CHAPTER 2

GENERAL AUDITING PRINCIPLES AND AUDITORS RESPONSIBILITIES



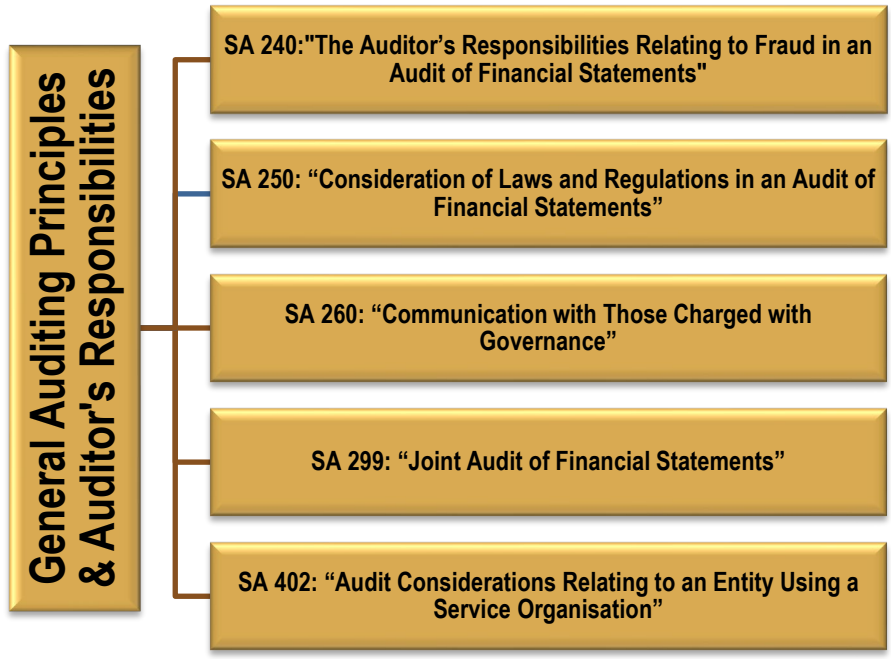
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand meaning of fraud and its characteristics, fraud risk factors with examples etc.
- Gain knowledge about SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".
- Gain knowledge about SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements".
- Learn about significance of communication with those charged with governance and gain knowledge about SA 260 "Communication with Those Charged with Governance".
- Gain knowledge about SA 299 "Joint Audit of Financial Statements".
- Gain knowledge about SA 402 "Audit Considerations Relating to an Entity Using a Service Organisation".

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CHAPTER OVERVIEW



CA. Bijoy is auditor of a listed company since last three years. Of late, the company is in news in financial circles for all the wrong reasons. There have been allegations of flouting of Securities Contracts (Regulation) Rules by clandestinely controlling more than required percentage of shares than mandated in rules. Besides, the said company has been accused of violating other provisions of securities laws.

There have also been allegations of manipulating share prices, of artificially keeping share prices high and failure to disclose all related party transactions. The company is a highly leveraged one. However, there has been no default and company has kept its commitments. SEBI is also seized of the matter on its own.

Ever since the above allegations were hurled through media, auditor of the company is in a fix. What do such allegations reflect? How he should proceed in audit of ensuing year? The regulatory report would take time and audit has to be completed within timelines. Audits of last two years were conducted in accordance with Standards on Auditing and no wrongdoings were noticed and unmodified opinion was expressed in audit reports. However, given the current scenario, there seemed to be a heightened level of audit risk. It would be foolish of him not to take notice of such developments.

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The allegations of violations of securities laws, manipulating share prices and failure to disclose all related party transactions could be fraud risk factors. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred. Hence, there are increased risks of material misstatement due to fraud. Due to assessment of increased risks of material misstatement due to fraud, audit procedures need to be designed and performed accordingly.

Besides above, suspected non-compliance with laws and regulations may have material effect on financial statements. It could involve hefty penalties and other issues. If management is not forthcoming in providing information relating to compliance with laws and regulations, does he need to obtain legal advice? Whether it would also lead to any impact on his opinion? Such questions were staring him in the face in current year of his tenure.

If he suspects fraud involving management, should he communicate these suspicions to audit committee and discuss with them nature, timing, and extent of audit procedures necessary to complete the audit?

1. GENERAL AUDITING PRINCIPLES AND AUDITOR'S RESPONSIBILITIES

SA 200 establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs. Audit has to be planned and performed with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. Misstatements can arise from errors or frauds. SA 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements. The auditor has to remain alert throughout the audit recognizing the possibility that material misstatement due to fraud could exist.

Entities are subject to various laws and regulations. Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity leading to material effect on financial statements. SA 250 deals with auditor's responsibilities in this regard while performing an audit of financial statements. Since many laws and regulations affect entities, auditor has to remain alert to the possibility of non-compliance with laws and regulations.

Communication with those charged with governance on a timely basis during audit serves many useful purposes and SA 260 deals with auditor's responsibilities in this regard. SA 299 details special consideration relating to responsibilities of auditors in a joint audit.

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It is very common for user entities these days to outsource activities from a third-party service organization. SA 402 dwells upon the user auditor's responsibility to obtain sufficient appropriate audit evidence in this respect.

2. SA 240 THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS

SA 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Its requirements assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

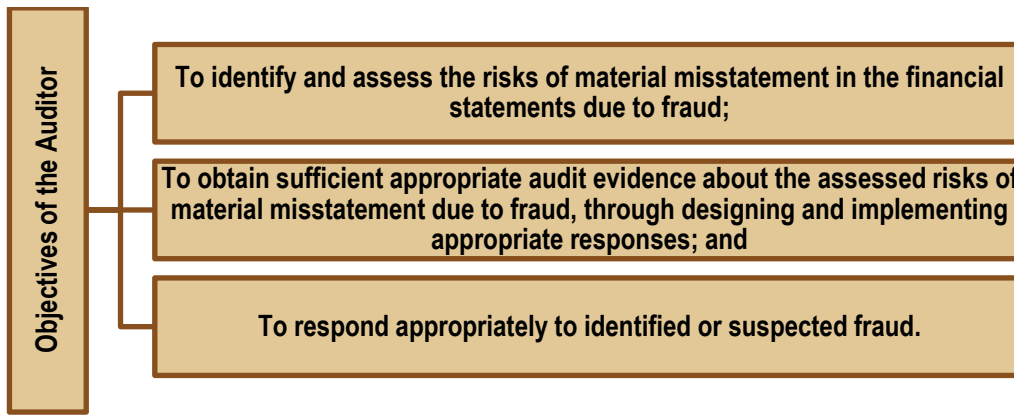
2.1 Objectives of the Auditor in accordance with SA 240

The objectives of the auditor in accordance with SA 240 are: -

(a) To identify and assess the risks of material misstatement in the financial statements due to fraud;

(b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

(c) To respond appropriately to identified or suspected fraud.



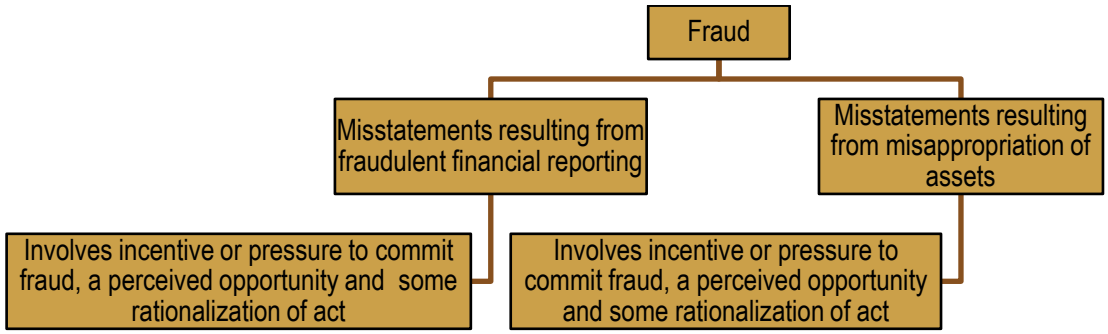
Meaning of Fraud and its Characteristics

Fraud is an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

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Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

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



Two types of intentional misstatements are relevant to the auditor: -

- **Misstatements resulting from fraudulent financial reporting**
- **Misstatements resulting from misappropriation of assets**

Fraud, whether due to misstatements resulting from fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. **For example: -**

Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant.	**Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.**	**A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.**	**Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.**

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2.2 How Fraudulent Financial Reporting may be caused by Entities?

Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.

Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

Fraudulent financial reporting may be accomplished by the following: -

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as: -
➢ Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
➢ Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
➢ Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
➢ Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
➢ Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
➢ Altering records and terms related to significant and unusual transactions.

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2.3 How Misappropriation of Assets may be accomplished by Entities?

Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect.

Misappropriation of assets can be accomplished in a variety of ways including: -

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

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

2.4 Whose Primary Responsibility is to Prevent and Detect Fraud?

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on *fraud prevention*, which may reduce opportunities for fraud to take place, and *fraud deterrence*, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behaviour which can be reinforced by an active oversight by those charged with governance.

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2.5 Responsibilities of the Auditor

An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

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

The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

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

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

What are fraud risk factors?

Fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud. For example: -

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;

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- The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
- A control environment that is not effective may create an opportunity to commit fraud.

Examples of fraud risk factors: Following are examples of fraud risk factors relating to misstatements arising from fraudulent financial reporting and from misappropriation of assets respectively : -

[A] Risk factors relating to misstatements arising from fraudulent financial reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting: -

Incentives/Pressures
Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by): -
➢ **High degree of competition or market saturation, accompanied by declining margins.**
➢ **High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.**
➢ **Significant declines in customer demand and increasing business failures in either the industry or overall economy.**
➢ **Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.**
➢ **Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.**
➢ **Rapid growth or unusual profitability especially compared to that of other companies in the same industry.**
➢ **New accounting, statutory, or regulatory requirements.**

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following: -

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.
- Need to obtain additional debt or equity financing to stay competitive— including financing of major research and development or capital expenditures.

