PAPER – 5: ADVANCED ACCOUNTING

PART – I: ANNOUNCEMENTS STATING APPLICABILITY & NON-APPLICABILITY For NOVEMBER, 2017 EXAMINATION

A. <u>Applicable for November, 2017 Examination</u>

I. <u>Companies Act, 2013</u>

Relevant Sections of the Companies Act, 2013 notified up to 30th April, 2017 will be applicable for November, 2017 Examination.

II. Amendments made by MCA in the Companies (Accounting Standards) Rules, 2006

Amendments made by MCA on 30.3.2016 in the Companies (Accounting Standards) Rules, 2006 have been made applicable for November, 2017 examination.

MCA has issued Companies (Accounting Standards) Amendment Rules, 2016 to amend Companies (Accounting Standards) Rules, 2006 by incorporating the references of the Companies Act, 2013, wherever applicable. Also, the Accounting Standard (AS) 2, AS 4, AS 10, AS 13, AS 14, AS 21 and AS 29 as specified in these Rules will substitute the corresponding Accounting Standards with the same number as specified in Companies (Accounting Standards) Rules, 2006.

Following table summarizes the changes made by the Companies (Accounting Standards) Amendment Rules, 2016 vis a vis the Companies (Accounting Standards) Rules, 2006 in the accounting standards relevant for Paper 5:

Name of the standard	Para no.	As per the Companies (Accounting Standards) Rules, 2006	As per the Companies (Accounting Standards) Amendment Rules, 2016	Implication
AS 4	Footnote to AS 4	Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory in respect of accounting periods commencing on or after 1-4-2004, all paragraphs of this Standard that deal	All paragraphs of this Standard that deal with contingencies are applicable only to the extent not covered by other Accounting Standards prescribed by the Central Government. For example, the	Footnote has been modified.

		with contingencies (viz. paragraphs 1(a), 2, 3.1, 4 (4.1 to 4.4), 5 (5.1 to 5.6), 6, 7 (7.1 to 7.3), 9.1 (relevant portion), 9.2, 10, 11, 12 and 16) stand withdrawn except to the extent they deal with impairment of assets not covered by other Indian Accounting Standards. For example, impairment of receivables (commonly referred to as the provision for bad and doubtful debts), would continue to be covered by AS 4.	impairment of financial assets such as impairment of receivables (commonly known as provision for bad and doubtful debts) is governed by this Standard.	
	8.5	There are events which, although they take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered by the financial statements.	There are events which, although they take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. For example, if dividends are declared after the balance sheet date but before the financial statements are approved for issue, the dividends are not recognized as a liability at the balance sheet date	No liability for proposed dividends must be created now. Such proposed dividends are to be disclosed in the notes.

			because no obligation exists at that time unless a statute requires otherwise. Such dividends are disclosed in the notes.	
	14	Dividends stated to be in respect of the period covered by the financial statements, which are proposed or declared by the enterprise after the balance sheet date but before approval of the financial statements, should be adjusted.	If an enterprise declares dividends to shareholders after the balance sheet date, the enterprise should not recognise those dividends as a liability at the balance sheet date unless a statute requires otherwise. Such dividends should be disclosed in notes.	No liability for proposed dividends should be created now. Such proposed dividends are to be disclosed in the notes.
AS 14	3(a)	Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies.	Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 2013 or any other statute which may be applicable to companies and includes 'merger'.	Definition of Amalgamation has been made broader by specifically including 'merger'.
	18 and 39	In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g.,	In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g.,	Corresponding debit on account of statutory reserve in case of amalgamation in the nature of

		‘Amalgamation Adjustment Account’) which is disclosed as a part of ‘miscellaneous expenditure’ or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.	‘Amalgamation Adjustment Reserve’) which is presented as a separate line item. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.	purchase is termed as ‘Amalgamation Adjustment Reserve’ and is now to be presented as a separate line item since there is not sub-heading like ‘miscellaneous expenditure’ in Schedule III to the Companies Act, 2013
AS 29	35 (An extract)	The amount of a provision should not be discounted to its present value.	The amount of a provision should not be discounted to its present value except in case of decommissioning, restoration and similar liabilities that are recognised as cost of Property, Plant and Equipment. The discount rate (or rates) should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s)	Now discounting of provision for decommissioning, restoration and similar liabilities should be done as per the pre-tax discount rate as mentioned therein.

			should not reflect risks for which future cash flow estimates have been adjusted. Periodic unwinding of discount should be recognized in the statement of profit and loss.	
	73		**Transitional Provisions** All the existing provisions for decommissioning, restoration and similar liabilities (see paragraph 35) should be discounted prospectively, with the corresponding effect to the related item of property, plant and equipment.	Discounting of above existing provisions and similar liabilities should be prospectively, with the corresponding effect to the related item of property, plant and equipment.

III Maintenance of Statutory Liquidity Ratio (SLR)

In exercise of the powers conferred by sub-section (2A) of Section 24 read with Section 51 and Section 56 of the Banking Regulation Act, 1949 (10 of 1949) and in partial modification of the Notification DBR.No.Ret.BC.63/12.01.001/2015-16 dated December 10, 2015, the Reserve Bank hereby specifies that:

(i) with effect from the dates given below, every scheduled commercial bank, local area bank, primary co-operative bank, state co-operative bank and central cooperative bank shall maintain in India assets (hereinafter referred to as 'SLR assets') the value of which shall not, at the close of business on any day, be less than:

(a) 20.75 per cent from October 1, 2016; and

(b) 20.50 per cent from January 7, 2017

of their total net demand and time liabilities in India as on the last Friday of the second preceding fortnight, valued in accordance with the method of valuation specified by the Reserve Bank from time to time; and

(ii) such SLR assets shall be maintained by:

A. Scheduled commercial banks and local area banks, as -

(a) cash; or

(b) gold as defined in Section 5(g) of Banking Regulation Act, 1949 valued at a price not exceeding the current market price: or

(c) unencumbered investment in any of the following instruments [hereinafter referred to as Statutory Liquidity Ratio securities ("SLR securities")], namely:-

(1) Dated securities of the Government of India issued from time to time under the market borrowing programme and the Market Stabilization Scheme; or

(2) Treasury Bills of the Government of India; or 3) State Development Loans (SDLs) of the State Governments issued from time to time under the market borrowing programme:

(d) the deposit and unencumbered approved securities required, under sub-section (2) of section 11 of the Banking Regulation Act, 1949(10 of 1949), to be made with the Reserve Bank by a banking company incorporated outside India;

(e) any balance maintained by a scheduled bank with the Reserve Bank in excess of the balance required to be maintained by it under section 42 of the Reserve Bank of India Act,1934 (2 of 1934);

Provided that the instruments referred to in items (1) to (3) above that have been acquired under reverse repo with Reserve Bank of India, shall not be included as SLR securities for the purpose of maintenance of SLR assets up to October 2, 2016.

IV Maintenance of Cash Reserve Ratio (CRR)

Reserve Bank of India has decided to reduce the Cash Reserve Ratio (CRR) of Scheduled Commercial Banks by 25 basis points from 4.25 per cent to ***4.00 per cent of their Net Demand and Time Liabilities (NDTL)*** with effect from the fortnight beginning February 09, 2013 vide circular DBOD.No.Ret.BC.76/ 12.01.001 /2012-13 dated January 29, 2013. The Local Area Banks shall also maintain CRR at 3.00 per cent of its net demand and time liabilities up to February 08, 2013 and 4.00 per cent of its net demand and time liabilities from the fortnight beginning from February 09, 2013.

B. <u>Not applicable for November, 2017examination</u>

Non-Applicability of Ind AS for November, 2017 Examination

The Ministry of Corporate Affairs has notified Companies (Indian Accounting Standards) Rules, 2015 on 16th February, 2015, for compliance by certain class of companies. These Ind AS have not been made applicable for November, 2017 Examination.

