M/s. Tick Tack & Co. are conducting the interim audit for the year ended 30th June 2005. The tangible fixed assets of each college are recorded in an asset register which is maintained at each college location by the respective college manager. The system operates as described below:

- In order to obtain new assets, a purchase requisition form is completed and approved by the manager at each college.
- The requisition is sent to the head office, where the purchases officer checks the requisition for approval and completes the purchase order for the new asset.
- Assets costing more than Rs. 50,000, are approved by the head of the Accounts Department. All assets over Rs. 2,00,000 require Board of Directors' approval.
- The purchase order is then sent to the supplier and a copy is sent to the central store at the location of the head office.
- The asset is received by the central store where the receiving clerk checks that all the asset details agree with those on the goods received note and the copy of the purchase order. The receiving clerk then issues the asset with its computer-generated sequential barcode number. This barcode is fixed to the asset and written on the goods received note and the supplier invoice.
- The relevant college manager inputs the new asset details into the asset register using a copy of the purchase order, the original requisition and the asset's barcode.
- For disposal or write-off of an asset, and asset disposal write-off form is completed by the relevant college manager, signed and sent to the head office. Disposals and write-offs are approved by the head of the Accounts Department. A copy of the form is filed at the head office and the approved original returned to the college manager for action. The college manager then updates the fixed asset register for the subsequent disposals/write-off.
- The asset register is maintained on tailored fixed assets accounting software systems, known as FAST and reconciled to the general ledger by each college manager monthly.
- The FAST system calculates depreciation automatically each month using the rate input by the college manager at the time the asset was added to the register.

Queries to the Readers

i) Identify five internal control strengths in the above case on which the auditor can place reliance.

ii) What tests of control should be designed to evaluate the effectiveness of each of the controls identified.

∞ Adapted from the case study published in Modern Auditing, Graham W Cosserat, (second edition), John Wiley & Sons, pg. 252.

CASE STUDY – 10
M/s. Fluffy Fresh & Co.

Auditing in an IT Driven Environment[∋]

Fluffy Fresh & Co. is a one-location bakery whose focus is specialty cookies with unique flavorings and ingredients for holidays and special occasions. The bakery only ships cookies that have been baked within the last 24 hours. In 2005, approximately 75% of the market for the Company's product was local and 25% national. The owner, Ms. Baker, noted that local market demand was relatively stable, and she expected demand from the national market to increase exponentially. Her goal for 2006 was to increase national market share. The company's order entry system consists of national and local customers placing order using the bakery's toll-free or local number and providing credit card, address, and other relevant order information. To ensure accuracy, the operator repeats the order to the customer, who has the option of receiving a fax confirmation. Orders are sequentially numbered and entered into personal computers by 12 data-entry operators. The personal computers are connected to a local area network (LAN).

After an order is entered, the computer system generates a production request for the 15 bakers working in three shifts and a mailing label. Four packers per shift pick and package the appropriate cookies and place mailing labels on decorative boxes, which are shipped by carriers that guarantee a maximum three-day delivery. The company accepts order 24 hours a day, seven days a week. Each mailing label contains a bar code that is scanned to update the outstanding orders file. Information on filled orders is automatically deleted from the system. For quality control, an inspector periodically compares the packed goods with the order. In 2005, Ms. Baker hired a consultant and developed an electronic storefront on the Internet. The website provides a catalogue of available cookie shapes, flavors, and styles and allows customers to place orders online as well as by telephone. The online customer completes an order form and provides the same information requested in a telephone order. The company sends the customer an e-mail confirmation when the order is filled that provides information on the expected delivery date. Orders received at the electronic storefront are captured on a file that is used as input to the existing order-entry system. Ms. Baker hired Mr. Shaw, a local college student majoring in information technology, to help develop the website.

By the end of 2006, national sales had increased beyond expectations and approximately 80% of all sales (national and local) were received *via* the Internet. The business experienced overall cost efficiencies, with no increase in the number of order-takers. Mr. Shaw was working four hours each weekday and was responsible for maintaining the LAN and all of the programming for processing customer orders, preparing production requests, printing mailing labels, and transmitting credit card charges to the company's bank. He also served as the weekend computer operator for nightly updating of files, printing reports and preparing backup. A LAN supervisor was also appointed who performed these duties during the week. Each weekend, Mr. Shaw would take the backup disk home with him so the company always had a current copy of its files off-site.

After some customer complaints about not receiving shipments, the packers started recording the number of shipments made during each shift on a summary sheet. The bookkeeper was responsible for comparing the number of shipments with the weekly sales summary report and investigating any differences. However, Mr. Shaw found that the bookkeeper frequently forgot to make the comparison, so he did it himself. Once Mr. Shaw completed his graduation, Ms. Baker hired him full time to write programs for an inventory control system and a system to automatically reconcile the credit card settlement report from the bank with the company's sales records. After these

[∋] Adapted from the CPA Journal, April 2000, AICPA.

projects were done, the owner had him develop programs to order supplies automatically by sending electronic data interchange records to the three baking ingredients suppliers and the decorative box supplier.

Ms. Baker believed that, due to the implementation of the electronic storefront and the increasing international exposure provided by the company's website, sales would increase significantly in the ensuring years. She wanted to construct new and larger production facilities to accommodate the expected demand. Ms. Baker contacted a local community bank that agreed to fund the expansion if the company could provide audited financial statements. She engaged M/s. KJ & Associates, a firm which had been performing tax services for the company for several years, to conduct an audit. The audit manager assigned the task noted that Fluffy Fresh & Co. sales system had evolved into one in which significant information was transmitted, processed, maintained, and accessed electronically.

Queries to the Readers

In this situation, what audit planning should be done and how the internal control environment should be evaluated for assessing risks arising due to IT driven environment?

CASE STUDY – 11

M/s. Excel Electronics Technologies Ltd.