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- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following: -

- **Significant financial interests in the entity.**
- **Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.**
- **Personal guarantees of debts of the entity.**
- **There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.**

Opportunities: The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following: -

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

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The monitoring of management is not effective as a result of the following: -

Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.	Oversight by those charged with governance over the financial reporting process and internal control is not effective.

There is a complex or unstable organizational structure, as evidenced by following: -

- Difficulty in determining the organization or individuals that have controlling interest in the entity.
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
- High turnover of senior management, legal counsel, or those charged with governance.

Internal control components are deficient as a result of the following: -
➢ Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
➢ High turnover rates or employment of accounting, internal audit, or information technology staff that are not effective.
➢ Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.

Attitudes/Rationalizations

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- Non-financial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.

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- Management failing to remedy known significant deficiencies in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following: -

  • Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.

  • Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.

  • Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.

  • Domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

[B] Risk factors relating to misstatements arising from misappropriation of assets

The following are examples of risk factors relating to misstatements arising from misappropriation of assets: -

Incentives/Pressures
Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following: -
➢ Known or anticipated future employee layoffs.
➢ Recent or anticipated changes to employee compensation or benefit plans.
➢ Promotions, compensation, or other rewards inconsistent with expectations.

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Opportunities

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

- Large amounts of cash on hand.
- Inventory items that are small in size, of high value, or in high demand.
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
➢ Inadequate segregation of duties or independent checks.
➢ Inadequate oversight of senior management expenditures, such as travel and other reimbursements.
➢ Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
➢ Inadequate job applicant screening of employees with access to assets.
➢ Inadequate record keeping with respect to assets.
➢ Inadequate system of authorization and approval of transactions (for example, in purchasing).
➢ Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
➢ Lack of complete and timely reconciliations of assets.
➢ Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
➢ Lack of mandatory vacations for employees performing key control functions.
➢ Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
➢ Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.

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- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behaviour indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behaviour or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

Why evaluation of fraud risk factors by auditor is necessary?

The auditor shall evaluate whether one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud.

The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify fraud risk factors. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

2.6 Maintaining Professional Skepticism

The auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.

Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further.

Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

2.7 Discussion among the Engagement Team

The discussion among the engagement team shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including

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how fraud might occur. The discussion shall occur notwithstanding the engagement team members' beliefs that management and those charged with governance are honest and have integrity.

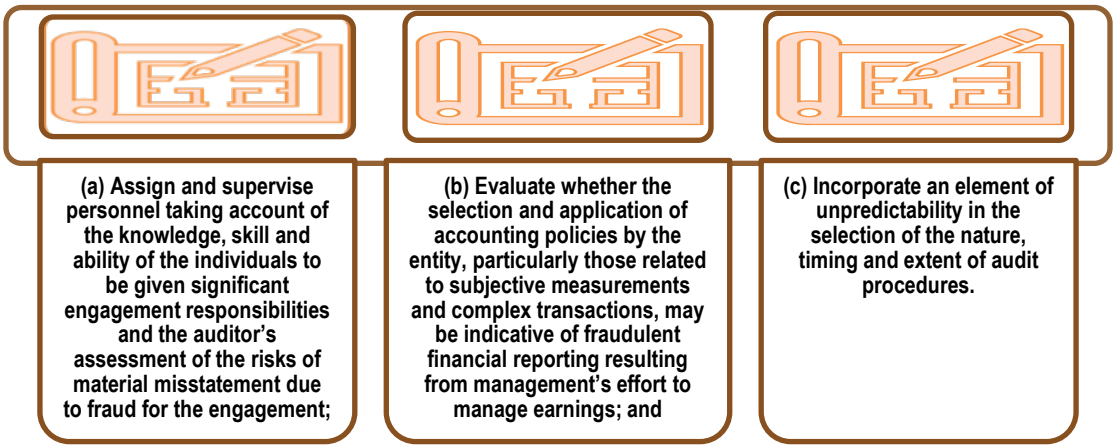
2.8 Risk Assessment Procedures and Related Activities be geared towards Obtaining Information for use in Identifying Risk of Material Misstatement due to Fraud

When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, the auditor shall perform the procedures to obtain information for use in identifying the risks of material misstatement due to fraud like inquiries of management and others within the entity, obtaining understanding as to how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks and evaluation of unexpected relationships identified in performing analytical procedures which may indicate risks of material misstatement due to fraud.

Besides, as discussed already, the auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present.

2.9 Responses to the Assessed Risks of Material Misstatement due to Fraud at the Financial Statement Level

In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor shall: -



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2.10 Audit Procedures Responsive to Assessed Risks of Material Misstatement due to Fraud at the Assertion Level

The auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level. In doing so, the auditor may change nature, timing and extent of audit procedures to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information.

For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor might find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

2.11 Audit Procedures Responsive to Risks related to Management Override of Controls

Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. This risk is present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to: -
(a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.
(b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud.
(c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

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The auditor shall determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to above.

2.12 Evaluation of Audit Evidence

The auditor shall evaluate whether analytical procedures that are performed when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment indicate a previously unrecognized risk of material misstatement due to fraud.

When the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence.

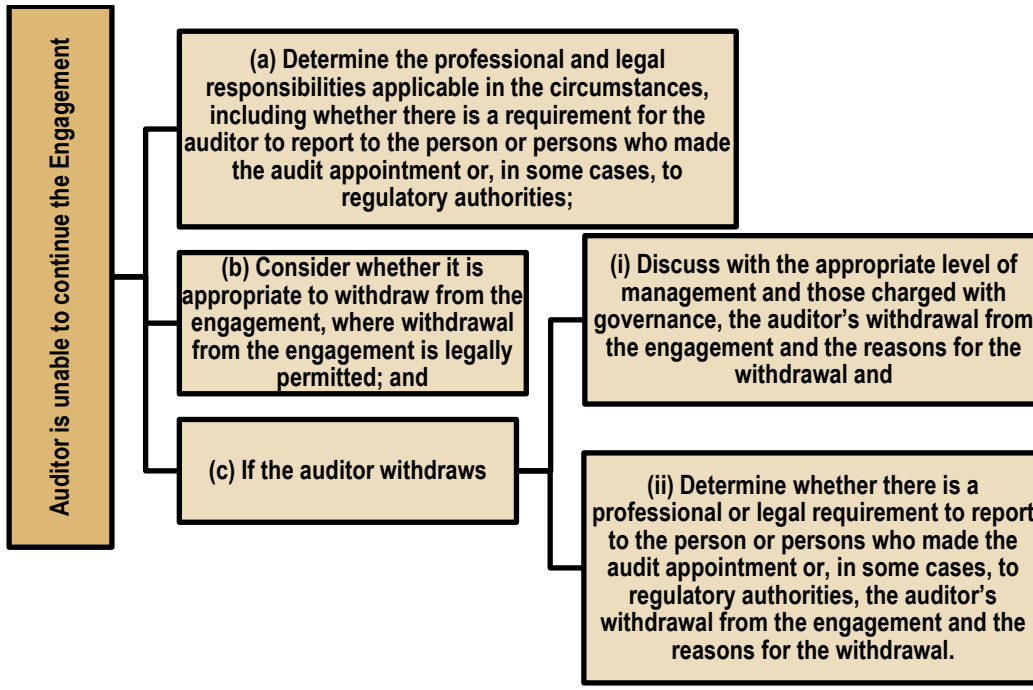
If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re- evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained.

When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor shall evaluate the implications for the audit.

2.13 Auditor is Unable to Continue the Engagement

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall: -

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2.14 Management Representations

The auditor shall obtain written representations from management and, where applicable, those charged with governance that: -

(a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;

(b) They have disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;

(c) They have disclosed to the auditor their knowledge of fraud or suspected fraud affecting the entity involving management, employees who have significant roles in internal control or others where the fraud could have a material effect on the financial statements; and

(d) They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

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2.15 Communications to Management and with Those Charged With Governance

If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving management, employees who have significant roles in internal control or others where the fraud results in a material misstatement in the financial statements, the auditor shall communicate these matters to those charged with governance on a timely basis.

If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit.

The auditor shall communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities.

2.16 Communications to Regulatory and Enforcement Authorities

If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. For example, in case of audit of banks, the auditor has a statutory duty to report the occurrence of fraud to the supervisory authorities, i.e. RBI.

Also, in some entities the auditor may have a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action. In some clients, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation.

2.17 Documentation

The auditor's documentation of the understanding of the entity and its environment and the assessment of the risks of material misstatement required shall include: -

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(a) 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

(b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.

The auditor's documentation of the responses to the assessed risks of material misstatement required shall include: -

(a) 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

(b) The results of the audit procedures, including those designed to address the risk of management override of controls.

The auditor shall document communications about fraud made to management, those charged with governance, regulators and others.

When the auditor has concluded that 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, the auditor shall document the reasons for that conclusion.

TEST YOUR UNDERSTANDING 1

My Décor Limited, presently engaged in manufacturing of fabrics, wants to set up a new plant for manufacturing of special kind of fabric providing an altogether different texture and feel. This kind of fabric has become a hit with retail customers. The company needs to set up plant for manufacturing the above kind of fabric involving huge capital outlays to stay competitive in the market.

You are auditor of the company and find that company's revenue has increased in financial year 2025-26 to ₹ 1000 crore from ₹ 750 crore in last year. By the time, you started the audit, there was no change in plant capacity and information regarding need to set up new plant has become known to you during inquiry of company's personnel.

Discuss, how you should proceed to deal with above situation, as auditor of the company, paying special attention to risk of material misstatement due to fraudulent financial reporting?

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TEST YOUR UNDERSTANDING 2

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

[i] Receivables are not reconciled at stipulated intervals.

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

The statutory auditor of the company finds that no action has been taken by the company on the said deficiencies pointed out in reports of internal auditor.

What does above situation indicate to statutory auditor of company?

3. SA 250 CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

SA 250 deals with auditor's responsibility to consider laws and regulations when performing an audit of financial statements. However, it does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

The requirements in this SA are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations.