PART – II : QUESTIONS AND ANSWERS

QUESTIONS

Sale of Partnership firm to Company

1. XYZ & Co. is a partnership firm consisting of Mr. X, Mr. Y and Mr. Z who share profits and losses in the ratio of 2:2:1 and ABC Ltd. is a company doing similar business.

Following is the summarized Balance Sheet of the firm and that of the company as at 31.3.2017:

Liabilities	XYZ & Co. ₹	ABC Ltd. ₹		XYZ & Co. ₹	ABC Ltd. ₹
Equity share capital:			Plant & machinery	5,00,000	16,00,000
Equity shares of ₹ 10 each		20,00,000	Furniture & fixture	50,000	2,25,000
Partners capital:			Inventories	2,00,000	8,50,000
X	2,00,000		Trade receivables	2,00,000	8,25,000
Y	3,00,000		Cash at bank	10,000	4,00,000
Z	1,00,000		Cash in hand	40,000	1,00,000
General reserve	1,00,000	7,00,000			
Trade payables	3,00,000	13,00,000			
	10,00,000	40,00,000		10,00,000	40,00,000

It was decided that the firm XYZ & Co. be dissolved and all the assets (except cash in hand and cash at bank) and all the liabilities of the firm be taken over by ABC Ltd. by issuing 50,000 shares of ₹ 10 each at a premium of ₹ 2 per share.

Partners of XYZ & Co. agreed to divide the shares issued by ABC Ltd. in the profit sharing ratio and bring necessary cash for settlement of their capital.

The trade payables of XYZ & Co. includes ₹ 1,00,000 payable to ABC Ltd. An unrecorded liability of ₹ 25,000 of XYZ & Co. must also be taken over by ABC Ltd.

Prepare:

(i) Realisation account, Partners' capital accounts and Cash in hand/Bank account in the books of XYZ & Co.

(ii) Pass journal entries in the books of ABC Ltd. for acquisition of XYZ & Co. and draw the Balance Sheet after the takeover.

Conversion of Partnership Firm to Company

2. A and V, sharing profits and losses equally, desired to convert their business into a limited company on 31st December, 2016 when their balance sheet stood as follows:

Liabilities	₹	₹	*Assets*	₹
Sundry creditors		1,92,000	Sundry debtors	2,40,000
Loan creditors		1,60,000	Bills receivable	40,000
Bank overdraft		64,000	Stock in trade	1,44,000
Reserve fund		24,000	Patents	32,000
Capital accounts:			Plant and machinery	64,000
A	1,60,000		Land and building	2,40,000
V	1,60,000	3,20,000		
		7,60,000		7,60,000

(a) The goodwill of the firm was to be valued at two years' purchase of the profits average of the previous three years.

(b) The loan creditor was agreed to accept 7½% redeemable preference shares in settlement of his claim.

(c) Land and buildings and plant and machinery were to be valued at ₹ 4,00,000 and ₹ 96,000 respectively.

(d) The vendors (sundry creditors) were to be allotted equity shares of the value of ₹ 4,20,000.

(e) The past working results of the firm showed that they had made profits of ₹ 1,20,000 in 2014, ₹ 1,44,000 in 2015 and ₹ 1,68,000 in 2016 after setting aside ₹ 8,000 to reserve fund each year.

You are required to show realisation account and partners' capital accounts in the books of the firm assuming that all the transactions are duly completed.

Amalgamation of Partnership firms

3. A and B are partners of AB & Co. sharing profits and losses in the ratio of 2:1 and C and D are partners of CD & Co. sharing profits and losses in the ratio of 3:2. On 1st April 2017, they decided to amalgamate and form a new firm M/s. AD & Co. wherein all the partners

of both the firm would be partners sharing profits and losses in the ratio of 2:1:3:2 respectively to A,B,C and D.

Their balance sheets on that date were as under:

Liabilities	*AB & Co. (₹)*	*CD & Co. (₹)*	*Assets*	*AB & Co. (₹)*	*CD & Co. (₹)*
Capitals					
A	1,50,000		Building	75,000	90,000
B	1,00,000		Machinery	1,20,000	1,00,000
C		1,20,000	Furniture	15,000	12,000
D		80,000	Inventory	24,000	36,000
Reserve	66,000	54,000	Debtors	65,000	78,000
Creditors	52,000	35,000	Due from CD		
Due to AB		47,000	& Co.	47,000	
& Co.			Cash at Bank	18,000	15,000
			Cash in hand	4,000	5,000
	3,68,000	3,36,000		3,68,000	3,36,000

The amalgamated firm took over the business on the following terms:

(a) Building was taken over at ₹ 1,00,000 and ₹ 1,25,000 of AB & Co. and CD & Co. respectively and Machinery was taken over at ₹ 1,25,000 and ₹ 1,10,000 of AB & Co. and CD & Co. respectively.

(b) Goodwill of AB & Co. was worth ₹ 75,000 and that of CD & Co. was worth ₹ 50,000. Goodwill account was not to be opened in the books of the new firm, the adjustments being recorded through capital accounts of the partners.

(c) Provision for doubtful debts has to be carried forward at ₹ 5,000 in respect of debtors of AB & Co. and ₹ 8,000 in respect of CD & Co.

You are required to:

(i) Compute the adjustments necessary for goodwill.

(ii) Pass the Journal Entries in the books of AD & Co. assuming that excess/deficit capital (taking D's capital as base) with reference to share in profits are to be transferred to current accounts.

Dissolution of partnership firm

4. (a) The partners P, Q & R have called you to assist them in winding up the affairs of their partnership on 31.12.2016. Their balance sheet as on that date is given below:

Liabilities	*Amount ₹*	*Assets*	*Amount ₹*
Capital Accounts:		Land & Building	50,000

P	65,000	Plant & Machinery	46,000
Q	50,500	Furniture & Fixture	10,000
R	32,000	Stock	14,500
Creditors	16,000	Debtors	14,000
		Cash at Bank	9,000
		Loan P	13,000
		Loan Q	7,000
Total	1,63,500	Total	1,63,500

(a) The partners share profit and losses in the ratio of 4:3:2.

(b) Cash is distributed to the partners at the end of each month.

(c) A summary of liquidation transactions are as follows:

January 2017

- ₹ 9,000 - collected from debtors; balance is uncollectable.
- ₹ 8,000 - received from the sale of entire furniture
- ₹ 1,000 - Liquidation expenses paid.
- ₹ 6,000 - Cash retained in the business at the end of month

February 2017

- ₹ 1,000 - Liquidation expenses paid.
- As part payment of his capital, R accepted a machinery for ₹ 9,000 (book value ₹ 3,500)
- ₹ 2,000 - Cash retained in the business at the end of month

March 2017

- ₹ 38,000 - received on the sale of remaining plant and machinery.
- ₹ 10,000 - received from the sale of entire stock.
- ₹ 1,700 - Liquidation expenses paid.
- ₹ 41,000 - Received on sale of land & building.
- No Cash is retained in the business.

You are required to prepare a schedule of cash payments amongst the partners by "Higher Relative Capital Method".

Issues related to Accounting in LLPs

(b) What are the liabilities of designated partners in a LLP. Explain in brief.

ESOPs

5. A company has its share capital divided into shares of ₹ 10 each. On 1-1-20X1, it granted 5,000 employees stock options at ₹ 50, when the market price was ₹ 140. The options were to be exercised between 1-3-20X2 to 31-03-20X2. The employees exercised their options for 4,800 shares only; remaining options lapsed. Pass the necessary journal entries for the year ended 31-3-20X2, with regard to employees' stock options.