Inflated Inventories⊕

Excel Electronics Technologies Ltd. (EET) is operating 25 electronics outlets in different parts in India. The company has reported significant increase in sales and overall profit earnings since it became public limited company in 2002. The company raised Rs. 50 crores through its first public issue which was oversubscribed about 60 times. According to Bhaskaran, the company's founder and chairman and one of the principal shareholders, EET's success may be attributed to rapid expansion of its retail showrooms combines with media blitz through sponsoring tele-serials. Bhaskaran always pointed out this fact with pride that though the EET has been operating in high tech area faced with a strong threat of product obsolescence and severe competition but it faced these challenges very boldly by entering into tie-ups with leaders in the electronics field and marketing the latest technology. EET reported consistent performance during last five years and earned profits of Rs. 10-12 crores every year. The share price also touched an high of Rs. 450 last year which plummeted back to Rs. 225 during the current year. In a takeover bid, Sloans Instruments International Inc. successfully took charge of EET. Shortly thereafter, in early 2007, the new management discovered that prior financial statements were incorrect and perhaps fraudulent.

In conducting fresh audit of EET, Pixley & Co., Chartered Accountants, discovered that instead of Rs. 12 crores profit during 2006-07 the company had actually incurred a loss of Rs. 15 crores during the same period. The auditors noted that the loss included certain items which should have been charged to prior years but it could not be reasonably ascertained the years to which specific charges could have been applied. The audit also revealed that inventories were inflated by Rs. 12 crore and sundry creditors were understand by approximately Rs. 2 crores.

The value of inventories was overstated by fabricating inventory stock sheets for non-existent inventory. This was done by (1) including goods in inventories which had already been recorded as purchase returns and were awaiting dispatch to vendors; and (2) by including unrecorded inventories in stores prior to physical inventory counts and auditor's observation of such counts. Thus, in fact the purchases had not been recorded but the goods were included in the closing stock. Sales were also inflated by including in a given outlet's sale those goods that were dispatched to other outlets. Even the manner of valuation of inventories was also a contributing factor on account of variation in selling prices at different points of time in the year as also substantial difference between export selling prices and domestic selling prices.

A study of internal control procedures in this area reveled that, as a matter of general policy, all the outlets located in different regions were dispatched goods from a central warehouse but, in exceptional cases, goods could be dispatched from an outlet having surplus stocks to an outlet in the same region. Sales at different outlets are made for payment by cash, by cheque or on hire-purchase term. Receipts are banked by Branch Manager of each outlet. A weekly statement is prepared by Branch Manager showing sales by cash and cheque and against hire-purchase including installments received and payments made for wages, etc. The procedure also envisages stock-taking by personnel from head-office on a yearly basis and reconciliation with the data held at the head-office. Seasonal discounts are offered by all outlets as per the uniform policy laid down by the head–office. The valuation of stocks at outlets is done at current selling prices but at the head-office level, it is reduced by normal profit margin. EET is also required to meet an export obligation to the extent of 25% of its production during the year.

⊕ Adapted from Case Study contributed by Mr. Vijay Kapur published in The Chartered Accountant, January 1998, page 64.

A detailed report submitted by the auditors to the management also noted that the sales growth at new outlets was a key success indicator emphasized during public issue.

Queries to the Readers

i) What were the specific weaknesses is the internal control procedures to be overcome to improve the procedure?

ii) Whether the method of valuation of stocks is proper, particularly in view of the fact that prices of certain electronic items varied greatly from month to month?

iii) What procedures might the auditors have applied that would have enabled them to detect the fraud?

iv) What should be auditor's responsibility for detecting the EET's fraud?

CASE STUDY – 12
M/s Heritage Export Ltd.

Detecting Fraud[γ]

A late evening news item on a TV network reported that the Central Bureau of Investigation (CBI) had unearthed a rich haul of selected art works of renowned artists. This caused great anxiety to Navroz, a Chartered Accountant and Senior Partner in M&N Associates. According to the show, some of the biggest international art dealers in India, acting in close connivance with a gang of smugglers, had been smuggling original artworks abroad. The next morning, the newspapers carried elaborate details of art dealers conspiring with smugglers. A list of such artworks, some of them going back to the 19th Century, which had been smuggled out of the country, was also given. The report also made it clear that there was a possibility that the original paintings missing from the stocks of these dealers might have been substituted by forgeries. Navroz felt even more disturbed on learning this, since his firm's list of clients included a good number of art dealers and antique exporters. In particular, Heritage Export Ltd. (HEL) is a fairly big international art dealer of repute, which specialised in impressionistic paintings.

As soon as Navroz reached his office, he noticed that the atmosphere was rather tense. Natasha, his private secretary, informed him that Sudhakaran has been anxiously waiting to see him for the last one hour. Sudhakaran is a qualified chartered accountant who had been working with M&N Associate for about five years and had developed an expertise in conducting the audit of art dealers and exporters apart from rendering investment advice to clients in procuring antique items and paintings. He closely followed the trends in the international market for such items, and was a frequent visitor to art exhibitions and auctions. He also subscribed to catalogues and specialist art magazines. Sudhakaran had been the principal audit supervisor of the annual audit of HEL for the last two years.

Sudhakaran informed Navroz that early in the morning, he received information that Paul Christopher, managing director, HEL, has been questioned by the CBI in connection with the smuggling. After going through the various press reports, it seemed probable that some of the classic works belonging to HEL had been missing for quite some time. But a perusal of audit files for the previous year showed that they were still in the possession of HEL and had been so shown in the financial statements. The situations seemed to be quite serious. In case the value of stocks reflected in HEL's financial statements was not backed by original paintings in their possession, the continuance of HEL as a going concern would be in doubt. Navroz told Sudhakaran to go to HEL's corporate office and acquire a complete schedule of paintings, giving all details including title of the works, artist's name, period, location, distinctive features, cost, value and other sundry information. Any representations made by the management in the past should also be scrutinised carefully once again. Sudhakaran left for HEL's office accompanied by two assistants.