3.1 Effect of Laws and Regulations on Financial Statements of an Entity

The effect on the financial statements of laws and regulations varies considerably. Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's financial statements.

Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health). Non-compliance

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with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

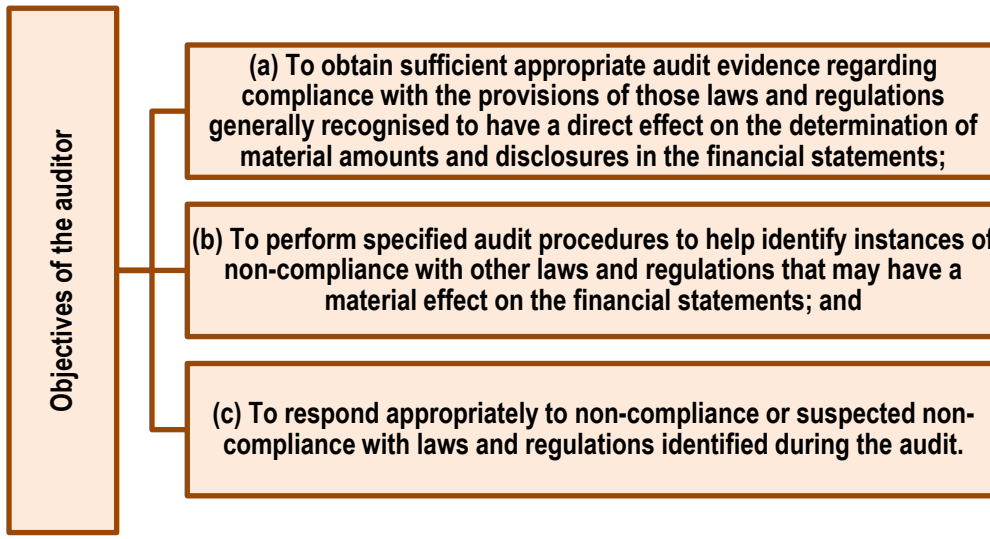
3.2. Objectives of Auditor in Accordance with SA 250

The objectives of the auditor in accordance with SA 250 are: -

(a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;

(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and

(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.



3.3 Responsibility of Management for Compliance with Laws and Regulations

It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

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The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations: -
➢ Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
➢ Instituting and operating appropriate systems of internal control.
➢ Developing, publicising and following a code of conduct.
➢ Ensuring employees are properly trained and understand the code of conduct.
➢ Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
➢ Engaging legal advisors to assist in monitoring legal requirements.
➢ Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to an internal audit function, an audit committee, a compliance function.

3.4 Responsibility of the Auditor

The auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

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

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

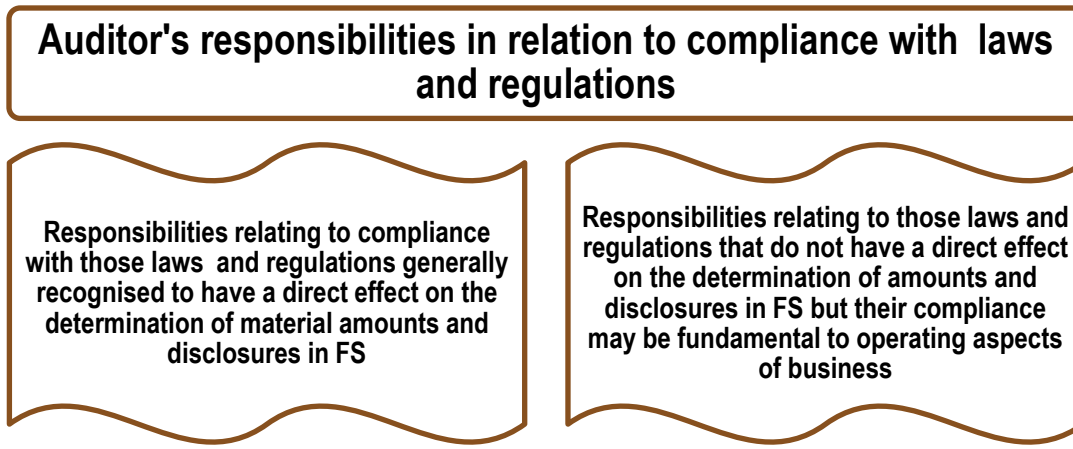
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Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognise the non-compliance.

SA 250 distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows: -

(a) The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws and

(b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations). Non-compliance with such laws and regulations may, therefore, have a material effect on the financial statements.



For the compliance with provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements, the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations.

For other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements but compliance with which may be fundamental to the operating aspects of the business, the auditor's responsibility is limited to undertaking specified audit

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procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

The auditor is to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected non-compliance to the auditor's attention. Maintaining professional skepticism throughout the audit, is important in this context, given the extent of laws and regulations that affect the entity.

The Auditor's consideration of compliance with laws and regulations

As part of obtaining an understanding of the entity and its environment, the auditor shall obtain a general understanding of: -

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

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

The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements. Such laws, for example, could relate to form and content of financial statements or industry- specific financial reporting issues.

The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:

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

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

Certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity. Non-compliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations, or call into question the entity's continuance as a going concern.

For example: Non-compliance with the requirements of the entity's license or other entitlement to perform its operations could have such an impact (for example, for a bank, non-compliance with

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capital or investment requirements). An NBFC might have to cease to carry on the business of a non-banking financial institution if it fails to obtain a certificate of registration issued under RBI Act and if its Net Owned Funds are less than the amount specified by the RBI in this regard.

There are also many laws and regulations relating principally to the operating aspects of the entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting. As the financial reporting consequences of other laws and regulations can vary depending on the entity's operations, the audit procedures as stated above are directed to bringing to the auditor's attention instances of non-compliance with laws and regulations that may have a material effect on the financial statements.

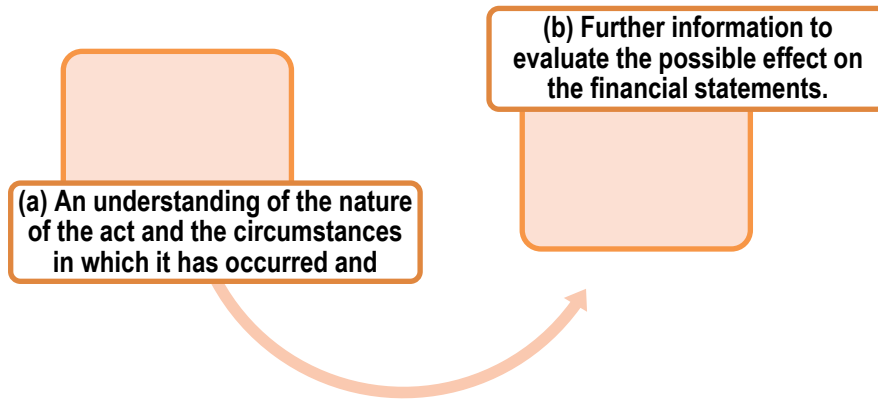
Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.

During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.

The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor.

3.5 Audit Procedures when Non-Compliance is Identified or Suspected

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



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If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice.

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

The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action.

3.6 Reporting of Identified or Suspected Non-Compliance

(A) Reporting non-compliance to Those Charged with Governance

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

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

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

(B) Reporting non-compliance in the Auditor's Report on the Financial Statements

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with SA 705, express a qualified or adverse opinion on the financial statements.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified

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opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SA 705.

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

(C) Reporting non-compliance to Regulatory and Enforcement Authorities

If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

3.7 Documentation

The auditor shall document identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.

TEST YOUR UNDERSTANDING 3

FAS Insurance Brokers Limited is a leading online insurance intermediary. During the year, Director General of GST Intelligence (DGGI) has issued notice to the company for allegedly creating fictitious invoices for "marketing and sales services" amounting to ₹ 50 crores in favour of non-life insurance companies. The premises of company were also searched during the year by DGGI officials. The matter was also informed to IRDAI by DGGI for violation of norms and regulations in this regard.

Does above situation has any bearing on your responsibilities as statutory auditor of the company? Outline briefly in context of possible non-compliance with laws by the company.

4. SA 260 COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

SA 260 deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.

Who are "Those charged with governance"?

"Those charged with governance" denote the person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes those overseeing the financial reporting process. For some

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entities, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

Governance structures vary by entities, reflecting influences such as different cultural and legal backgrounds, size and ownership characteristics. For example, in some entities, a supervisory board exists that is separate from executive board. In other entities, both supervisory and executive functions are performed by a single board. In some entities, those charged with governance hold positions that are an integral part of the entity's legal structure. For example, company directors. In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.

In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee.

Such diversity means that it is not possible to specify for all audits the persons with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate persons with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities and some not-for-profit organizations.

In such cases, the auditor may need to discuss and agree with the engaging party the relevant persons with whom to communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained in accordance with SA 315 is relevant. The appropriate persons with whom to communicate may vary depending on the matter to be communicated.

Significance of Communication with Those charged with governance

Communication from auditor is important with those charged with governance. An effective two-way communication is important in assisting:

[a] The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity.

[b] The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events and

[c] Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

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4.1 Objectives of Auditor in Accordance with SA 260

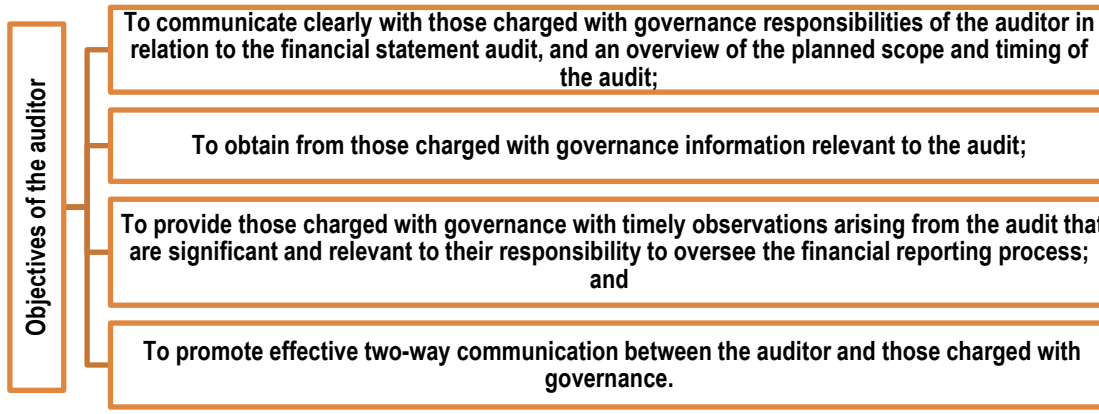
The objectives of the auditor are: -

(a) To communicate clearly with those charged with governance responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;

(b) To obtain from those charged with governance information relevant to the audit;

(c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and

(d) To promote effective two-way communication between the auditor and those charged with governance.