Buy Back of Securities

6. Alpha Limited furnishes the following summarized Balance Sheet as at 31st March, 2017:

Liabilities	*(₹ in lakhs)*	*Assets*	*(₹ in lakhs)*
Equity share capital	2,400	Machinery	3,600
(fully paid up shares of ₹ 10 each)		Furniture	450
Securities premium	350	Investment	148
General reserve	530	Inventory	1,200
Capital redemption reserve	400	Trade receivables	500
Profit & loss A/c	340	Cash at bank	1,500
12% Debentures	1,500		
Trade payables	1,400		
Other current liabilities	478		
	7,398		7,398

On 1st April, 2017, the company announced the buy back of 25% of its equity shares @ ₹ 15 per share. For this purpose, it sold all of its investments for ₹ 150 lakhs.

On 5th April, 2017, the company achieved the target of buy back.

You are required to:

(1) Pass necessary journal entries for the buy-back.

(2) Prepare Balance Sheet of Alpha Limited after buy-back of the shares.

Redemption of Debentures

7. Malik Ltd. have authorized capital of 8,00,000 equity shares of ₹ 10 each. But out of these 2,40,000 shares have been issued as fully paid.

The company has an outstanding 14% Debentures loan of ₹ 24,00,000 redeemable at 102 per cent and interest has been paid up to date on December 31, 2016. On that date, the balance of the Debenture Redemption Reserve Account is ₹ 20,00,000 and corresponding Investment Account ₹ 20,00,000 (at cost) of which the market value is ₹ 18,00,000.

The directors resolved to redeem the Debentures on January 1, 2017 and the holders are given an option to receive payment either wholly in cash or wholly in fully paid equity shares @ 8 shares for every ₹ 100 of debentures.

75% of the holders decided to exercise the option for taking shares in repayment and cash for the rest is procured by realizing an adequate amount of investment at the prevailing market value.

Draw up journal entries (including Cash Book Entries) to give effect to the above transactions.

Underwriting of Shares and Debentures

8. Differentiate between "Firm underwriting" and "Partial underwriting along with firm underwriting".

Amalgamation of Companies

9. The following were the summarized Balance Sheets of P Ltd. and V Ltd. as at 31-3-20X1:

Liabilities	P Ltd. (₹ in lakhs)	V Ltd. (₹ in lakhs)
Equity Share Capital (Fully paid shares of ₹ 10 each)	15,000	6,000
Securities Premium	3,000	–
Foreign Project Reserve	–	310
General Reserve	9,500	3,200
Profit and Loss Account	2,870	825
12% Debentures	–	1,000
Trade payables	1,200	463
Provisions	1,830	702
	33,400	12,500

Assets	P Ltd. (₹ in lakhs)	V Ltd. (₹ in lakhs)
Land and Buildings	6,000	–
Plant and Machinery	14,000	5,000
Furniture, Fixtures and Fittings	2,304	1,700
Inventory	7,862	4,041
Trade receivables	2,120	1,100
Cash at Bank	1,114	609
Cost of Issue of Debentures	—	50
	33,400	12,500

All the bills receivable held by V Ltd. were P Ltd.'s acceptances.

On 1st April 20X1, P Ltd. took over V Ltd in an amalgamation in the nature of merger. It was agreed that in discharge of consideration for the business P Ltd. would allot three fully paid equity shares of ₹ 10 each at par for every two shares held in V Ltd. It was also agreed that 12% debentures in V Ltd. would be converted into 13% debentures in P Ltd. of the same amount and denomination.

Details of trade receivables and trade payables as under:

Assets	P Ltd. (₹ in lakhs)	V Ltd. (₹ in lakhs)
Trade payables		
Bills Payable	120	-
Creditors	1,080	463
	1,200	**463**
Trade receivables		
Debtors	2,120	1,020
Bills Receivable	—	80
	2,120	**1,100**

Expenses of amalgamation amounting to ₹ 1 lakh were borne by P Ltd.

You are required to:

(i) Pass journal entries in the books of P Ltd. and

(ii) Prepare P Ltd.'s Balance Sheet immediately after the merger considering that the cost of issue of debentures shown in the balance sheet of the V Ltd. company is not transferred to the P Ltd. company.

Internal Reconstruction of a Company

10. Following is the summarized Balance Sheet of Ravi Limited as on 31st March, 2017.

Balance Sheet as on 31st March 2017

Liabilities	Amount ₹	Assets	Amount ₹
Authorised and Issued equity share capital:		Patent	4,00,000
30,000 shares of ₹100 each fully paid	30,00,000	Plant & machinery	30,00,000
20,000 7% cumulative preference shares of ₹100 each fully paid	20,00,000	Building	5,50,000
General Reserve	6,00,000	Trade receivables	23,50,000
Loan from Director	4,40,000	Inventory	16,30,000

Trade Payables	24,60,000	Cash	1,20,000
Outstanding expenses	3,20,000	Bank Balance	2,30,000
Declared dividend	3,00,000	Profit and Loss account	8,40,000
	91,20,000		**91,20,000**

Note: The arrears of preference dividend amount to ₹ 2,80,000.

The company had suffered losses since last 3 years due to bad market conditions and hope for a better position in the future.

The following scheme of reconstruction has been agreed upon and duly approved by all concerned:

(1) Equity shares to be converted into 3,00,000 shares of ₹10 each.

(2) Equity shareholders to surrender to the company 80 percent of their holdings.

(3) Preference shareholders agree to forgo their right on arrears of dividends in consideration of which 7% preference shares are to be converted into 8% preference shares.

(4) Trade payables agree to reduce their claim by one fourth in consideration of their getting shares of ₹ 5,00,000 out of the surrendered equity shares.

(5) Directors agree to forego the amounts due on account of loan.

(6) Surrendered shares not otherwise utilized to be cancelled.

(7) Assets to be reduced as under:

	₹
Patent by	4,00,000
Plant & Machinery by	4,00,000
Inventory by	3,40,000

(8) Trade receivables to the extent of ₹ 17,00,000 are considered good.

(9) Revalued figures for building is accepted at ₹ 7,00,000.

(10) Declared dividend is paid to the equity shareholders.

(11) Any surplus after meeting the losses should be utilized in writing down the value of the plant further.

(12) Expenses of reconstruction amounted to ₹ 60,000.

(13) Further 40,000 equity shares were issued to the existing members for increasing the working capital. The issue was fully subscribed and paid up.

You are required to pass the Journal Entries for giving effect to the above arrangement and also to draw up the resultant Balance Sheet of the Company.

Liquidation of Company

11. The following is the summarized Balance Sheet of Shah Ltd. Co. which is in the hands of the liquidator:

Balance Sheet as at 31.3.2017

Liabilities	₹	*Assets*	₹
Share Capital:		Fixed assets	2,00,000
1,000, 6% Preference Shares of ₹ 100 each, fully paid	1,00,000	Inventory Book debts	1,20,000 2,40,000
2,000 Equity shares of ₹ 100 each, fully paid	2,00,000	Cash in hand Profit and loss A/c	40,000 3,00,000
2,000 Equity shares of ₹ 100 each ₹ 75 paid up	1,50,000		
Loan from bank (on security of stock)	1,00,000		
Trade Payables	3,50,000		
	9,00,000		9,00,000

The assets realized the following amounts (after all costs of realization and liquidator's commission amounting to ₹ 5,000 paid out of cash in hand).

	₹
Fixed assets	1,68,000
Inventory	1,10,000
Trade Receivables	2,30,000

Calls on partly paid shares were made but the amounts due on 200 shares were found to be irrecoverable.

You are required to prepare Liquidator's Final Statement of Receipts and Payments.

Financial Statements of Insurance Companies

12. X Fire Insurance Co. Ltd. commenced its business on 1.4.20X1. It submits you the following information for the year ended 31.3.20X2:

	₹
Premiums received	15,00,000
Re-insurance premiums paid	1,00,000
Claims paid	7,00,000

Expenses of Management	3,00,000
Commission paid	50,000
Claims outstanding on 31.3.20X2	1,00,000
Create reserve for unexpired risk @50%	

Prepare Revenue account for the year ended 31.3.20X2.