Two days later, Sudhakaran reported to Navroz that the total stock of impressionistic paintings would have been valued at Rs. 60 crore. The total turnover of HEL for the current year was around Rs. 150 crore. During the previous accounting years, the value of the paintings had been included in the financial statements on the basis of a certificate given by the management. In addition, the assessment of value was certified by Murtaza Ali, an eminent artist and consultant to HEL. Despite persistent enquiries expressing grave doubt about the originality of such paintings, the HEL management maintained that all paintings in their possession were the originals and the same had also been certified by a highly–respected person in the world of art. After discussing the matter at some length, Navroz decided that it would be appropriate to commission an independent specialist to determine the authenticity of the paintings. Accordingly, it was decided to approach Wilson & Christ (W&C), a firm of international fame, to take up this special assignment. Navroz got in touch with Christopher to work out the details of scope of work and consultancy fees. But to his surprise, there was lot of resistance to the appointment of W&C. Christopher argued incessantly that the

[γ] Adapted from Case Study contributed by Mr. Vijay Kapur published in The Chartered Accountant, February 1998, pages 30-31.

situation was not alarming, since this aspect has been verified and certified by renowned experts in the field, and moreover, the fees of W&C were likely to be very high. Despite this, Navroz decided to go ahead with the appointment of W&C on his own. W&C informed M&N Associates that their charges would be worked out on the basis of a percentage of the value of the stocks and audit fees, subject to the fact that the total fees would not be less than 50 per cent of audit fees. Traveling expenses would be charged on an actual basis.

W&C were informed about their scope of work and the fact that their findings would have significant support for verification and valuation of paintings being shown in the financial statements. The report of W&C revealed that it was almost certain that Rs. 10 crore worth of stock was definitely authentic, about Rs. 15 crore worth of stock was definitely forged, and there was considerable doubt about the remaining stock. In their report, W&C explained the objective and scope of their work. A complete description of material and assumptions used in arriving at such conclusions were also given. They also clarified that on certain stocks it was difficulty for them to comment since they could not physically verify them.

W&C's report was quite disturbing. Both Navroz and Sudhakaran debated the issue at length but could not reach a consensus on how to deal with the situation.

Queries to the Readers

i) Should M&N Associates accept at face value the report issued by Wilson & Christ?

ii) Whether M&N Associates should refer to Wilson & Christ's report in their audit report?

iii) What course of action should be taken with regard to the nature of the doubts which had been expressed by Wilson & Christ?

iv) Whether another specialist be appointed or what further additional procedures should be performed by M&N Associates under the circumstances?

v) Who should bear the consultancy fees charges by W&C and in what proportion? In case HEL refuses to pay, would sharing a part of audit fees with W&C be in order?

CASE STUDY – 13
Konark Pvt. Ltd.

The Expectation Gap[√]

It was a fine morning when S.K. Parnami, managing director of Konark Pvt. Ltd. met Arun Dale, senior partner of his company's auditors Dale & Associates (DA), at the Royal Golf Club. As conversation picked up, Parnami told Dale about his plans to expand Konark's ceramic and melamine potteries business, and about the way he would raise money for that. He would raise a term loan from a financial institution and negotiate with his bankers for renewal of overdraft facilities. But while all this was fine, what worried Parnami was the fall in net profits for the current year over the previous year, despite both turnover and gross profits increasing considerably.

Parnami, while expressing his general displeasure over the state of affairs in his company, said that, in his view, appointment of "independent auditors" during the last three years would have solved much of his problems. That would have ensured the company's resources were utilised efficiently, and no manipulation or misappropriations were possible in the management of financial affairs. In Parnami's opinion, one of the primary tasks of auditors was to ensure minimisation of tax liability, but in Konark's case, its tax liability had gone up over the period. Parnami also felt that the audit fees were quite high and disproportionate to the benefits derived from having the financial statements audited. Further, he said the auditors had not even bothered to look at the stocks in the 10 depots of the company.

A little astonished, Dale explained to Parnami the objectives of audit and the professional responsibilities of auditors. He also emphasised that it was the responsibility of the management to prevent and detect frauds and errors by maintaining an adequate and efficient system of internal control in the company. However, before leaving, Dale told Parnami that he would like to make a presentation to him on auditor's duties and responsibilities sometime the following week.

Later in the afternoon, Dale reached his office and began skimming the papers on Konark. He noted that Konark was initially established as a partnership firm about 10 years back. It was incorporated as a private limited company after about seven years, and since then DA had been its auditors. Konark, with two manufacturing units as Mirzapur and Bulandshahar in Uttar Pradesh, had a workforce of 225. While physical distribution of finished products was handled by 10 retain depots mainly in the northern and central areas of the country, each of the depots was headed by a storekeeper–cum–accountant. On an average, 80 or 90 daily-wage workers were employed at the manufacturing locations, while contract labour was engaged at the depots.

Since conversion to a company, Konark's turnover had gone up from an initial Rs. 1.5 crore to about Rs. 6 crore in 1996-97. Its net profits had also risen consistently throughout (from Rs. 20 lakh to Rs. 1 crore) until the previous year. In 1996-97, however, the net profits fell, while sundry debtors went up considerably. Looking at the papers, Dale did feel that there was something amiss somewhere. He summoned K. Sundreshan, partner-in-charge of the audit, to understand first-hand the affairs of Konark. During the course of discussion, Sundreshan made the following submission:

- While Konark's major shareholder was S.K. Parnami, the company was controlled mainly by R.K. Singh, chief accountant, who was married to Parnami's eldest daughter.
- During preliminary audit, Konark's internal control was found to be very weak in respect of salaries at both the manufacturing units, but no major errors had been detected.

√ Adapted from Case Study contributed by Mr. Vijay Kapur published in The Chartered Accountant, October 1997, pages 30-31.

- Sale of wood from plantations in the periphery of certain deports was booked through petty cash.
- No proper explanation was given for certain expenses booked as entertainment expenses. While no proper receipts were available, Singh had said the auditors should not bother about the entertainment expenses since Konark was a private limited company, and it was, more or less, a family affair.
- No reconciliation had ever been done with reference to the total quantity of items manufactured, items sold, and stock-in-hand. The explanation given was that reconciliation was not possible since there were too many items with different colours and designs. Moreover, it was not possible to count and value the stocks at the end of the year since staff was limited.
- One of the audit clerks had overheard a customer telling the accountant that he had already made the payment in cash to Singh. It was suspected that Singh had not deposited the amount subsequently.