Determining appropriate persons with whom to communicate : The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate.

4.2 Matters to be Communicated by the Auditor

Following matters are required to be communicated by auditor with those charged with governance:-

[a] The auditor's responsibilities in relation to the financial statement audit
The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:
(a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance and
(b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

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The auditor's responsibilities in relation to the financial statement audit are often included in the engagement letter or other suitable form of written agreement that records the agreed terms of the engagement. Law, regulation or the governance structure of the entity may require those charged with governance to agree the terms of the engagement with the auditor. When this is not the case, providing those charged with governance with a copy of that engagement letter or other suitable form of written agreement may be an appropriate way to communicate with them.

[b] Planned scope and timing of the audit

Communication regarding the planned scope and timing of the audit may: -

- Assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and the concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures and
- Assist the auditor to understand better the entity and its environment.

The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor.

Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they require special audit consideration. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process.

While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Care is necessary when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

[c] Significant findings from the audit

The auditor shall communicate with those charged with governance: -

(i) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

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When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

(ii) Significant difficulties, if any, encountered during the audit;

(iii) Unless all of those charged with governance are involved in managing the entity: -

(1) Significant matters arising during the audit that were discussed, or subject to correspondence, with management;

(2) Written representations the auditor is requesting

(iv) Circumstances that affect the form and content of the auditor's report, if any and

(v) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.

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

Significant difficulties encountered during the audit may include such matters as: -

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

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In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.

Significant matters that were discussed, or subject to correspondence with management may include such matters as: -
• Significant events or transactions that occurred during the year.
• Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.
• Concerns about management's consultations with other accountants on accounting or auditing matters.
• Discussions or correspondence in connection with the initial or recurring appointment of the auditor regarding accounting practices, the application of auditing standards, or fees for audit or other services.
• Significant matters on which there was disagreement with management, except for initial differences of opinion because of incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information.

The agreed terms of the audit engagement are required to be recorded in an audit engagement letter or other suitable form of written agreement and include, among other things, reference to the expected form and content of the auditor's report. Communication in this respect is intended to inform those charged with governance about circumstances in which the auditor's report may differ from its expected form and content or may include additional information about the audit that was performed.

Circumstances in which the auditor is required or may otherwise consider it necessary to include additional information in the auditor's report in accordance with the SAs, and for which communication with those charged with governance is required, include when: -

- The auditor expects to modify the opinion in the auditor's report in accordance with SA 705.
- A material uncertainty related to going concern is reported in accordance with SA 570.
- Key audit matters are communicated in accordance with SA 701.
- The auditor considers it necessary to include an Emphasis of Matter paragraph or Other Matter paragraph in accordance with SA 706 or is required to do so by other SAs.
- The auditor has concluded that there is an uncorrected material misstatement of the other information in accordance with SA 720.

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In such circumstances, the auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate a discussion of how such matters will be addressed in the auditor's report.

4.3 Communication of Auditor's Independence in Case of Listed Entities

In the case of listed entities, the auditor shall communicate with those charged with governance
(a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence; and
(b) (i) All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor; and (ii) The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

The Communication Process

The auditor shall communicate with those charged with governance the form, timing and expected general content of communications.

The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Written communications need not include all matters that arose during the course of the audit. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required in case of listed entities.

The auditor shall communicate with those charged with governance on a timely basis.

Adequacy of the Communication Process

The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and shall take appropriate action.

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4.4 Documentation

Where matters required by SA 260 to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation.

TEST YOUR UNDERSTANDING 4

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

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



5. SA 299 JOINT AUDIT OF FINANCIAL STATEMENTS

SA 299 lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200. It deals with the special considerations in carrying out audit by joint auditors.

However, it does not deal with the relationship between a principal auditor who is appointed to report on the financial statements of an entity and another auditor who is appointed to report on the financial statements of one or more component (divisions, branches, subsidiary, joint venture, associates, other entity) included in the financial statements of the entity.

What is joint audit of financial statements?

A joint audit is an audit of financial statements of an entity by two or more auditors appointed with the objective of issuing the audit report. Such auditors are described as joint auditors.

The practice of appointing more than one auditor to conduct the audit of large entities has been in vogue for a long time, sometimes voluntarily by the shareholders or sometimes due to the requirements of laws or regulations. Such auditors, known as joint auditors, conduct the audit jointly and report on the financial statements of the entity.

For example, section 139(3) of the Companies Act, 2013 provides that members of a company may resolve to provide that the audit shall be conducted by more than one auditor.

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5.1 Objectives in accordance with SA 299

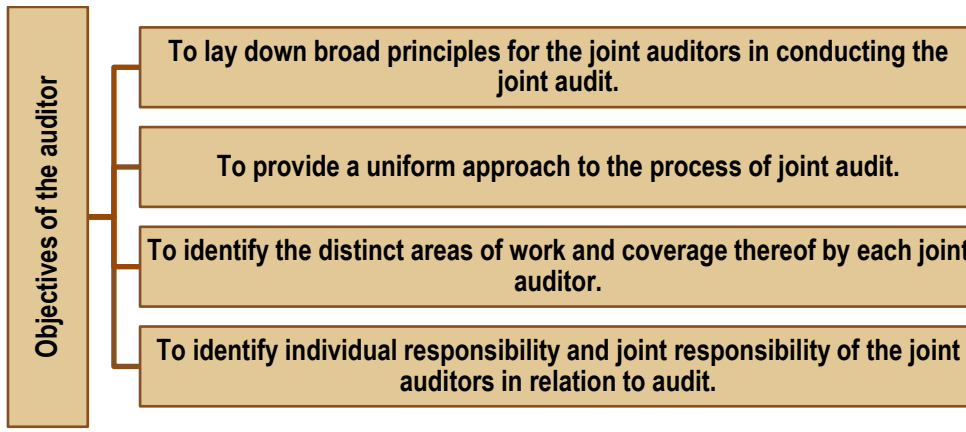
The objectives in accordance with SA 299 are as under: -

(a) To lay down broad principles for the joint auditors in conducting the joint audit.

(b) To provide a uniform approach to the process of joint audit.

(c) To identify the distinct areas of work and coverage thereof by each joint auditor.

(d) To identify individual responsibility and joint responsibility of the joint auditors in relation to audit.



5.2 Audit planning, Risk Assessment and Allocation of Work

The engagement partner and other key members of the engagement team from each of the joint auditors shall be involved in planning the audit. Overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan shall be established jointly.

Prior to the commencement of the audit, the joint auditors shall discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors shall: -
(a) Identify division of audit areas and common audit areas amongst the joint auditors that define the scope of the work of each joint auditor. Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors.

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(b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required
(c) Consider and communicate among all joint auditors the factors that, in their professional judgment, are significant in directing the engagement team's efforts
(d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other or similar engagements performed earlier by the respective engagement partner for the entity is relevant.
(e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

At this stage, risks of material misstatement need to be considered and assessed by each of the joint auditors and shall be communicated to other joint auditors, and documented, whether pertaining to the overall financial statements level or to the area of allocation among the other joint auditors.

The joint auditors shall discuss and document the nature, timing, and the extent of the audit procedures for common and specific allotted areas of audit to be performed by each of the joint auditors and the same shall be communicated to those charged with governance.

The joint auditors shall obtain common engagement letter and common management representation letter.

After identification and allocation of work among the joint auditors, the work allocation document shall be signed by all the joint auditors and the same shall be communicated to those charged with governance of the entity.

The documentation of allocation of work helps in avoiding any dispute or confusion which may arise among the joint auditors regarding the scope of work to be carried out by them. Further, the communication of allocation of work to the entity helps in avoiding any dispute or confusion which may arise between the entity and the joint auditors.

5.3 Responsibility and Co-ordination among Joint Auditors

The audit process involves obtaining and evaluating information and explanations from the management. This responsibility is shared by all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility.

In respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. In cases where specific divisions, zones or units are allocated to different joint auditors, it is the separate and specific responsibility of each joint auditor to obtain information and explanations from

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the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by said joint auditor. The joint auditors shall have proper coordination and rationality wherever required.

All the joint auditors shall be jointly and severally responsible for: -

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

(b) decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors.

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

(d) examining that the financial statements of the entity comply with the requirements of the relevant statutes

(e) presentation and disclosure of the financial statements as required by the applicable financial reporting framework

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

Where, in the course of the audit, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgment by other joint auditors, the said joint auditor shall communicate the same to all the other joint auditors in writing prior to the completion of the audit.

It shall be the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the areas of work allocated to said joint auditor. It is the individual responsibility of each joint auditor to study and evaluate the prevailing system of internal control and assessment of risk relating to the areas of work allocated to said joint auditor.

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As regards decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors, all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing and extent of the audit procedures agreed upon among them, proper execution of these audit procedures is the individual responsibility of the joint auditor concerned.

5.4 Audit Conclusion and Reporting

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

Each Joint Auditor is entitled to assume that: -

- **(a) The other joint auditors have carried out their part of the audit work and the work has actually been performed in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner.**
- **(b) The other joint auditors have brought to said joint auditor's notice any departure from applicable financial reporting framework or significant observations that are relevant to their responsibilities noticed in the course of the audit.**

Where financial statements of a division/branch are audited by one of the joint auditors, the other joint auditors are entitled to proceed on the basis that such financial statements comply with all the legal and regulatory requirements and present a true and fair view of the state of affairs and of the results of operations of the division/branch concerned.