Banking Companies

13. The following facts have been taken out from the records of City Bank Ltd. as on 31st March, 2017:

	₹	₹
Rebate on bill discounted (not due on March 31st, 2016)		91,600
Discount received		4,05,000
Bill discounted	24,50,000	

An analysis of the bills discounted is as follows:

	Amount	*Due date*	*Rate of discount*
	₹	*2017*	
(i)	7,50,000	April 8	12%
(ii)	3,00,000	May 5	14%
(iii)	4,40,000	June 12	14%
(iv)	9,60,000	July 15	15%

You are required to:-

(i) Calculate Rebate on Bill Discounted as on 31st March, 2017.

(ii) The amount of discount to be credited to the profit and loss account.

Departmental Accounts

14. The following balances were extracted from the books of M/s Division. You are required to prepare Departmental Trading Account and Profit and Loss account for the year ended 31st December, 2016 after adjusting the unrealized department profits if any.

	Deptt. A ₹	*Deptt. B* ₹
Opening Stock	50,000	40,000
Purchases	6,50,000	9,10,000
Sales	10,00,000	15,00,000

General expenses incurred for both the departments were ₹ 1,25,000 and you are also supplied with the following information: (a) Closing stock of Department A ₹ 1,00,000 including goods from Department B for ₹ 20,000 at cost of Department A. (b) Closing stock of Department B ₹ 2,00,000 including goods from Department A for ₹ 30,000 at cost to Department B. (c) Opening stock of Department A and Department B include goods of the value of ₹ 10,000 and ₹ 15,000 taken from Department B and Department A respectively at cost to transferee departments. (d) The rate of gross profit is uniform from year to year.

Branch Accounting

15. ABC Ltd. has head office at Delhi (India) and branch at New York (U.S.A). New York branch is an integral foreign operation of ABC Ltd. New York branch furnishes you with its trial balance as on 31st March, 2017 and the additional information given thereafter:

	Dr. ($)	*Cr. ($)*
Stock on 1st April, 2016	150	–
Purchases and sales	400	750
Sundry Debtors and creditors	200	150
Bills of exchange	60	120
Sundry expenses	540	–
Bank balance	210	–
Delhi head office A/c	–	540
	1,560	1,560

The rates of exchange may be taken as follows:

- on 1.4.2016 @ ₹ 40 per US $
- on 31.3.2017 @ ₹ 42 per US $
- average exchange rate for the year @ ₹ 41 per US $.

New York branch account showed a debit balance of ₹ 22,190 on 31.3.2017 in Delhi books and there were no items pending reconciliation.

You are asked to prepare trial balance of New York branch in ₹ in the books of ABC Ltd.

Framework for Preparation and Presentation of Financial Statements

16. (a) With regard to financial statements name any four.
    (1) Users
    (2) Qualitative characteristics
    (3) Elements
    (b) What are fundamental accounting assumptions?

AS 4

17. (a) A company deals in petroleum products. The sale price of petrol is fixed by the government. After the Balance Sheet date, but before the finalisation of the company's accounts, the government unexpectedly increased the price retrospectively. Can the company account for additional revenue at the close of the year? Discuss in line with provisions of AS 4.

AS 5

(b) Explain whether the following will constitute a change in accounting policy or not as per AS 5.

(i) Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement.

(ii) Management decided to pay pension to those employees who have retired after completing 5 years of service in the organistaion. Such employees will get pension of ₹ 20,000 per month. Earlier there was no such scheme of pension in the organization.

AS 11

18. (a) A company had imported raw materials worth US Dollars 6,00,000 on 5th January, 2017, when the exchange rate was ₹ 43 per US Dollar. The company had recorded the transaction in the books at the above mentioned rate. The payment for the import transaction was made on 5th April, 2017 when the exchange rate was ₹ 47 per US Dollar. However, on 31st March, 2017, the rate of exchange was ₹ 48 per US Dollar. The company passed an entry on 31st March, 2017 adjusting the cost of raw materials consumed for the difference between ₹ 47 and ₹ 43 per US Dollar.

In the background of the relevant accounting standard, is the company's accounting treatment correct? Discuss.

AS 12

(b) S Ltd. received a grant of ₹ 5,000 lakhs during the last accounting year (2015-16) from government for welfare activities to be carried on by the company for its employees. The grant prescribed conditions for its utilization. However, during the year 2016-17, it was found that the conditions of grants were not complied with and the grant had to be refunded to the government in full. Elucidate the correct accounting treatment, with reference to the provisions of AS 12.

AS 16

19. (a) Suhana Ltd. issued 12% secured debentures of ₹ 100 Lakhs on 01.05.2016, to be utilized as under:

Particulars	*Amount (₹ in lakhs)*
Construction of factory building	40

Purchase of Machinery	35
Working Capital	25

In March 2017, construction of the factory building was completed and machinery was installed and ready for it's intended use. Total interest on debentures for the financial year ended 31.03.2017 was ₹ 11,00,000. During the year 2016-17, the company had invested idle fund out of money raised from debentures in banks' fixed deposit and had earned an interest of ₹ 2,00,000.

Show the treatment of interest under Accounting Standard 16 and also explain nature of assets.

AS 26

(b) During 2016-17, an enterprise incurred costs to develop and produce a routine, low risk computer software product, as follows:

	Amount (₹)
Completion of detailed programme and design	25,000
Coding and Testing	20,000
Other coding costs	42,000
Testing costs	12,000
Product masters for training materials	13,000
Packing the product (1,000 units)	11,000

What amount should be capitalized as software costs in the books of the company, on Balance Sheet date?

AS 20

20. (a) Compute Basic and Adjusted Earnings per share from the following information:

Net Profit for 2015-16	₹ 22 lakhs
Net Profit for 2016-17	₹ 33 lakhs
No. of shares before Rights Issue	1,10,000
Rights issue Ratio	One for Every Four Held
Rights Issue Price	₹ 180
Date of exercising Rights option	31.7.2016 (fully subscribed on this date)
Fair value of share before Rights Issue	₹ 270

All workings may be rounded off to two decimals.

AS 29

(b) An airline is required by law to overhaul its aircraft once in every five years. The pacific Airlines which operate aircrafts does not provide any provision as required by law in its final accounts. Discuss with reference to relevant Accounting Standard 29.

SUGGESTED ANSWERS

1. (i) In the books of XYZ & Co.

Realisation Account

		₹			₹
To	Plant & Machinery	5,00,000	By	Trade payables	3,00,000
To	Furniture & Fixture	50,000	By	ABC Ltd. (Refer W.N.)	6,00,000
To	Inventories	2,00,000	By	Partners' Capital Accounts (loss):	
To	Trade receivables	2,00,000		X's Capital A/c	20,000
				Y's Capital A/c	20,000
				Z's Capital A/c	10,000
		9,50,000			9,50,000

Partners' Capital Accounts

		X ₹	Y ₹	Z ₹			X ₹	Y ₹	Z ₹
To	Realisation A/c	20,000	20,000	10,000	By	Balance b/d	2,00,000	3,00,000	1,00,000
To	Shares in ABC Ltd.	2,40,000	2,40,000	1,20,000	By	General Reserve	40,000	40,000	20,000
To	Cash A/c	-	80,000	-	By	Cash A/c	20,000	-	10,000
		2,60,000	3,40,000	1,30,000			2,60,000	3,40,000	1,30,000

Cash and Bank Account

		Cash ₹	Bank ₹			Cash ₹	Bank ₹
To	Balance b/d	40,000	10,000	By	Cash A/c (Contra)*		10,000
To	Bank A/c (Contra)*	10,000		By	Y	80,000	
To	X	20,000					

*It is assumed that cash at bank has been withdrawn to pay ₹ 80,000 to partner Y. However, payment to Y of ₹ 80,000 can also be made by cash ₹ 70,000 & by cheque ₹ 10,000.

To Z	10,000				
	80,000	10,000		80,000	10,000

(ii) In the Books of ABC Ltd.