After considering Sundreshan's submission, Dale felt some frauds may have been perpetrated by a few officials at Konark in collusion with the accountant. This would have ultimately led to the fall in net profits. Subsequently, as he had promised, Dale made a presentation to Parnami on the roles and responsibilities of auditors and those of the management. He also indicated the possible impact of Sundreshan's revelations on the accounts of the company.

At the end of the presentation, Parnami simply nodded his head, almost in disbelief. Apparently, he was still not quite convinced about the whole affair.

Queries to the Readers

i) What are the role and responsibility of the auditors in detecting frauds and errors, and the contribution of audit to the efficient management of the business affairs of a company?

CASE STUDY – 14
Gamma Surgical Equipment

Planning the Audit⇔

Gamma Surgical Equipment (GSE), a New Delhi-based company, is a distributor of surgical equipment. It is the principal distributor for British Laboratories in the northern region where it has a market–share of 30 per cent. For the accounting year 2006-07, the annual sales of GSE were about Rs. 20 crore, and its net income Rs. 1.80 crore. GSE's income figure also included a substantial income of about Rs. 50 lakh from investments, both long-term as well as current. R. Krish and Co., Chartered Accountants, have been auditing the financial statements of GSE for the past three years. As a matter of policy, the firm has a well-established practice of rotating the partner-in-charge of audit every three years so that the quality of audit is maintained. Pursuant to this policy, V.S. Narayan, CA. a partner of the firm was given the charge of GSE audit for the current accounting period for the first time. While going through the previous year's audit working papers. Narayan noted that the overall performance of GSE had been quite impressive and its markets share had gone up steadily over a period of time.

A close review of the organization chart showed that marketing was the dominant activity of the company, and a major part of the workforce comprised sales personnel in all, there are eight sales executives representing different territories in the region headed by a sales manager who are responsible not only for booking orders and ensuring delivery of goods to hospitals in far-flung villages and remote areas, but also for follow-up of incollectible amount. As against this, Narayan felt that a host of functions were being performed by a single individual and, practically, there was no adequate segregation of duties as far as staff functions were concerned. There was also no separate dispatch department, and the mail including cheques was distributed directly to the officer to whom it was addressed.

The following day, Narayan reached GSE's corporate office to commence the audit for the year. Since debtors constituted a significant aspect of the business. Narayan decided to concentrate on the sales cycle. He observed that there were three persons working in the accounts section whose duties had been allocated. S.K. Pai, accounts officer and overall in-charge of the accounts section, dealt with sales from the receipt of orders to the collection and recording of cash from debtors. Sonam, accounts executive, dealt with all purchases and expected payments including entries in the cashbook. Prachi, accounts clerk, maintained the petty cashbook and dealt with preparation and payment of wages. The preliminary review revealed that the total debtors outstanding at the end of the year as per the ageing schedule were as follows:

i)	Outstanding debts for over six months:	
	Considered good	Rs. 6 crore
	Considered doubtful	Rs. 2 lakh
ii)	Other debts considered good (Outstanding for less than six months)	Rs. 17 crore

Narayan was perplexed as to how the debtors considered good could exceed the annual turnover by about Rs. 3 crore. He wondered that even if sales of the last six months were counted on an average basis, the excess of debtors over sales would be about Rs. 8 crore. As per analysis of the past trends in debtors expressed as percentage of total sales, no cyclical fluctuations were noticeable and GSE did not belong to the category of a seasonal industry.

Further, while reviewing investment operations, Narayan noted that R.V. Manan had been working as manager (investments) for the last five years. The company had authorized Manan to open accounts with various brokers in

⇔ Adapted from Case Study contributed by Mr. Vijay Kapur published in The Chartered Accountant, December 1997, pages 26-27.

his own name. To provide maximum flexibility, all purchases and sales investments were authorised by Manan. Broker's advices and other correspondence from brokers, including cheques for sale proceeds, were directly mailed to Manan. The cheques were drawn in fabour of R.V. Manan C/o GSE A/c. The investment ledger was maintained by Manan but the general ledger was maintained by Pai.

Narayan noted, to his dismay, that the procedure offered considerable scope for defalcation of sums received from brokers, particularly in view of the fact that cheques were received directly by Manan. It was quite likely that he might not have passed on broker's advices to Pai for recording in the general ledger. During his two day stay at GSE, Narayan felt that both Manan and Pai had been maintaining quite a luxurious lifestyle that did not quite match their monthly salary and perks. He was stunned to learn that both had been planning their next vacation abroad and planned to spend about Rs. 5 lakh. Narayan brought all these facts to the notice of the managing director (MD). However, there was lukewarm response from the MD since he felt that given the number of persons working in the accounts section, he was able to supervise the activities more closely.

With regard to the above, Narayan concluded that the internal control system was quite weak and, thus, called for detailed substantive audit procedures and periodic surprise checks. He was, however, unable to lay down a concrete plan of action on certain issues regarding the course of action to the followed under the circumstances.

Queries to the Readers

i) Whether to inform the board of directors about the weaknesses in the internal control system on an immediate basis.

ii) How the division of duties should be restructured, given the number of employees working in the company, with regard to cost-benefit analysis, and whether the same should be carried out by the auditors themselves.

iii) The type of substantive audit procedures that should be performed to assess that sundry debtors and investments are reflected properly in all respects.

iv) Whether auditors can be held liable for not detecting defalcation, if any, perpetuated and concealed by the top management.

CASE STUDY – 15
ABC Limited

Relying Upon the Work of an Internal Auditor

ABC Limited, a listed company with a turnover of over Rs. 100 crore. It is mainly involved in manufacture / trading of office automation products. The manufacturing facility and corporate office are based in the same location. It has sales / branch offices across the country. The company has an internal audit department comprising of three personnel including the IA head who is professionally qualified and has a number of years experience in the industry / company. The other members of the team are graduates with a number of years in the company. The IA head reports independently to the Managing Director and is also present in the audit committees.