Before finalizing their audit report, the joint auditors shall discuss and communicate with each other their respective conclusions that would form the content of the audit report.

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5.5 Communication with Those Charged with Governance

When the joint auditors expect to modify the opinion in the auditor's report, the joint auditors shall communicate with those charged with governance the circumstances that led to the expected modification and the proposed wording of the modification to ensure compliance with SA 705. If the joint auditors expect to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the joint auditors shall communicate with those charged with governance regarding this expectation and the proposed wording of this paragraph to ensure compliance with SA 706.

TEST YOUR UNDERSTANDING 5

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

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

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

6. SA 402 AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANISATION

SA 402 deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations. Specifically, it expands on how the user auditor applies SA 315 and SA 330 in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

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What is a Service organization?

- Service organisation is a third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities' information systems relevant to financial reporting. User entity is an entity that uses a service organisation and whose financial statements are being audited.

Who is a service auditor?

- Service auditor is an auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation. User auditor is an auditor who audits and reports on the financial statements of a user entity.

Many entities outsource aspects of their business to organisations that provide services ranging from performing a specific task under the direction of an entity to replacing an entity's entire business units or functions, such as the tax compliance function. Many of the services provided by such organisations are integral to the entity's business operations; however, not all those services are relevant to the audit.

When services provided by a service organization are relevant to the audit of a user entity's financial statements?

Services provided by a service organisation are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organisation are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets.

A service organisation's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following: -
(a) The classes of transactions in the user entity's operations that are significant to the user entity's financial statements
(b) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements
(c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements that are used to initiate, record, process and report the user entity's transactions
(d) How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements

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(e) The financial reporting process used to prepare the user entity's financial statements, including significant accounting estimates and disclosures and
(f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments

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

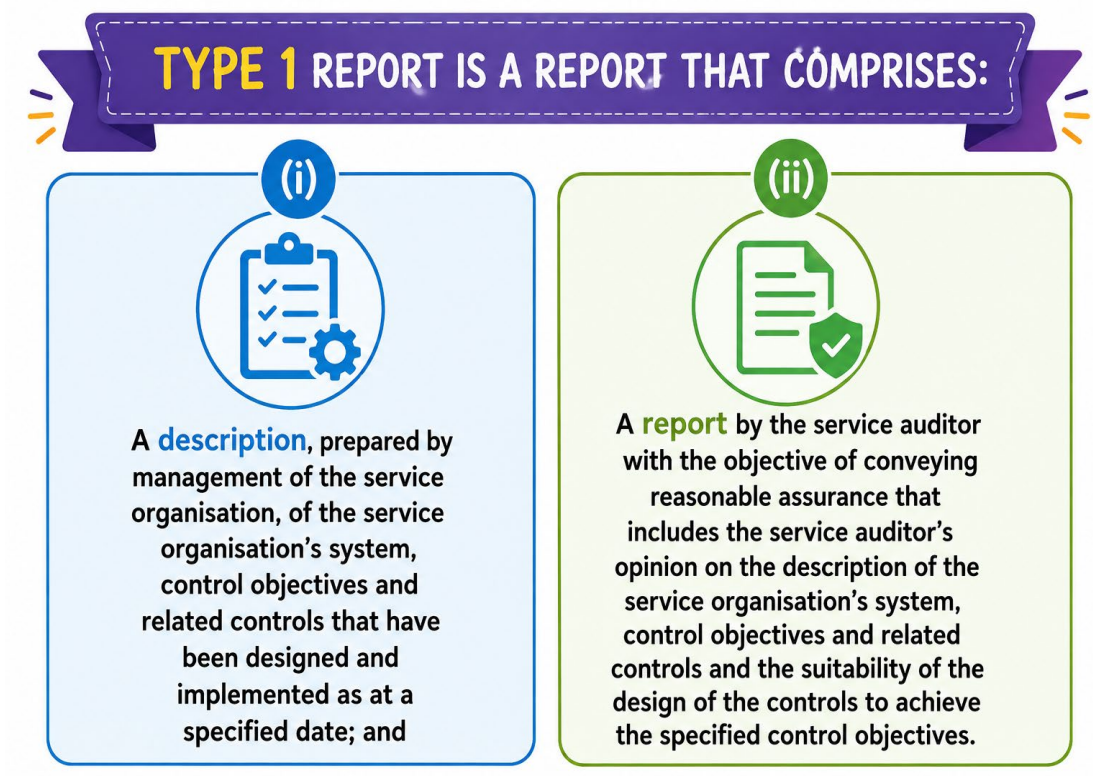
6.1 Objectives of User Auditor in accordance with SA 402

The objectives of the user auditor, when the user entity uses the services of a service organisation, are:-

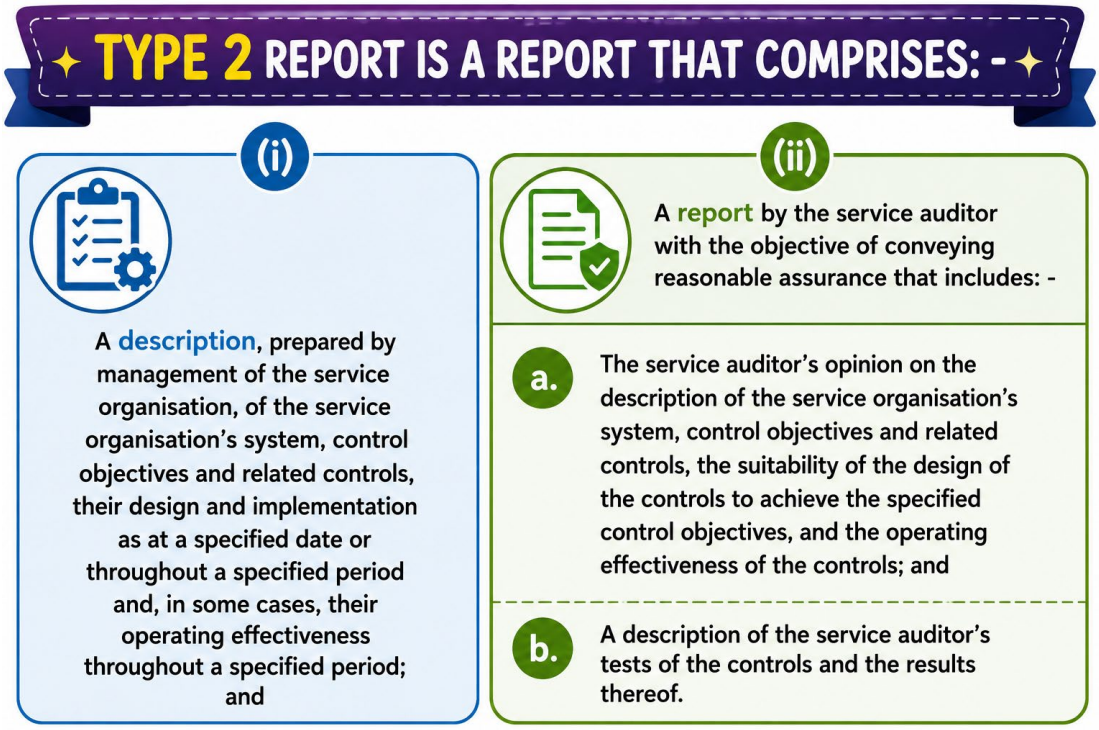
(a) To obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement; and

(b) To design and perform audit procedures responsive to those risks.

6.2 Type 1 report and Type 2 report



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6.3 Obtaining an Understanding of the Services

1. **Obtaining an understanding of the services provided by a service organisation, including internal control:** When obtaining an understanding of the user entity in accordance with SA 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including: -

(a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control. Information on nature of services provided by a user organization may be available from sources such as user manuals, contract between the user entity and service organization, reports by service auditors etc.
(b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation. In certain situations, the transactions processed and the accounts affected by the service organisation may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.
(c) The degree of interaction between the activities of the service organisation and those of the user entity. The degree of interaction refers to the extent to which a user entity is

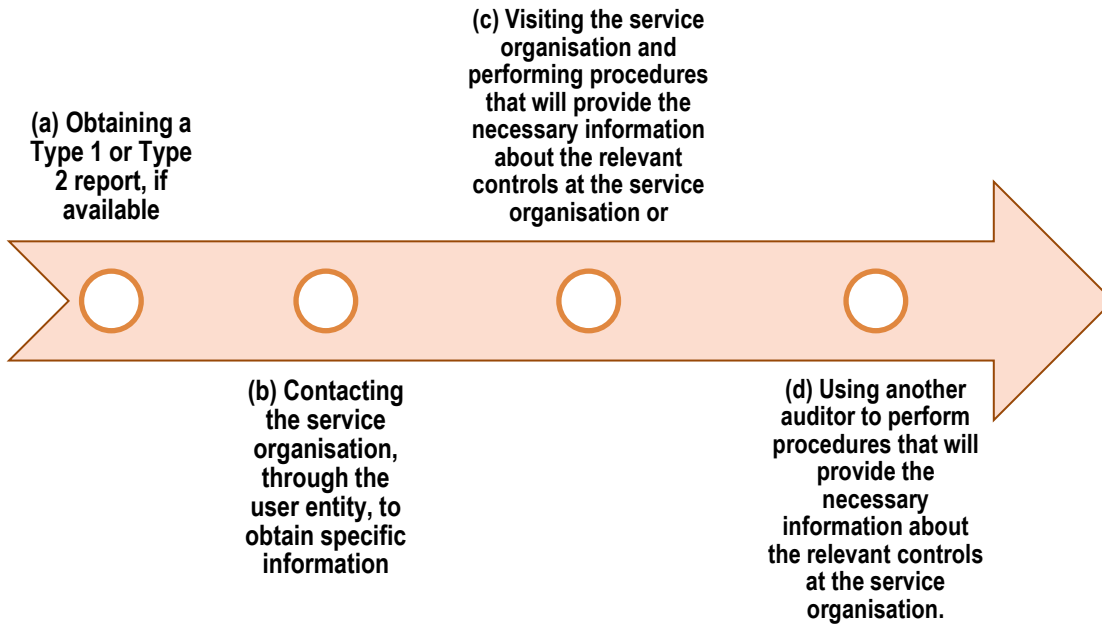
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able to and elects to implement effective controls over the processing performed by the service organisation. For example, a high degree of interaction exists between the activities of the user entity and those at the service organisation when the user entity authorises transactions and the service organisation processes and does the accounting for those transactions
(d) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.