Journal Entries

			Dr. (₹)	*Cr. (₹)*
1.	Business Purchase Account	Dr.	6,00,000	
	To XYZ & Co.			6,00,000
	(Being business of XYZ & Co. purchased and payment due)			
2.	Plant and Machinery Account	Dr.	5,00,000	
	Furniture and Fixture Account	Dr.	50,000	
	Inventories Account	Dr.	2,00,000	
	Trade Receivables Account	Dr.	2,00,000	
	To Trade Payables Account			3,00,000
	To Unrecorded Liability Account			25,000
	To Business Purchase Account			6,00,000
	To Capital Reserve Account (Bal. Fig.)			25,000
	(Being take over of all assets and liabilities)			
3.	XYZ & Co.	Dr.	6,00,000	
	To Equity Share Capital Account			5,00,000
	To Securities Premium Account			1,00,000
	(Being purchase consideration discharged in the form of shares of ₹ 10 each issued at a premium of ₹ 2 each)			
4.	Trade Payables Account	Dr.	1,00,000	
	To Trade Receivables Account			1,00,000
	(Being mutual owings eliminated)			

Balance Sheet of ABC Ltd. (After take over of XYZ & Co.)

as at 31.3.2017

	Note No.	*₹*
Equity and Liabilities		
Shareholders funds		

Share capital	1	25,00,000
Reserve and Surplus	2	8,25,000
Current liabilities		
Trade Payables (3,00,000 + 13,00,000 – 1,00,000)		15,00,000
Others (Unrecorded Liability)		25,000
Total		48,50,000
Assets		
Non-current assets		
Fixed assets		
Tangible assets	3	23,75,000
Current assets		
Inventories (2,00,000 + 8,50,000)		10,50,000
Trade Receivables (2,00,000 + 8,25,000 – 1,00,000)		9,25,000
Cash and cash equivalent	4	5,00,000
Total		48,50,000

Notes to Accounts

			₹
1.	*Share Capital*		
	2,50,000, Equity shares of ₹ 10 each fully paid up		25,00,000
	(out of which 50,000 shares has been issued for consideration other than cash)		
2	*Reserve and Surplus*		
	Securities Premium	1,00,000	
	Capital Reserve	25,000	
	General Reserve	7,00,000	8,25,000
3.	*Tangible assets*		
	Plant and Machinery (5,00,000 + 16,00,000)	21,00,000	
	Furniture and fixture (50,000 + 2,25,000)	2,75,000	23,75,000
4.	*Cash and cash equivalent*		
	Cash at Bank	4,00,000	
	Cash in hand	1,00,000	5,00,000

Working Note:

Computation of purchase consideration:

50,000, Equity shares of ₹ 12 (10+2) each = ₹ 6,00,000

Equity shares distributed among partners:

Partner X	=	20,000 shares @ ₹ 12	= ₹ 2,40,000
Partner Y	=	20,000 shares @ ₹ 12	= ₹ 2,40,000
Partner Z	=	10,000 shares @ ₹ 12	= ₹ 1,20,000
			₹ 6,00,000

2. **Books of A and V**

Realisation Account

	₹	₹		₹
To Sundry debtors		2,40,000	By Sundry creditors	1,92,000
To Bills receivable		40,000	By Loan creditors	1,60,000
To Stock in trade		1,44,000	By Bank overdraft	64,000
To Patents		32,000	By Purchasing Company	8,40,000
To Plant and Machinery		64,000	(W.N. 2)	
To Land and Building		2,40,000		
To Capital A/c (Profit)				
A	2,48,000			
V	2,48,000	4,96,000		
		12,56,000		12,56,000

Partners' Capital Accounts

	A	V		A	V
	₹	₹		₹	₹
To Shares in Purchasing Co.	4,20,000	4,20,000	By Balance b/d	1,60,000	1,60,000
			By Reserves	12,000	12,000
			By Realization A/c	2,48,000	2,48,000
	4,20,000	4,20,000		4,20,000	4,20,000

Working Notes:

1. Goodwill = (1,20,000 + 1,44,000 + 1,68,000 + 24,000*)/3 x 2 Years = 3,04,000

   * Profit transferred to reserve @ ₹ 8,000 for 3 years.

2. **Calculation of Purchase Consideration**

	₹	₹
Assets taken over:		
Goodwill (W.N.1)		3,04,000
Land and Buildings		4,00,000
Plant and Machinery		96,000
Debtors		2,40,000
Bills Receivable		40,000
Stocks		1,44,000
Patents		32,000
		12,56,000
Less: Liabilities taken over:		
Creditors	1,92,000	
Loan Creditors	1,60,000	
Bank Overdraft	64,000	4,16,000
Purchase Consideration		8,40,000

3. (i) Adjustment for raising & writing off of goodwill

	Goodwill raised in old profit sharing ratio			*Goodwill written off in new ratio*	*Difference*
	AB & Co.	*CD & Co.*	*Total*	*AD & Co.*	
	₹	₹	₹	₹	₹
A	50,000		50,000 Cr.	31,250 Dr.	18,750 Cr.
B	25,000		25,000 Cr.	15,625 Dr.	9,375 Cr.
C		30,000	30,000 Cr.	46,875 Dr.	16,875 Dr.
D		20,000	20,000 Cr.	31,250 Dr.	11,250 Dr.
	75,000	50,000	1,25,000	1,25,000	

(ii) In the books of AD & Co.

Journal Entries

Date	*Particulars*		*Debit*	*Credit*
			₹	₹
April 1, 2017	Building A/c	Dr.	1,00,000	
	Machinery A/c	Dr.	1,25,000	
	Furniture A/c	Dr.	15,000	

	Stock A/c	Dr.	24,000	
	Debtors A/c	Dr.	65,000	
	CD & Co. A/c	Dr.	47,000	
	Cash at bank A/c	Dr.	18,000	
	Cash in hand A/c	Dr.	4,000	
	To Provision for doubtful debts A/c			5,000
	To Creditors A/c			52,000
	To A's capital A/c (W.N. 2a)			2,10,667
	To B's capital A/c (W.N.2 a)			1,30,333
	(Being the sundry assets and liabilities of AB & Co. taken over at the values stated as per the agreement)			
April 1, 2017	Building A/c	Dr.	1,25,000	
	Machinery A/c	Dr.	1,10,000	
	Furniture A/c	Dr.	12,000	
	Stock A/c	Dr.	36,000	
	Debtors A/c	Dr.	78,000	
	Cash at bank A/c	Dr.	15,000	
	Cash in hand A/c	Dr.	5,000	
	To Provision for doubtful debts A/c			8,000
	To Creditors A/c			35,000
	To AB & Co. A/c			47,000
	To C's capital A/c (W.N. 2b)			1,74,600
	To D's capital A/c (W.N. 2b)			1,16,400
	(Being the sundry assets and liabilities of CD & Co. taken over at the values stated as per the agreement)			
	C's capital A/c	Dr.	16,875	
	D's capital A/c	Dr.	11,250	
	To A's capital A/c			18,750
	To B's capital A/c			9,375
	(Being adjustment in capital accounts of the partners on account of goodwill)			
	AB & Co. A/c	Dr.	47,000	

	To CD & Co. A/c (Being mutual indebtedness of AB & Co. and CD & Co. cancelled)			47,000
	A's Capital A/c	Dr.	1,24,267	
	To A's Current A/c (Being excess amount in A's capital A/c transferred to A's current A/c - refer W.N.3)			1,24,267
	B's Capital A/c	Dr.	87,133	
	To B's Current A/c (Being excess amount in B's capital A/c transferred to B's current A/c - refer W.N.3)			87,133

Working Notes:

(1) Profit on Revaluation

	AB & Co.	*CD & Co.*
	₹	₹
Building (1,00,000 – 75,000)	25,000	
(1,25,000 – 90,000)		35,000
Machinery (1,25,000 – 1,20,000)	5,000	
(1,10,000 – 1,00,000)		10,000
	30,000	45,000
Less: Provision for doubtful debts	(5,000)	(8,000)
	25,000	37,000

(2) Balance of capital accounts of partners on transfer of business to AD & Co.