The company is facing high blockage of funds in current assets mainly certain category of stock, certain debtors and certain loans and advances (to group companies).

The above balances from the statutory auditors' perspective are high risk and involve judgement regarding reliability, analysis of contractual terms etc. The company may have high exposure in them in terms of sticky balances which may be overstated.

The internal auditor's have covered the following areas as part of their annual audit programme-cash and bank balances, payroll, purchase-payable cycle. However it is seen that the specific balances which are considered risky by the statutory auditors have not been covered by the internal audit team although they are material also from the company's perspective.

In view of the above what implications are there in the statutory auditor's scope of reliance of the internal audit work, evaluation of internal audit work. What implications are there in CARO reporting?

Source: Anonymous

CASE STUDY – 16

Going Concern Audit Report

You are the manager responsible for performing hot reviews on audit files where there is a potential disagreement between your firm and the client regarding a material issue. You are reviewing the going concern section of the audit file of Sunshine Ltd, a client with considerable cash flow difficulties, and other, less significant operational indicators of going concern problems. The working papers indicate that Sunshine Ltd is currently trying to raise finance to fund operating cash flows, and state that if the finance is not received, there is significant doubt over the going concern status of the company. The working papers conclude that the going concern assumption is appropriate, but it is recommended that the financial statements should contain a note explaining the cash flow problems faced by the company, along with a description of the finance being sought, and an evaluation of the going concern status of the company. The directors do not wish to include the note in the financial statements.

Identify and discuss the implications for the audit report if:

(i) the directors refuse to give the disclosure note.

(ii) the directors agree to give the disclosure note.

Suggested Response

i) The Directors refuse to give the disclosure note:

The audit report should contain a qualified or an adverse opinion due to the disagreement. The auditors need to make a decision as to the significance of the non-disclosure of the uncertainty surrounding going concern assumption. If it is decided that without the note the financial statements are not fairly presented, and could be considered misleading, an adverse opinion should be expressed.

ii) The Directors agree to give the disclosure note:

If the directors agree to give the disclosure note, it should be reviewed by the auditors to ensure that it is sufficiently detailed. In evaluating the adequacy of the disclosure in the note, the auditor should consider whether the disclosure explicitly draws the reader's attention to the possibility that the entity may not be able to continue as a going concern in the foreseeable future. The note should include a description of conditions giving rise to significant doubt, and the directors' plans to deal with the conditions. If the disclosure is considered adequate, then the opinion should not be qualified. The auditors should, however, consider adding an emphasis of matter paragraph to highlight the existence of the material uncertainties, and to draw attention to the note to the financial statements. The emphasis of matter paragraph should firstly contain a brief description of the uncertainties, and also refer explicitly to the note to the financial statements where the situation has been fully described. The emphasis of matter paragraph should re-iterate that the audit opinion is not qualified. However, it could be the case that a note has been given in the financial statements, but that the details are inadequate and do not fully explain the significant uncertainties affecting the going concern status of the company. In this situation the auditors should express a qualified opinion. The auditor, however, may also consider expressing an adverse opinion, if it is warranted under the circumstances based on the Auditor's professional judgment.

Source: Implementation Guide to Standard on Auditing (SA) 570, Going Concern.

CASE STUDY – 17

Going Concern Audit Report

XYZ Inc. is a manufacturer of televisions. The domestic market for electronic goods is currently not doing well, and therefore many entities in this business are switching to exports. As per the audited financial statements for the year ended March 31, 20XX, the entity had net losses of Rs.120 million. At March 31, 20XX, its current assets aggregate to Rs.1,200 million and the current liabilities aggregate to Rs.1,500 million. Due to expected favorable change in the government policies for the electronic industry, the entity is projecting profits in the coming years. Furthermore, the shareholders of the entity have arranged alternative additional sources of finance for its expansion plans and to support its working capital needs in the next 12 months.

Required:

Should XYZ Inc. prepare its financial statements under the going concern assumption?

Suggested Solution

In this case, the two factors that raise doubts about the entity's ability to continue as a going concern are:

- The net loss for the year amounting to Rs.120 million.
- The working capital deficiency (current liability of Rs.1,500 million Less: current assets of Rs.1,200 million) of Rs.300 million existing at the balance sheet date.

However, there are two mitigating factors:

- The arrangements made by the shareholders to fund the entity's expansion and working capital needs; and
- Projected future profitability due to expected favourable changes in government policies for the industry the entity is operating in.

Based on these sets of factors, it may be possible for the management of the entity to argue that the going concern assumption is appropriate and that any other basis of presentation of financial statements would be unreasonable at the moment. However, if matters deteriorate further instead of improving, then in the future another detailed assessment would be needed to ascertain whether the going concern assumption is still valid and accordingly suitable disclosure may be made in the financial statements and the same shall be considered by the auditor *vis a vis* need to give Emphasis of Matter Paragraph or Qualified or Adverse Opinion, as the case may be.

Source: Implementation Guide to Standard on Auditing (SA) 570, Going Concern.

CASE STUDY - 18

Determination of Provision (Form and Content of Documentation)

The client is a software company. During the audit of the accounts for the year ended 31st March 2012, a difference of opinion pertaining to provision for doubtful debts arose. The client had provided Rs. 10 lakhs as provision for doubtful receivables. He is of the opinion that this is sufficient as most of the receivables are from group companies. The auditor challenged this because as per his estimate, it should have been at least Rs. 60 lakhs. After many meetings and arguments, both parties agreed that a provision of Rs. 40 lakhs was appropriate. The audit working papers do not have any record of how the provision was determined. The auditor says that once he was satisfied about the adequacy of provision, he is not required to keep any record on his file.

Is the opinion right?

Analysis and conclusion

As per Para 8 of SA 230, the auditor should prepare audit documentation regarding "Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions."

All significant matters arising during the course of the audit need to be documented. Specifically, those pertaining to provisions and estimates where professional judgment is necessary to arrive at a conclusion, should be documented. Some examples of such situations are provision for doubtful debts, useful life of unique technical assets, provision for warranty, etc.