2. **When obtaining an understanding of internal control relevant to the audit in accordance with SA 315, the user auditor shall evaluate the design and implementation of relevant controls** at the user entity that relate to the services provided by the service organisation, including those that are applied to the transactions processed by the service organisation.

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

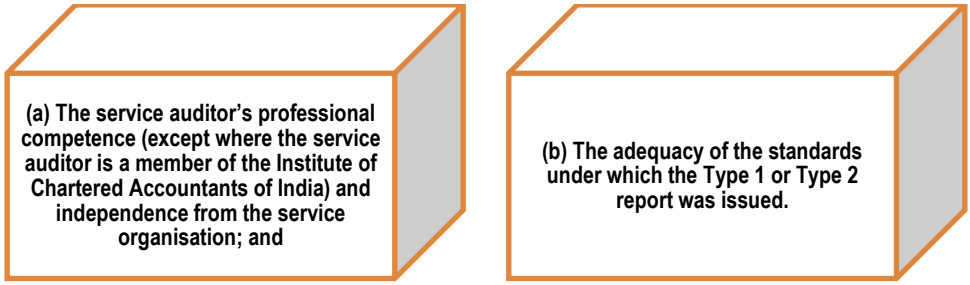
4. **If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures: -**



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6.4 Using Type 1 or Type 2 Report

Using A Type 1 Or Type 2 Report to Support the User Auditor's Understanding of The Service Organisation : In determining the sufficiency and appropriateness of the audit evidence provided by a Type 1 or Type 2 report, the user auditor shall be satisfied as to: -



If the user auditor plans to use a Type 1 or Type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organisation, the user auditor shall:

(a) Evaluate whether the description and design of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes;

(b) Evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity's internal control relevant to the audit; and

(c) Determine whether complementary user entity controls identified by service organisation are relevant to the user entity and, if so, obtain an understanding of whether the user entity has designed and implemented such controls.

Complementary user entity controls refer to controls that the service organisation assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives, are identified in the description of its system.

6.5 Responding to the Assessed Risks of Material Misstatement

In responding to assessed risks in accordance with SA 330, the user auditor shall: -

(a) Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity; and, if not,

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(b) Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.

6.6 Tests of Controls

When the user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively, the user auditor shall obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures: -

(a) Obtaining a Type 2 report, if available;

(b) Performing appropriate tests of controls at the service organisation; or

(c) Using another auditor to perform tests of controls at the service organisation on behalf of the user auditor.

Using a Type 2 report as audit evidence that controls at the service organisation are operating effectively

If, the user auditor plans to use a Type 2 report as audit evidence that controls at the service organisation are operating effectively, the user auditor shall determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by:

(a) Evaluating whether the description, design and operating effectiveness of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes ;

(b) Determining whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;

(c) Evaluating the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and

(d) Evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements nd provide sufficient appropriate audit evidence to support the user auditor's risk assessment.

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6.7 Fraud, Non-Compliance with Laws and Regulations and Uncorrected Misstatements in relation to Activities at the Service Organisation

The user auditor shall inquire of management of the user entity whether the service organisation has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, non-compliance with laws and regulations or uncorrected misstatements affecting the financial statements of the user entity. The user auditor shall evaluate how such matters affect the nature, timing and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report.

6.8 Reporting by the User Auditor

The user auditor shall modify the opinion in the user auditor's report in accordance with SA 705 if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements.

The user auditor shall not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion.

If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion, the user auditor's report shall indicate that such reference does not diminish the user auditor's responsibility for that opinion.

Key Takeaways

- Fraud is an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.
- SA 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Its requirements assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.
- Fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.
- The effect on the financial statements of laws and regulations varies considerably. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's financial statements.

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- Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.
- SA 250 deals with auditor's responsibility to consider laws and regulations when performing an audit of financial statements.
- Communication from auditor is important with those charged with governance. SA 260 deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.
- A joint audit is an audit of financial statements of an entity by two or more auditors appointed with the objective of issuing the audit report. Such auditors are described as joint auditors.
- SA 299 lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200. It deals with the special considerations in carrying out audit by joint auditors.
- Service organisation is a third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities' information systems relevant to financial reporting. User entity is an entity that uses a service organisation and whose financial statements are being audited.
- SA 402 deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations.

Note:

Content of SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing"; SA 210 "Agreeing the Terms of Audit Engagements" and SA 230 "Audit Documentation" is covered in depth at Intermediate level. Thus, application part of above SAs may be discussed in the form of Case Study at Final level.

Student may note that SA 200 is covered in chapter 1: Nature, Objective and Scope of Audit available at https://resource.cdn.icai.org/93332bos-aps5884-ch1.pdf , SA 210 is covered in chapter 11: Ethics and Terms of Audit Engagements available at https://resource.cdn.icai.org/93342bos-aps5884-ch11.pdf and SA 230 is covered in chapter 6: Audit Documentation at Intermediate level, available at: https://resource.cdn.icai.org/93337bos-aps5884-ch6.pdf

For a concise revision of the key concepts covered in this chapter, students may refer to the Saransh Booklet for Paper 3: Advanced Auditing, Assurance and Professional Ethics, which serves as a useful last-mile revision resource for examination preparation. Saransh Booklet can be accessed at https://boslive.icai.org/AAAPE_SARANSH.pdf

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TEST YOUR KNOWLEDGE

Theoretical Questions

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

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

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

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

5. *MN & Associates are the statutory auditors of ABC Ltd. for the FY 2025-26. During the course of audit, the engagement partner, Mr. Manohar notices a misstatement resulting from a suspected fraud that brings into question the audit team's ability to continue performing the audit. How should the audit team deal with the situation?*

6. *UVW & Associates are the statutory auditors of Moon Ltd., a listed company, for the financial year 2025-26. CA Udhav is the engagement partner for the audit assignment. He was of the understanding that as per the requirement of one of the SAs he has a responsibility to communicate following matters to those charged with governance:*

   (a) The auditor's responsibilities in relation to the financial statement audit.

   (b) Planned scope and timing of the audit.

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(c) Auditor independence

Which of the matters is not included in the list prepared by CA Udhav. Discuss such matters in detail.

7. *FAB Limited is availing the services of Atiya Private Limited for its payroll operations. Payroll cost accounts for 63% of total cost for FAB Limited. Atiya Limited has provided the type 2 report as specified under SA 402 for its description, design, and operating effectiveness of control.*

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

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

Comment whether CA Akram is correct in removing the reference of the work done by service auditor?

8. *Arihant Ltd. was engaged in the business of owning and managing hotels and resorts, selling tourism packages and performing airline bookings for corporate and individuals. It appointed Upadhyay & Co. as its statutory auditor for the financial year 2025-26. While planning the audit, the audit team decided that the risk of improper revenue recognition from hotel business should not be treated as a fraud risk. This conclusion was based on the assessment of earlier years, wherein no fraud was identified in revenue recorded from such business. While testing the internal financial controls over the process of revenue recognition, it was identified that the controls are not properly designed to mitigate the risk of fraud and risk of improper revenue recognition. As a result, the audit team decided to perform additional substantive testing. However, the audit team still were to the conclusion that there is no risk of fraud in revenue recognition. During the course of substantive testing, it was identified that the management did not account for revenue received from corporate hotel bookings amounting to ₹ 43 crore. These amounts were partially received in the company's bank accounts and partially received in the CFO's personal account. The amounts received in the bank account of the company were disclosed as advances received against the future bookings. In the light of above scenario, kindly guide the statutory auditors with respect to their responsibility relating to fraud in an audit of a financial statement.*

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9. *Alpha Manufacturing Ltd. (AML) is engaged in the production of speciality machinery for the automotive industry. The company operates in a competitive market and is under pressure to meet aggressive revenue and profitability targets to secure additional funding from the investors. The audit firm BETA LLP has been engaged to conduct AML's statutory audit for the financial year 2025-26. BETA LLP performed risk assessment procedures and related activities towards obtaining information in identifying risk of material misstatement due to fraud and also evaluated whether there is an indication that one or more fraud risk factors are present. Analytical procedures reveal unexpected relationships potentially indicating fraudulent activities, such as sales inflation by management to meet earnings targets. Management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery.*

   Guide BETA LLP to decide the course of action in determining overall responses to address the assessed risks of material misstatement due to fraud at the (i) Financial Statement Level and (ii) Assertion Level.

10. *Key Ventures Limited is availing the services of Chipmetric Limited for processing of its accounting data including payroll operations. Payroll costs account for 75% of the total costs of Key Ventures Limited. CA Tej, the auditor of Key Ventures Limited wants to obtain an understanding of the nature and significance of the services provided by Chipmetric Limited and their effect on the user entity's internal control to identify and assess the risks of material misstatement. In this regard, he wants to use Type 1 or Type 2 report.*

    What shall be the considerations of CA Tej in determining the sufficiency and appropriateness of the audit evidence? Suggest the procedures if he plans to use a Type 1 or Type 2 report as audit evidence to support the understanding about the design and implementation of controls at Chipmetric Limited as per relevant Standard on Auditing.