(a) AB & Co.

	A's Capital	*B's Capital*
	₹	₹
Balance as per the Balance Sheet	1,50,000	1,00,000
Reserves in the profits and losses sharing ratio	44,000	22,000
Profit on revaluation in the profits and losses sharing ratio (W.N.1)	16,667	8,333
	2,10,667	1,30,333

(b) CD & Co.

	C's Capital	D's Capital
	₹	₹
Balance as per the Balance Sheet	1,20,000	80,000
Reserves in the profits and losses sharing ratio	32,400	21,600
Profit on revaluation in the profits and losses sharing ratio (W.N.1)	22,200	14,800
	1,74,600	1,16,400

(3) Calculation of capital of each partner in the new firm

Particulars	A	B	C	D
	₹	₹	₹	₹
Balance as per W.N.2	2,10,667	1,30,333	1,74,600	1,16,400
Adjustment for goodwill	18,750	9,375	(16,875)	(11,250)
	2,29,417	1,39,708	1,57,725	1,05,150
Total capital ₹ 4,20,600* in the new ratio of 2:1:3:2	(1,05,150)	(52,575)	(1,57,725)	(1,05,150)
Transfer to Current Account	1,24,267 Cr.	87,133 Cr.	-	-

* Taking D's capital as the base which is 2/8th of total capital; total capital will be 1,05,150 x 8/2 i.e. ₹ 4,20,600.

4. (a)

Particulars	Cash	Creditors	Capitals		
	₹	₹	P (₹)	Q (₹)	R (₹)
Balance due after loan		16,000	52,000	43,500	32,000
January					
Balance available	9,000				
Realization less expenses and cash retained	10,000				
Amount available and paid	19,000	(16,000)	-	-	(3,000)
Balance due	-	-	52,000	43,500	29,000
February					
Opening Balance	6,000				

Expenses paid and cash carried forward	3,000				
Available for distribution	3,000				
Cash paid to Q and Machinery given to R			-	3,000	9,000
Balance due	-		52,000	40,500	20,000
March					
Opening Balance	2,000				
Amount realized less expenses	87,300				
Amount paid to partners	89,300		41,689	32,767	14,844
Loss			10,311	7,733	5,156

Working Note:

(i) **Highest Relative Capital Basis**

	P (₹)	*Q (₹)*	*R (₹)*
Scheme of payment for January 2017			
Balance of Capital Accounts	65,000	50,500	32,000
Less: Loans	(13,000)	(7,000)	-
(A)	52,000	43,500	32,000
Profit Sharing Ratio	4	3	2
Capital / Profit sharing Ratio	13,000	14,500	16,000
Capital in profit sharing ratio, taking P's capital as base (B)	52,000	39,000	26,000
Excess of R's capital and Q's Capital (A – B) (i)		4,500	6,000
Profit Sharing Ratio		3	2
Capital / Profit sharing Ratio		1,500	3,000
Capital in profit sharing ratio, taking Q's capital as base (ii)		4,500	3,000
Excess of R's Capital over Q's capital (i – ii)			3,000

(ii) **Scheme of distribution of available cash for March:**

	P (₹)	*Q (₹)*	*R (₹)*
Balance of Capital Accounts at end of February (A)	52,000	40,500	20,000
Profit Sharing Ratio	4	3	2

Capital / Profit sharing Ratio	13,000	13,500	10,000
Capital in profit sharing ratio, taking R's capital as base (B) (i)	40,000	30,000	20,000
Excess of P's Capital and Q's Capital (A – B) (i)	12,000	10,500	
Profit Sharing Ratio	4	3	
Capital / Profit sharing Ratio	3,000	3,500	
Capital in profit sharing ratio taking P's capital as base (ii)	12,000	9,000	
Excess of Q's Capital over P's Capital (i – ii)	-	1,500	
Payment ₹ 1500 (C)		(1,500)	
Balance of Excess Capital (i –C)	12,000	9,000	
Payment ₹ 21000 (D)	(12,000)	(9,000)	
Balance due (A – C – D)	40,000	30,000	20,000
Balance cash Payment (₹ 89,300 – ₹ 22,500) = ₹ 66,800 (E)	(29,689)	(22,267)	(14,844)
Total Payment (₹ 89,000) (C + D +E) (iii)	41,689	32,767	14,844
Loss (A – iii)	10,311	7,733	5,156

(b) Liabilities of designated partners

As per Section 8 of LLP Act, unless expressly provided otherwise in this Act, a designated partner shall be-

(1) responsible for the doing of all acts, matters and things as are required to be done by the limited liability partnership in respect of compliance of the provisions of this Act including filing of any document, return, statement and the like report pursuant to the provisions of this Act and as may be specified in the limited liability partnership agreement; and

(2) liable to all penalties imposed on the limited liability partnership for any contravention of those provisions.

5. **In the books of Company**

Journal Entries

Date	Particulars		Dr. ₹	Cr. ₹
1-3-X2 to 31-3-X2	Bank A/c	Dr.	2,40,000	
	Employees compensation expenses A/c	Dr.	4,32,000	
	To Equity Share Capital A/c			48,000
	To Securities Premium A/c			6,24,000

	(Being allotment to employees 4,800 shares of ₹ 10 each at a premium of ₹ 130 at an exercise price of ₹ 50 each)		
31-3-X2	Profit and Loss account Dr. To Employees compensation expenses A/c (Being transfer of employees compensation expenses)	4,32,000	4,32,000

Working Note:

1. Employee Compensation Expenses = Discount between Market Price and option price = ₹ 140 – ₹ 50 = ₹ 90 per share = ₹ 90 x 4,800 = ₹ 4,32,000 in total.
2. The Employees Compensation Expense is transferred to Securities Premium Account.
3. Securities Premium Account = ₹ 50 – ₹ 10 = ₹ 40 per share + ₹ 90 per share on account of discount of option price over market price = ₹ 130 per share = ₹ 130 x 4,800= ₹ 6, 24,000 in total.

6. **In the books of Alpha Limited**

Journal Entries

Date 2017	*Particulars*	*Dr.*	*Cr. (₹ in lakhs)*
April 1	Bank A/c Dr.	150	
	To Investment A/c		148
	To Profit on sale of investment		2
	(Being investment sold on profit)		
April 5	Equity share capital A/c Dr.	600	
	Securities premium A/c Dr.	300	
	To Equity shares buy back A/c		900
	(Being the amount due to equity shareholders on buy back)		
	Equity shares buy back A/c Dr.	900	
	To Bank A/c		900
	(Being the payment made on account of buy back of 60 Lakh Equity Shares)		
April 5	General reserve A/c Dr.	530	
	Profit and Loss A/c Dr.	70	

	To Capital redemption reserve A/c		600
	(Being amount equal to nominal value of bought back shares from free reserves transferred to capital redemption reserve account as per the law)		

Balance Sheet (After buy back)

Particulars	*Note No*	*Amount (₹ in Lakhs)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	1,800
(b) Reserves and Surplus	2	1,322
(2) Non-Current Liabilities		
(a) Long-term borrowings - 12% Debentures		1,500
(3) Current Liabilities		
(a) Trade payables		1,400
(b) Other current liabilities		478
Total		6,500
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
(i) Tangible assets	3	4,050
(2) Current assets		
(a) Current investments		
(b) Inventory		1,200
(c) Trade receivables		5,00
(d) Cash and cash equivalents (W.N.)		750
Total		6,500

Notes to Accounts

			₹
1.	**Share Capital**		
	Equity share capital (Fully paid up shares of ₹10 each)		1800