Hence, in the above situation, the auditor and the client have discussed and argued, considering various scenarios, before arriving at a conclusion on the provision for doubtful debts. Issues debated and discussed at the meetings should be documented. The auditor should also have sufficient evidence to support his conclusion which may include breakup of the doubtful debts, subsequent realization, past history of repayments, etc.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY - 19

Documentation of Wage Settlement (Oral Communication)

The client has entered into a retrospective wage settlement agreement during the current financial year. The related wage arrears amount to Rs. 100 crores which is above the relevant materiality levels. Necessary adjustments were made in the books of accounts. Consequently, provision for gratuity has also increased significantly. The same has been provided in the books of accounts.

The auditor is of the opinion that, since all the facts of the case, the subsequent decisions and the adjustment in the books have already been orally communicated to those charged with governance; the same need not be documented.

Is this opinion correct?

Analysis and conclusion

As per Para 10 of SA 230, "The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place."

Judging the significance of a matter requires an objective analysis of the facts and circumstances.

Going by the facts, the case in question is an exceptional item which is to be considered as a significant matter. Hence, though the management/those charged with governance is/are already aware of the issue and its resolution by way of oral discussions, the same will need to be documented. Generally the same may be communicated through the audit committee/ Board Meeting presentation.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY - 20

Cross Referencing Risk and Audit Program

The audit team, after due discussions, identified and documented the significant risks pertaining to the organization. The team also had a pre-determined standard audit program for every area of balance sheet and profit and loss.

The audit procedures were performed as per the audit program and the same was documented.

However, risk and the program were not cross referenced. The team is of the opinion that the same need not be done.

Analysis and Conclusion

As per SA 315,"Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", an auditor needs to discuss amongst the team members, understand the entity and its environments, assess the significant risks of the organization and understand the relevant controls in the entity to mitigate such risks. Risks are identified at the financial statement and the assertion level.

As per para 29 of SA 330, "The Auditor's Responses to Assessed Risks", the Overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed and the linkage of those procedures with the assessed risks at the assertion level should be documented.

In the given case, the audit team has identified the risks and the procedures. However, the procedures have not been linked with the assessed risks. Hence, the documentation is not complete.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY – 21

Documentation of Responses to Assertions

Every account balance in the books of accounts needs to be audited based on certain assertions. These include completeness, accuracy, valuation, etc.

The auditor was auditing the accounts of a hotel. Revenue comprising primarily of room revenue and revenue from food and beverages is an assumed risk. While determining the assertions of revenue, the most important assertion identified was “completeness”. Checks pertaining to cut off, etc was done to verify the same. However, the same was not explicitly documented.

Analysis and Conclusion

As per SA 330: The Auditor’s Responses to Assessed Risks, the following need to be documented:

- The results of the audit procedures, including the conclusions where these are not otherwise clear.
- The form and extent of audit documentation is a matter of professional judgment, and is influenced by:
  - nature, size and complexity of the entity and its internal control,
  - availability of information, and
  - audit methodology and technology used in the audit.

In the given case, though the risks have been assessed and assertions identified, documentation is not complete if the audit checks in response to assessed risks and conclusion thereof have not been documented.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY - 22

Revisions of Work Papers

The audit team, during the finalization of the audit of a client in the hotel industry, had several revisions in the financial statements. Consequently, the related working papers also underwent numerous changes.

The audit manager is of the opinion that the old papers can be destroyed wherever there were revisions and it is enough to preserve the final version. However, the audit team is of the opinion that all revisions need to be filed for traceability.

Which opinion is right?

Analysis and Conclusion

As per Para A22 of SA 230, “The completion of the assembly of the final audit file after the date of the auditor’s report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if they are administrative in nature. Examples of such changes include: Deleting or discarding superseded documentation.”

Hence, old papers which have been revised may be deleted or discarded.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY - 23

Audit of Inventory (Comprehensiveness and Relevance)

During the audit of inventory of a manufacturing company, a working paper had the following details pertaining to finished stock:

Item	Quantity	Rate (Rs.)	Value (Rs.)
A	36,042.80	42.51	15,32,179
B	3,250.00	165.22	5,36,965
C	1,176.50	146.99	1,72,938
D	82.00	2,482.19	2,03,540
E	64.00	1,740.52	1,11,393

As a reviewer identify the missing details.

Analysis and Conclusion:

As per Para 9(a), "In documenting the nature, timing and extent of audit procedures performed, the auditor shall record the identifying characteristics of the specific items or matters tested."

The auditor is expected to record all such information which enables an "experienced auditor" to understand the work done and conclusions reached without the help of the engagement team.

As per Para 6(c), an experienced auditor is "An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:

i. Audit processes;

ii. SAs and applicable legal and regulatory requirements;

iii. The business environment in which the entity operates; and

iv. Auditing and financial reporting issues relevant to the entity's industry.

Keeping in mind the above, the following essential details are missing in the working paper:

- Unit of Measurement
- Previous year comparative figures
- NRV *vs* Cost comparison not detailed
- Cost formulae – Current year Vs Previous year
- Excluded costs
- Absorption of fixed overheads
- Quantity reconciliation
- Reference to physical verification paper

The working paper can be called complete only when the above details are incorporated.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY - 24

Assembly of Final File

The audit team completed the field work and finalization of the audit. Financials and audit report were signed on 10th July 2012. Due to statutory and tax audit pressure, the team was reallocated to another assignment before closure of the audit file. The team attended to the closure of the file after the tax audit season, i.e. 30th September 2012.

Is this in compliance with the requirements of the standard?

Analysis and Conclusion

As per Para 14 of SA 230, "The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report."

Para 74 of SQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files. Para 75 of SQC 1 says "An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report."

Hence, the file needs to be completed by 10th September 2012.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY - 25

The Devil Called "Microsoft Excel" (Form and Content of Documentation)

Working for 2 hours to make a 33MB excel file to a mail friendly size of 886 KB and ensuring that relevant information is not compromised, the auditor was thoroughly dejected trying to fix the problem, without knowing where the problem was.