11. *AJ Private Limited is a company involved in the business of textile manufacturing and having its factory at NOIDA. The business of the company is spread across India. Due to the recent fire incidents, the local authority of NOIDA passed a regulation wherein it is compulsory for any organisation in its jurisdictional area to have a valid Fire No Objection Certificate (Fire NOC) issued by the regulatory authority. You are appointed as the statutory auditor of the company for the financial year 2025-26. During initial risk assessment phase, you observed that the company is not in possession of Fire*

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NOC as stipulated by the regulatory authority. You approached those charged with governance regarding this matter and requested them to provide their justification on the same. They are of the opinion that obtaining Fire NOC is outside the purview of the financial statements, hence, you are not required to look after this aspect. What are the auditor's responsibilities in relation to compliance with laws and regulations?

12. *As the senior audit manager for "Alpha Tech Ltd.", a listed technology company with significant debt financing, you are planning the audit for the financial year ending March 31, 2026. Your previous two audits resulted in an unmodified opinion. However, the company has recently been in the media spotlight due to allegations of manipulating share prices and not disclosing all related party transactions. The company is under intense pressure from external stakeholders to meet aggressive earnings targets.*

    During your preliminary risk assessment, you identify that:

    - *A significant portion of the senior management's compensation is tied to achieving unrealistic profitability targets.*
    - *The company's financial results show rapid, unusual profitability compared to its competitors.*
    - *A number of significant, complex, and unusual transactions occurred very close to the year-end.*
    - *You also notice that there has been a high turnover of senior management and legal counsel in the past year.*

    Based on the above facts and with reference to relevant SA, you are required to identify and explain the specific fraud risk factors present in the scenario that suggest a heightened risk of material misstatement due to fraudulent financial reporting.

13. *PMP Industries Ltd. is a listed manufacturing company. CA F is the statutory auditor for the F.Y. 2025-26. During the course of audit CA F and his audit team made the following observations:*

    - *Fictitious sales of ₹ 20 crores through fake invoices*
    - *Missing inventory worth ₹ 8 crores with forged records*

    On communicating the observations with the Management and those charged with governance they refused to take corrective action. Instead of making the corrections,

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the Managing Director threatened legal action if disclosures are made in the Audit Report. The Board of Directors is divided, with promoter directors supporting the Managing Director and others agreeing to the auditor's contention.

Since the fraud is material to the financial statements, CA F finds it difficult to continue the audit engagement due to these exceptional circumstances. State with reference to the relevant Standard on Auditing the course of action CA F will take.

14. *CA Ravi is the engagement partner of PQR Ltd. for conducting the Statutory audit for the FY 2025-26. During the audit of PQR Ltd., he had the following observations:*

    (i) Management used an outdated discount rate (12% as against 8%) leading to ₹ 2 crore understatement of recoverable amount/ overstatement of impairment loss, which in the auditor's view is not appropriate.

    (ii) Management delayed providing expected inventory records for 10 days, causing extensive extra effort.

    You are required to:

    (i) State with reasons how each of the above constitutes a significant finding requiring communication to "Those charged with governance" as per relevant Standard on Auditing.

    (ii) State, apart from the above, other significant findings that an auditor should communicate to "Those charged with governance".

15. *CA. Arvind, statutory auditor of Divinity Technologies Pvt. Ltd., noticed that Mr. Kamlesh was engaged by Management for investigation of suspected fraud within the organisation. CA. Arvind formally requested a copy of the report of the same to understand the nature, extent and implications of the suspected fraud so that he could appropriately consider it in his audit procedures and reporting responsibilities. Despite multiple written reminders, the management did not provide the report.*

    In view of this, CA. Arvind requested the management to at least provide a written representation regarding the fraud on/by the Company. The management neither provided the investigation report nor responded to his request to provide the requested representation. How should CA. Arvind deal in the given situation?

16. *Tree Ltd. appointed GH & Associates and IJ & Co. as joint auditors for conducting the audit for the year ending on 31st March 2026.*

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During the audit, it was observed that there is a significant understatement in the value of trade receivables. The trade receivable valuation work was looked after by GH & Associates, however, there was no documentation outlining the division of the work between the joint auditors.

Comment on the above situation with respect to the allocation of responsibilities among joint auditors as per relevant Standards on Auditing.

17. ***SKY Hospital is a very renowned hospital for Orthopedic Surgeries in Pune having sophisticated infrastructure. SKY Hospital has recently implemented a comprehensive information system, developed and managed by CT Contractors, which is used for maintaining complete and integrated records of indoor patients. This system captures and processes details relating to patients' diagnosis, treatment plans, medications administered, as well as billing and corresponding receipt transactions, thereby supporting both clinical and financial reporting functions of the hospital. CA Yash is the statutory auditor of SKY Hospital. During the course of audit, he became aware that the hospital is using a system developed and managed by CT Contractors. Since the hospital relies on this system for maintaining patient and billing records, CA Yash is concerned whether the controls implemented at CT Contractors are operating effectively or not. For this purpose, CA Yash requested CT Contractors to provide an assurance report issued by a practicing chartered accountant, containing an opinion on the description of the CT Contractor's system and the effectiveness of the controls in place. Which type of report should be obtained by CA Yash in terms of relevant Standard on Auditing? What aspects are to be considered by CA Yash in using such assurance report as audit evidence that controls at CT Contractors are operating effectively?***

18. ***You are appointed as Statutory Auditor of High Ltd. and are in the midst of conducting Audit for the financial year ending on 31st March, 2026. During the course of audit, you come across a situation involving recording of purchases amounting to ₹ 1.30 crores from a company incorporated on 24th March, 2026. Upon further inquiry, you discovered that purchases have been booked at the instructions of one of the directors. Further, despite this entry in books, no payment was made and there is lack of documentary or other evidence validating these purported purchases. How would you deal in the given situation?***

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Answers to Test Your Understanding:

1. The given situation highlights need for the company to set up new plant for manufacturing of special kind of fabric to stay competitive in the market. Setting up of such plant involves huge capital outlays which could entail financing arrangements. Therefore, excessive pressure exists for management to be involved in fraudulent financial reporting. In such a situation, management may be tempted to inflate its revenues to show rosy picture. It is a fraud risk factor and needs to be evaluated by the auditor.

The revenues of the company have jumped from ₹ 750 crore in last year to ₹ 1000 crore in year 2025-26 without any change in plant capacity. The auditor may consider above said fraud risk factor for assessing risk of material misstatement due to fraud.

In case of auditor assessing risk of material misstatement due to fraudulent financial reporting, audit procedures to address such risk like performing substantive analytical procedures relating to revenue, use of computer assisted audit techniques to identify unusual revenue transactions and testing controls pertaining to revenue transactions need to be performed.

2. Management failing to remedy known significant deficiencies in internal control on a timely basis is a fraud risk factor for misstatements arising from fraudulent financial reporting.

When management does not correct significant deficiencies in internal control on a timely basis, it reflects an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act.

Failure to rectify known control deficiencies pertaining to reconciliation of receivables and review of customer credit limits has the potential to fraud. Lack of timely reconciliation of receivables may lead to intentional misstatements. Further, non-reviewing customer limit may lead to grant of credit beyond creditworthiness of customers. It may result in intentional tying up of company's funds with risky customers due to collusion.

The above situation is a fraud risk factor for fraudulent financial reporting.

3. When the auditor becomes aware of the existence of or has information about investigations by government departments and regulatory organizations, it may be an indication of non-compliance with laws and regulations.

In the instant case, notice has been served upon the company by DGGI for allegedly creating fictitious invoices in guise of providing *"marketing and sales services"* for ₹ 50 crores. Issuing an invoice without supply of services is a serious offence under GST laws and it could involve

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penalties and imprisonment. Such suspected non-compliance may have a direct effect on financial statements.

The matter has also been informed to regulator i.e. IRDAI. Violation of IRDAI regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

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

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

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

If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice.

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

4. SA 260 requires the auditor to communicate with those charged with governance on a timely basis.

SA 701 states that the appropriate timing for communications about key audit matters will vary with the circumstances of the engagement. However, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit, and may further discuss such matters when communicating about audit findings. Doing so may help to alleviate the practical challenges of attempting to have a robust two-way dialogue about key audit matters at the time the financial statements are being finalized for issuance.

Communication with those charged with governance enables them to be made aware of the key audit matters that the auditor intends to communicate in the auditor's report, and provides them with an opportunity to obtain further clarification where necessary. The auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate this discussion.

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Communication with those charged with governance recognizes their important role in overseeing the financial reporting process, and provides the opportunity for those charged with governance to understand the basis for the auditor's decisions in relation to key audit matters and how these matters will be described in the auditor's report. It also enables those charged with governance to consider whether new or enhanced disclosures may be useful in light of the fact that these matters will be communicated in the auditor's report.

5. In respect of common areas, the joint auditors are only responsible for appropriateness of nature, timing and extent of planned audit procedures agreed among them. The responsibility of individual execution lies with concerned joint auditor.

In the instant case, audit procedures relating to testing design and operating effectiveness of controls over computer operations including back-up, batch-processing and data center security have been planned jointly as it is a common area.

However, audit procedures relating to testing controls over batch processing were actually performed by team of DES & Associates although these were planned jointly. In case of any lapses in performing such procedures, DES & Associates would be responsible.

Hints / Answers to Theoretical Questions:

1. Where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement. Therefore, B is not required to go by majority opinion of 2-1.

In such circumstances, the audit report issued by the joint auditors shall make a reference to the separate audit report issued by the other joint auditor. Further, separate audit report shall also make reference to the audit report issued by other joint auditors. Such reference shall be made under the heading "Other Matter Paragraph" as per SA 706.

2. As required in SA 260, in the case of listed entities, the auditor shall communicate with those charged with governance: -

(a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence and

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(b) i. All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor and

ii. The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

Further, as per the Companies Act, 2013 requires audit committee to review and monitor auditor's independence. Therefore, audit committee requiring auditor to justify her independence is well within its purview.

3. It needs to be verified that the company has put in place systems and procedures to meet with new regulatory requirements. The same can be verified by examining policies and procedures developed by company in this regard like devising appropriate system of internal control, sensitizing employees regarding new rules, engaging legal advisors etc.