2.	**Reserves and Surplus**			
	General Reserve	530		
	Less: Transfer to CRR	(530)	-	
	Capital Redemption Reserve	400		
	Add: Transfer due to buy-back of shares from P/L	70		
	Transfer due to buy-back of shares from Gen. res.	530	1,000	
	Securities premium	350		
	Less: Adjustment for premium paid on buy back	(300)	50	
	Profit & Loss A/c	340		
	Add: Profit on sale of investment	2		
	Less: Transfer to CRR	(70)	272	1,322
3.	**Tangible assets**			
	Machinery		3,600	
	Furniture		450	4,050

Working Note:

Cash at bank after buy-back

	₹ in lakhs
Cash balance as on 1st April, 2017	1,500
Add: Sale of investments	150
	1,650
Less: Payment for buy back of shares	(900)
	750

7. Journal Entries

2017			₹	₹
Jan. 1	14% Debentures A/c	Dr.	24,00,000	
	Premium on Redemption of Debentures A/c	Dr.	48,000	
	To Debentures holders A/c			24,48,000
	(Being amount payable on redemption of ₹ 24,00,000 debentures at a premium of 2%)			
	Debenture Redemption Reserve A/c	Dr.	48,000	
	To Premium on Redemption of Debentures A/c			48,000
	(Being premium on redemption adjusted against Debenture Redemption Reserve A/c)			

	Debenture holders A/c $\left(24,48,000 \times \frac{75}{100}\right)$	Dr.	18,36,000	
	To Equity Share Capital A/c (1,44,000 × ₹10)			14,40,000
	To Securities Premium A/c (1,44,000 x ₹ 2.75)			3,96,000
	(Being issue of 1,44,000 shares of ₹ 10 each at a premium of ₹ 2.75 per share to 75% debenture holders who exercised conversion option)			
	Bank A/c	Dr.	6,12,000	
	Debenture Redemption Reserve A/c	Dr.	68,000	
	To Debenture Redemption Reserve Investment A/c			6,80,000
	(Being investment sold at loss)			
	Debenture holders A/c (24,48,000 x 25%)	Dr.	6,12,000	
	To Bank A/c			6,12,000
	(Being cash payment to 25% debenture-holders)			
	Debenture Redemption Reserve A/c	Dr.	18,84,000	
	To General Reserve A/c			18,84,000
	(Being balance of Debenture Redemption Reserve A/c transferred on 100% redemption of debentures)			
	Investment A/c	Dr.	13,20,000	
	To Debenture Redemption Reserve Investment A/c			13,20,000
	(Being balance of Debenture Redemption Reserve Investment transferred to Investment (General) A/c)			

Working Notes:

(1)	For every ₹ 100 debenture, amount payable on redemption including premium is	₹ 102
	Less: Face value of 8 shares of ₹ 10 each to be issued for redemption of each debenture (8 × ₹ 10)	<u>₹ 80</u>

	Premium on issue of 8 shares	₹ 22
	Therefore, premium on issue of each share $\left(\frac{₹\ 22}{8}\right)$	₹2.75
(2)	Shares to be issued for conversion of 75% Debentures into shares @ 8 shares for every ₹ 100 Debenture i.e. $₹24{,}00{,}000 \times \frac{75}{100} \times \frac{8}{100} = 1{,}44{,}000$ shares	
(3)	Cash payment for remaining 25% debenture holders who exercised the option of cash i.e., $₹24{,}00{,}000 \times \frac{25}{100} \times \frac{102}{100} = ₹6{,}12{,}000$	
(4)	Face value of investment to be sold to realize ₹ 6,12,000 will be ₹ 6,80,000 $\left(\text{i.e.} ₹\frac{20{,}00{,}000}{18{,}00{,}000} \times ₹\ 6{,}12{,}000\right)$ Loss on sale of investment = 6,80,000 – 6,12,000 = 68,000	
(5)	Debenture Redemption Reserve transferred to General Reserve: 20,00,000 – 48,000 – 68,000 = ₹ 18,84,000	

8. Distinction between firm underwriting and partial underwriting along with firm underwriting

In firm underwriting the underwriter agrees to subscribe upto a certain number of shares / debentures irrespective of the nature of public response to issue of securities. He gets these securities even if the issue is fully subscribed or over-subscribed. These securities are taken by the underwriter in addition to his liability for securities not subscribed by the public.

Under partial underwriting along with firm underwriting, unless otherwise agreed, individual underwriter does not get the benefit of firm underwriting in determination of number of shares/debentures to be taken up by him.

9. Books of P Ltd.

Journal Entries

	Dr. (*₹ in Lacs*)	*Cr.* (*₹ in Lacs*)	
Business Purchase A/c	Dr.	9,000	
To Liquidator of V Ltd.			9,000
(Being business of V Ltd. taken over for consideration settled as per agreement)			

Plant and Machinery	Dr.	5,000	
Furniture & Fittings	Dr.	1,700	
Inventory	Dr.	4,041	
Debtors	Dr.	1,020	
Cash at Bank	Dr.	609	
Bills Receivable	Dr.	80	
To Foreign Project Reserve			310
To General Reserve (3,200 - 3,000)			200
To Profit and Loss A/c (825 – 50*)			775
To Liability for 12% Debentures			1,000
To Creditors			463
To Provisions			702
To Business Purchase			9,000
(Being assets & liabilities taken over from V Ltd.)			
Liquidator of V Ltd. A/c	Dr.	9,000	
To Equity Share Capital A/c			9,000
(Purchase consideration discharged in the form of equity shares)			
Profit & loss A/c	Dr.	1	
To Bank A/c			1
(Liquidation expenses paid by P Ltd.)			
Liability for 12% Debentures A/c	Dr.	1,000	
To 13% Debentures A/c			1,000
(12% debentures discharged by issue of 13% debentures)			
Bills Payable A/c	Dr.	80	
To Bills Receivable A/c			80
(Cancellation of mutual owing on account of bills)			

Balance Sheet of P Ltd. as at 1st April, 20X1 (after merger)

		Particulars	Notes	₹ (in lakhs)
		Equity and Liabilities		
1		**Shareholders' funds**		
	A	Share capital	1	24,000
	B	Reserves and Surplus	2	16,654
2		**Non-current liabilities**		
	A	Long-term borrowings	3	1,000
3		**Current liabilities**		
	A	Trade Payables (1,543 + 40)		1,583
	B	Short-term provisions		2,532
		Total		**45,769**
		Assets		
1		**Non-current assets**		
	A	Fixed assets		
		Tangible assets	4	29,004
2		**Current assets**		
	A	Inventories		11,903
	B	Trade receivables		3,140
	C	Cash and cash equivalents		1,722
		Total		**45,769**

Notes to accounts

		₹
1.	**Share Capital**	
	Equity share capital	
	Authorised, issued, subscribed and paid up	
	24 crores equity shares of ₹ 10 each (Of the above shares, 9 crores shares have been issued for consideration other than cash)	24,000
	Total	**24,000**
2.	**Reserves and Surplus**	
	General Reserve	9,700

	Securities Premium	3,000
	Foreign Project Reserve	310
	Profit and Loss Account	3,644
	Total	**16,654**
3.	**Long-term borrowings**	
	Secured	
	13% Debentures	1,000
4.	**Tangible assets**	
	Land & Buildings	6,000
	Plant & Machinery	19,000
	Furniture & Fittings	4,004
	Total	**29,004**

Working Note:

Computation of purchase consideration

The purchase consideration was discharged in the form of three equity shares of P Ltd. for every two equity shares held in V Ltd.

Purchase consideration = ₹ 6,000 lacs × $\frac{3}{2}$ = ₹ 9,000 lacs.

* Cost of issue of debenture adjusted against P & L Account of V Ltd.