The auditor was reviewing a report, where significant issues were documented in a word document and related annexures in a spreadsheet. The size of the annexure was 33MB for just 68 sheets. Teams had taken screen shots of ERP sample pages to explain a point (Very good from evidence perspective but not from file size management point of view).

Where is the real problem here?

Analysis and Conclusion

After working out permutations and combinations, the problem was successfully identified!

i. Complete dump of transactions for a period as taken from the ERP was pasted in the spreadsheet with few annexures running to 10000 lines!

ii. On the annexures, filters were applied to explain the problems. However, the complete data was sitting in the annexure without relevance. E.g. The observation reported delay in collection over 5 days from due date and the annexure contained the complete debtors ledger dump with at least 30 columns (many of those columns may not be relevant in context) with appropriate filters applied!

Solution -

i. Remove unwanted columns, unwanted rows.

ii. Reduce the image sizes when you copy screen shots into a file.

Documentation in soft copy is good provided a proper trade off is made between Required details and file size.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY - 26

Preference Share Holders Redemption (Documentation)

Preference shares issued by A Ltd. in October xx05 are due for redemption on xx10. Preference shares have not been redeemed on due date and negotiations between the parties have not concluded as on audit report date.

The auditor has made a comment on Preference share redemption in Audit report without qualifying audit opinion but has not documented the same in the working papers. Is this correct?

Analysis and Conclusion

Preference share redemption is a significant event that will have an impact on cash flows of the company and has been included in "emphasis of matter" paragraph in the audit report. As per para A8 of SA 230, auditor has to document such matters (information on negotiation between preference shareholders and the company) in the working papers.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY - 27

Change in Risk Assessment and Audit Procedures

A Ltd. Auditors had not considered “Fixed assets” as significant risk area at the Planning stage. During FY 2012, A Ltd. had written off fixed assets with WDV of Rs.10 lacs as these assets could not be traced by management. On further inquiry, auditors identified that fixed assets register was not properly updated and critical information such as quantity and serial numbers were not available in fixed asset register. Auditors revised their audit approach and considered “Fixed assets” as significant risk area and modified their audit procedures pertaining to fixed assets verification.

Should auditors document the reason for considering fixed assets as “significant risk” in working papers and the reason for change in audit procedures in working papers?

Analysis and Conclusion

As per para A8 of SA 230, where risk assessment is revised and audit procedures are modified, then such changes need to be considered as a significant matter and documented in audit working papers. As a result, the reasons for considering Fixed assets as significant risk and all observations and procedures pertaining to fixed assets needs to be documented in the working papers.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY - 28

Acceptance of Salary Escalation Assumption

Management of A Ltd. expects future salary escalation to be about 8% for purpose of computing gratuity liability and leave encashment liability as per actuarial valuation, whereas weighted average salary increase for FY 2012 was about 16% and 17% for FY 2011. Auditors questioned the management on reasonableness of the salary escalation assumption used for computation of the liability.

Management expects the salary escalation to be less compared to previous years as salary level of all employees are in line with market. Management further provided salary increment expected to be given for all employees on payroll as on balance sheet date. Weighted average salary increase computed based on forecast data given by management is 8%.

Auditors accepted the 8% salary escalation rate but did not document the data and explanation given by the management in working papers. Is this correct?

Analysis and Conclusion

Please refer para A9 in SA 230. As salary escalation rate is a significant matter that requires professional judgment, it is critical to document the reason for accepting 8% salary escalation rate in the working papers.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY – 29

Purposeful Documentation

A firm XYZ was carrying out a government audit. In a government audit, a supplementary report is required to be submitted to the CAG. On review of the report, it was found that for a query requiring the auditor's comments on legal cases, an ageing analysis of the cases had been performed.

Is the same sufficient documentation?

Analysis and Conclusion

Documentation must be purposeful.

In the above case, while the auditor had analysed the ageing of the legal cases, information such as the purpose of the case, the amount involved, etc. had not been highlighted and hence becomes insufficient.

Documentation must be done with a purpose and all data does not become information useful in audits.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY – 30

Contents of Documentation

While reviewing a work paper on "pre-paid expenses" an auditor noticed that the schedule prepared by the audit team gave the opening balance, debits to the account, credits to the account and closing balance.

Is the same sufficient documentation?

Analysis and Conclusion

Audit documentation highlights the audit performed by the team. The above documentation process would indicate that the team has taken a short cut to perform the audit.

A pre-paid expense schedule should clearly state, in respect of significant items:

1. Name of item;
2. Total amount paid,
3. Period to which it relates,
4. The pre-paid amount as on Balance Sheet date,
5. Period for which prepayment was done; and
6. The pre-paid amount on the same date of the previous year

Auditor should ensure that proper schedules are obtained from client so as to prepare sufficient work papers. Extracts from ledger by themselves are not adequate audit documentation.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY – 31

Documentation should be after a Lot of Thought and Application of Mind, and done Logically and Cogently:

On reviewing an audit report, an experienced auditor observed that godown rent cost had increased in the audit period and the reason stated for the same was "Increase in rates or increase in kgs stored".

Does the same constitute proper documentation?

Analysis and Conclusion

The use of the word "or" does not make the observation conclusive.

What the writer wanted to convey was probably that in some cases rent is paid on per kg basis and in some cases as fixed rent. Both have increased.

However use of the word 'or' makes it looks like a multiple choice question, requiring the reader/reviewer to take his pick.

Part explanation is not correct.

For example, let us say that there an increase in salaries on account of new recruitments and also decrease as some people have left. Auditor should ensure both aspects are covered in explanation. You can't just use a part explanation because that sufficiently explains the variation.