Further, financial stability of the company may be threatened due to new regulatory requirements. The management may be under pressure. It is also a fraud risk factor and may need to be evaluated by auditor.

4. Refer Para 3.4

5. Refer Para 2.13

6. SA 260 "Communication with Those Charged with Governance" deals with auditor's responsibility to communicate with those charged with governance in relation to an audit of financial statements. Among various matters as included by CA Udhav in his list, one of the matters that is not mentioned in the list is Significant findings from the audit. With respect to such matter, the auditor shall communicate with those charged with governance: -

(a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is

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acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

(b) Significant difficulties, if any, encountered during the audit;

(c) Unless all of those charged with governance are involved in managing the entity: -

(i) Significant matters arising during the audit that were discussed, or subject to correspondence, with management;

(ii) Written representations the auditor is requesting

(d) Circumstances that affect the form and content of the auditor's report, if any and

(e) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.

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

7. Refer Para 6.8

Thus, in view of the above, contention of CA Akram in removing reference of the work done by service auditor is in order as in case of unmodified audit report, user auditor cannot refer to the work done by service auditor.

8. As per SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" and SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.

In accordance with SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" and SA 330, "The Auditor's Responses to Assessed Risks" the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level and assertion level.

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The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property. However, when there is a complex revenue structure or when there is lack of controls on revenue recognition, then there is a high probability of fraud risk in revenue recognition.

Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit.

In the current scenario, the company was earning revenue from multiple streams. Also, it was identified that the controls are not properly designed to mitigate the risk of fraud and risk of improper revenue recognition. During the year it was identified that the management did not account for revenue from corporate hotel bookings amounting to ₹ 43 crore. These amounts were partially received in the company's bank accounts and partially received in the CFO's personal account. The amounts received in the bank account of the company were disclosed as advances received against future bookings.

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

9. (i) Responses to the Assessed Risks of Material Misstatement due to Fraud at the Financial Statement Level: Refer Para 2.9

(ii) Audit Procedures Responsive to Assessed Risks of Material Misstatement due to Fraud at the Assertion Level: Refer Para 2.10

10. Refer Para 6.4

11. SA 250, "Considerations of Laws and Regulations in an Audit of Financial Statements" distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows:

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(i) The provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws; and

(ii) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties. Non-Compliance with such laws and regulations may, therefore, have a material effect on the financial statements.

For the compliance with provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements, the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations.

For other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements but compliance with which may be fundamental to the operating aspects of the business, the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

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

12. *As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.*

Specific Fraud Risk Factors Present in Alpha Tech Ltd.:

Incentives/Pressures:

- *A significant portion of the senior management's compensation is tied to achieving unrealistic profitability targets: Financial stability or profitability is*

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threatened by economic, industry, or entity operating conditions, such as rapid growth or unusual profitability especially compared to that of other companies in the same industry.

- *The company's financial results show rapid, unusual profitability compared to its competitors: Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as high degree of competition or market saturation, accompanied by declining margins.*

Opportunities:

- *A number of significant, complex, and unusual transactions occurred very close to the year-end: The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.*
- *High turnover of senior management and legal counsel in the past year: High turnover of senior management and legal counsel creates low morale among senior management.*

13. *Refer Para 2.13*

In the given case, CA F has identified material misstatements arising from fraud, namely fictitious sales of ₹20 crores and missing inventory of ₹8 crores supported by forged records. Despite due communication, both management and those charged with governance have refused to take corrective action, and the Managing Director has further attempted to intimidate the auditor by threatening legal action. These circumstances clearly constitute exceptional circumstances that cast serious doubt on the auditor's ability to continue the audit engagement with integrity and independence. Accordingly, CA F should take the abovementioned actions in compliance with SA 240 under the given circumstances.

14. *(i) Whether the given matters constitute significant findings requiring communication to TCWG: As per SA 260 "Communication with Those Charged with Governance", the auditor is required to communicate the following matters:*

I. The auditor shall communicate with those charged with governance the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the

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auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity. In this case, Management used a discount rate of 12% instead of 8%, resulting in understatement of recoverable amount by ₹ 2 crore; and overstatement of impairment loss. Use of an outdated discount rate indicates deficiency in management's estimation process and affects the appropriateness of accounting estimates. The incorrect discount rate resulted in a ₹ 2 crore overstatement of impairment loss/understatement of recoverable amount. Such a material error is a significant audit finding. Therefore, the inappropriate use of outdated discount rate constitutes a significant audit finding that must be communicated to TCWG under SA 260.

II. *The auditor shall communicate with those charged with governance significant difficulties, if any, encountered during the audit. Management delayed providing inventory records for 10 days, causing extensive extra effort to the auditor. This also constitutes a significant finding requiring communication to TCWG under SA 260.*

(ii) *Other significant findings that an auditor should communicate to "Those charged with governance":*

- *Unless all of those charged with governance are involved in managing the entity:-*
  - *Significant matters arising during the audit that were discussed, or subject to correspondence, with management;*
  - *Written representations the auditor is requesting;*
- *Circumstances that affect the form and content of the auditor's report, if any and*
- *Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.*

15. *As per SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor is responsible for obtaining reasonable assurance*

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that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.

As per SA 580, "Written Representations", if management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist.

In the instant case, the auditor observed that there was an investigation conducted at the instance of the management on a possible suspicion of fraud. Therefore, the auditor requested for investigation report which was not provided by the management despite of many reminders. The auditor also insisted for written representation in respect of fraud on/by the company. For this request also management remained silent.

It may be noted that, if management does not provide one or more of the requested written representations, the auditor shall discuss the matter with management; re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government (in case amount of fraud is ₹1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than ₹1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report as per Clause (xi) of Paragraph 3 of CARO, 2020, (a) whether any fraud by the company or any fraud on the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated; (b) whether any report under sub-section (12) of section 143 of the Companies Act has been filed by the auditors in Form ADT-4 as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the Central Government;

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

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

(ii) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(iii) If the auditor withdraws:

(1) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(2) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

16. Responsibility and Co-ordination among Joint Auditors: As per SA 299, "Joint Audit of Financial Statements", where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of the work would usually be in terms of audit identifiable units or specified area. In some cases, due to the nature of the business entity under audit, such a division of the work may not be possible. In such situations, the division of the work may be with reference to items of assets or liabilities or income or expenditure or with reference to period of time. The division of the work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

In respect of the audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate audit of the work performed by him. On the other hand all the joint auditors are jointly and severally responsible –

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

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(ii) Decisions taken by all the joint auditors under audit planning phase concerning the nature, timing and extent of the audit procedure to be performed by each of the auditor;

(iii) Matters which are bought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(iv) Examining that the financial statements of the entity comply with the requirements of the relevant statute;

(v) Presentation and disclosure of financial statements as required by the applicable financial reporting framework;

(vi) Ensuring that the audit report complies with the requirements of the relevant statutes, the applicable Standards on Auditing and the other relevant pronouncements issued by ICAI;

The joint auditors shall also discuss and document the nature, timing, and the extent of the audit procedures for common and specific allotted areas of audit to be performed by each of the joint auditors and the same shall be communicated to those charged with governance. After identification and allocation of work among the joint auditors, the work allocation document shall be signed by all the joint auditors and the same shall be communicated to those charged with governance of the entity.

Hence, in respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures.

In the instant case, Tree Ltd. appointed two CA Firms GH & Associates and IJ & Co. as joint auditors for conducting audit. As observed during the course of audit that there is a significant understatement in the value of trade receivable and valuation of trade receivable work was looked after by GH & Associates.

In view of SA 299, GH & Associates will be held responsible for the same as trade receivable valuation work was looked after by GH & Associates only. Further, there is violation of SA 299 as the division of work has not been documented.

17. *In the given scenario, CA. Yash, as the statutory auditor of SKY Hospital, is concerned about the effectiveness of controls at the service organization, specifically the system managed by CT Contractors. To address this concern, CT Contractors should provide a Type 2 assurance report from a practicing chartered accountant as per SA 402, "Audit*

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Considerations Relating to an Entity Using a Service Organisation". This report will offer an opinion on the description of the system in use at SKY Hospital, as well as evaluate the effectiveness of the controls implemented by CT Contractors.

Refer "Using a Type 2 report as audit evidence that controls at the service organisation are operating effectively" described under Para 6.6

18. *SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," emphasize that fraud can be perpetrated by management override of controls, such as the creation of fictitious journal entries, particularly towards the end of an accounting period, to manipulate operating results or achieve specific objectives.*

In the case of High Ltd., where purchases of ₹ 1.30 crore were recorded at year-end without supporting evidence, it became apparent during the investigation that the company had entered fictitious journal entries to manipulate the operating results.

Given this situation, the auditor would align their approach based on the impact of the misstatement resulting from such fictitious journal entries. If, due to fraud or suspected fraud, the auditor encounters exceptional circumstances that cast doubt on their ability to continue the audit, they must assess the professional and legal responsibilities applicable. This includes considering reporting obligations to those who appointed the auditor or, in some cases, to regulatory authorities. The appropriateness of withdrawal from the engagement is also a consideration, where legally permitted.

Furthermore, the auditor is mandated to report in accordance with Section 143(12) of the Companies Act, 2013. According to Section 143(12) read with Rule 13 of Companies (Audit & Auditor's) Rules, 2014, if the auditor, during the performance of their duties, has reason to believe that an offence of fraud involving an amount of ₹1 crore or more has been committed by the company's officers or employees, reporting to the Central Government is required in the prescribed manner.

Additionally, reporting obligations extend to Clause (xi) of Paragraph 3 of Companies (Auditor's Report) Order, 2020. The auditor is obligated to disclose whether any fraud by the company or against the company by its officers or employees has been observed or reported during the year. If affirmative, the nature and amount involved are to be indicated. This comprehensive reporting framework ensures transparency, adherence to legal requirements, and protection of stakeholders' interests in the face of potential fraudulent activities.

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