Do not leave something on 'materiality' ground if there is a genuine reason which needs to be explained. This happens when salaries of two departments are there (for both underlying agreement being same and the increase on a/c of the new agreement is 25%) and one (admin. dept) has 25% increase and another (sales dept.) 3% increase, you need to explain both variations as otherwise the real reason why it is 13% will not come out;

Explanations must be with figures and not just facts.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY- 32

Complete Work Papers

When doing an analytical review, the following was observed by an auditor:

Lease rent: The lease rent has reduced as no. of employees has reduced

Analysis and Conclusion

Audit documentation must be complete.

Work papers must be such that a qualified person with no previous knowledge of the reviewed company should be able to go through the file himself and review it.

In the above case, upon enquiry, it was understood that in a particular division computers were hired for all employees and as the no. of employees in that division had come down, the no. of computers hired had also come down.

However, the same was not properly highlighted through the work paper.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.

CASE STUDY – 33

Documentation in the Eyes of a Peer Reviewer

The following points were highlighted by a reviewer during the peer review of an audit firm and the auditor's responses to the same.

S.No.	Reviewer	Auditor
1.	Cut off reviews are not documented under revenue	No cut off is applicable in this company.
2.	Going concern – next year projections are not attached or documented	Projected sales are not provided to us.
3.	IT controls are not documented	Company uses Tally which has no controls
4.	Revenue not considered as key /significant/ fraud risk.(in a bank)	No income allocated to us in the Joint auditors' area /responsibilities.
5.	PAR not in file. (Preliminary analytical review)	PAR not relevant as no changes are made to financials during the audit.

Analysis and Conclusion

Documentation is an essential part of the audit. As per the SA on Audit documentation, an experienced auditor should be able to understand the work papers even without the engagement team being present. The above review points pertain to insufficient documentation and may be handled as follows:

1. **Cut off:** There is no company where cut off is not applicable for revenue. In a manufacturing company it could mean dispatches not billed in the right period; in a software company, this could mean revenue of current year postponed to next year or vice versa.

2. **Going concern:** Looking at next one year projections is essential. If the Company has no projections/budget etc the next year projections needs to be discussed at least orally with CFO, etc.

3. **IT controls:** Precautions taken if the software does not have controls, has to be documented. E.g. Serial no. control over vouchers, Reconciliation of MIS with company accounts, TB signed by CFO periodically, copy of Tally taken on CD, etc.

4. **Joint audit:** If key branches are audited, revenue is certainly covered and needs to be documented as a risk.

Preliminary analytical review: This is mandatory. In case there is no change in the figures, one can mention the same in the final analytical review.

Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation..

Technical Posers

Technical Poser – 1

The client had provided Rs. 10 lakhs as provision for doubtful receivables. The auditor challenged this because as per his estimate, it should have been at least Rs. 60 lakhs. After many meetings and arguments, both parties agreed that a provision of Rs. 40 lakhs was appropriate. The audit working papers do not have any record of how the provision was determined. The auditor says that once he was satisfied about the adequacy of provision, he is not required to keep any record on his file.

Is the auditor's argument valid?

Technical Poser – 2

When testing cash and bank balances, the cashier provided the auditor a bank confirmation of Rs. 2,50,00,000 on the official letterhead of the Bank. This was duly tallied with the bank statement and filed among the audit working papers. Next year it was discovered that both, the bank statement and the confirmation, were forged and the actual bank balance was only Rs. 1,50,000.

Is there any failure on the part of the auditor in carrying out the audit?

Technical Poser – 3

The statutory auditor of a nationalised bank held discussion with the internal auditor and obtained a program of internal audit coverage made during the year. Based on this, the statutory auditor decided not to include areas covered by internal audit in his own audit program, as he relied on the work of the internal auditor.

Is the statutory auditor justified in his action?

Technical Poser – 4

When asked for planning documentation for the audit of a listed company, the auditor produces two-page document called "Audit Plan". This contains a table giving the various account balances to be tested, the randomly selected months for which vouching is to be done, and some details of finalisation work like stock-take.

Would you consider document appropriate?

Technical Poser – 5

For determining the liability for gratuity, the client produces a report obtained from a reputed independent actuary. On examination of the assumptions made in the actuary's report, the auditor notices that the rate of return on gratuity trust investments assumed is 10%. The auditor knows that the current return on it is no more than 6%.

Can the auditor challenge the actuary's report?

Technical Poser – 6

Audit of a distillery is being done at the head office in Mumbai. The company has a sales outlet for army personnel on the Indo-Pak border in Kashmir. The auditor relied on the written representation of the company's management that stock worth Rs. 2 crores lying at the godown near Srinagar was physically verified by the local storekeeper, without performing any other audit procedures. It was later found that no such godown existed.

On what counts would the auditor be lacking in this case?

Technical Poser – 7

A number of material account receivable balances from certain related parties are outstanding for more than five years. The parties do not respond to balance confirmation requests. The management assures the auditor that all the parties are sound and the money will be recovered. Audited financial statements of one of the parties are shown to the auditor as proof of its solvency. Taking these financial statements on record as evidence, the auditor agrees that no provision for doubtful debts need be made.

Is the auditor's decision appropriate?

Technical Poser – 8

Provision was made in the books on account of translation loss in respect of a foreign subsidiary that was consolidated. Prior to signing the financial statements, the exchange rate became favourable. The management urged the auditor to reverse the charge to income in view of evidence of rate correction provided by the subsequent event.

Should the auditor agree?

Technical Poser - 9

Newspaper reports allege that the promoter-managing director of a company had committed an excise duty fraud in that company's subsidiary. The company's auditor checked excise duty workings of the holding company that he audited and concluded that no such fraud appeared to have been committed in the auditee company.

Were the auditor's procedures adequate?

Technical Poser – 10

Last year's auditor's report was qualified as regards short provision for receivables. This year, the provision is adequate. The auditor, therefore, dropped the qualification altogether from his current year's auditor's report.

Is the auditor justified in dropping the qualification from the current year's audit report?

Technical Poser - 11

A private limited company has a board of directors but no audit committee. The auditor, by and large, deals with the company's financial controller. All audit issues were discussed with the controller, the financial statements finalised, and the auditor's report issued.

Would this be a violation of Standards on Auditing?

Source- Auditing and Assurance Standards Board