10. Books of Ravi Ltd.

Journal Entries

Particulars		Debit (₹)	Credit (₹)
Equity Share Capital (₹ 100 each) a/c	Dr	30,00,000	
To Equity share capital (₹ 10 each) A/c			30,00,000
(Sub division of equity share into ₹ 10 each)			
Equity Share Capital (₹10) A/c	Dr.	24,00,000	
To Share surrendered A/c			24,00,000
(Surrender of 80% of share holding by equity share holders)			
7% Cumulative preference share capital A/c	Dr.	20,00,000	
To 8% cumulative preference share capital A/c			20,00,000

(Conversion of 7% Cumulative Preference share capital into 8% Cumulative Preference share capital. They also forgo their right to arrears of dividends)			
Shares Surrendered A/c	Dr.	5,00,000	
To Equity share capital A/c			5,00,000
(Surrendered share issued against trade payables under reconstruction scheme)			
Declared Dividend A/c	Dr.	3,00,000	
Expenses of reconstruction A/c	Dr.	60,000	
To Bank A/c			3,60,000
(Dividend to Equity Share holder's and reconstruction expenses paid)			
Share surrendered A/c	Dr.	19,00,000	
To capital Reduction A/c			19,00,000
(Cancellation of unissued surrendered shares) (24,00,000-5,00,000)			
Loan from Director A/c	Dr.	4,40,000	
Trade Payables A/c	Dr.	6,15,000	
Building A/c	Dr.	1,50,000	
To Capital reduction A/c			12,05,000
(Amount sacrificed by directors and trade payables and appreciation in value of building)			
Capital reduction A/c	Dr.	31,05,000	
To Patent A/c			4,00,000
To Trade receivables A/c			6,50,000
To Inventory A/c			3,40,000
To Profit and Loss A/c			8,40,000
To Expenses on Reconstruction A/c			60,000
To Plant A/c (bal. fig)			8,15,000
(Various assets and expenses written off)			
Bank A/c	Dr.	4,00,000	
To Share application money A/c			4,00,000
(Application money received on full and final payment)			

Share application money A/c Dr.	4,00,000	
To Share capital A/c		4,00,000
(Being 40,000 equity shares of ₹ 10 each issued and fully paid up)		

Note: Cancellation of preference dividend need not be journalised. On cancellation, it ceases to be contingent liability and hence no further disclosure required.

Balance Sheet of Ravi Ltd. (and Reduced) as at 31st March, 2017

	Particulars	Note	Amount (₹)
I.	**EQUITY AND LIABILITIES**		
	1. Shareholders' funds		
	a. Share capital	1	35,00 000
	b. General reserve		6,00 000
	2. Current liabilities		
	a. Trade payables (24,60,000-6,15,000)		18,45,000
	b. Other current liabilities (outstanding expenses)		3,20,000
	Total		62,65,000
II.	**ASSETS**		
	1. Non-current assets		
	Fixed assets		
	i. Tangible assets	2	28,85,000
	ii. Intangible assets	3	-
	2. Current assets		
	a. Inventories (16,30,000- 3,40,000)		12,90,000
	b. Trade receivables (23,50,000- 6,50,000)		17,00,000
	c. Cash and cash equivalents	4	3,90,000
	Total		62,65,000

Notes to the financial statements

(1) Share capital

	Particulars	Amount (₹)
a.	Authorised	
	• 3,00,000 equity shares of ₹10 each	30,00,000

	• 20,000 8% cumulative preference shares of ₹100 each	20,00,000
b.	Issued, subscribed and fully paid up • 1,50,000 equity shares of ₹10 each (of the above, 50,000 shares were issued as fully paid up for consideration other than cash under the scheme of reconstruction) • 20,000 8% cumulative preference shares of ₹100 each	15,00,000 20,00,000
	Total	**35,00,000**

(2) Tangible assets

Particulars	₹
Plant (30,00,000-8,15,000)	21,85,000
Building (5,50,000 + 1,50,000)	7,00,000
Total	28,85,000

(3) Intangible assets

Particulars	**₹**
Patent (4,00,000-4,00,000)	-

(4) Cash and cash equivalents

	Particulars	**₹**
a.	Balance with bank (2,30,000-3,00,000-60,000+4,00,000)	2,70,000
b.	Cash on hand	1,20,000
	Total	3,90,000

11. Liquidator's Final Statement of Receipts and Payments A/c

	₹	₹		₹
To Cash in hand To Assets realised:		40,000	By Liquidator's remuneration and expenses	5,000
Fixed assets	1,68,000		By Trade Payables	3,50,000
Inventory			By Preference shareholders	1,00,000
(1,10,000 – 1,00,000) Book debts	10,000 2,30,000	4,08,000	By Equity shareholders @ ₹ 10 on 2,000 shares	20,000
To Cash - proceeds of call on 1,800 equity shares @ ₹ 15*		27,000		
		4,75,000		4,75,000

Working Note:

Return per equity share

	₹
Cash available before paying preference shareholders (₹ 4,48,000 – ₹ 3,55,000)	93,000
Add: Notional calls 1,800 shares (2,000-200) × ₹ 25	45,000
	1,38,000
Less: Preference share capital	(1,00,000)
Available for equity shareholders	38,000
Return per share= $\frac{₹\ 38,000}{3,800\ (4,000-200)} = ₹\ 10$	
and Loss per Equity Share ₹ (100-10) = ₹ 90	

*Calls to be made @ ₹ 15 per share (₹ 90-75) on 1,800 shares.

12. Form B – RA (Prescribed by IRDA)

Name of the Insurer: X Fire Insurance Co. Ltd.

Registration No. and Date of registration with the IRDA: …………………..

Revenue Account for the year ended 31st March, 20X2

	Particulars	*Schedule*	*Current year ended on 31st March, 20X2*
			₹
1.	Premium earned (Net)	1	7,00,000
	Total (A)		7,00,000
1.	Claims incurred (Net)	2	8,00,000
2.	Commission	3	50,000
3.	Operating Expenses related to insurance business	4	3,00,000
	Total (B)		11,50,000
	Operating Profit/(Loss) from Fire Insurance Business [C = (A – B)]		(4,50,000)

Schedule 1

Premium earned (Net)

	₹
Premium received from direct business written	15,00,000
Less: Premium on re-insurance ceded	(1,00,000)
	14,00,000
Adjustment for change in reserve for unexpired risk	7,00,000
Net Premium Earned	7,00,000

Schedule 2

Claims incurred (Net)

	₹
Claims paid – Direct	7,00,000
Add: Claims outstanding on 31.3.20X2	1,00,000
Total claims incurred	8,00,000

Schedule 3

Commission

Commission paid	50,000
Net commission	50,000

Schedule 4

Operating expenses related to insurance business

	₹
Expenses of Management	3,00,000

13. (i) **Calculation of Rebate on bills discounted**

S.No.	*Amount (₹)*	*Due date 2017*	*Unexpired portion*	*Rate of discount*	*Rebate on bill discounted ₹*
(i)	7,50,000	April 8	8 days	12%	1,972
(ii)	3,00,000	May 5	35 days	14%	4,028
(iii)	4,40,000	June 12	73 days	14%	12,320
(iv)	9,60,000	July 15	106 days	15%	41,820
					60,140

(ii) Amount of discount to be credited to the Profit and Loss Account

	₹
Transfer from Rebate on bills discount as on 31st March, 2016	91,600
Add: Discount received during the year ended 31st March, 2017	4,05,000
	4,96,600
Less: Rebate on bills discounted as on 31st March, 2017	60,140
Discount credited to the Profit and Loss Account	4,36,460

14. Departmental Trading and Loss Account of M/s Division

For the year ended 31st December, 2016

	Deptt. A	*Deptt. B*		*Deptt. A*	*Deptt. B*
	₹	₹		₹	₹
To Opening stock	50,000	40,000	By Sales	10,00,000	15,00,000
To Purchases	6,50,000	9,10,000	By Closing stock		
To Gross profit	4,00,000	7,50,000		1,00,000	2,00,000
	11,00,000	17,00,000		11,00,000	17,00,000
To General Expenses (in ratio of sales)	50,000	75,000	By Gross profit	4,00,000	7,50,000
To Profit ts/f to general profit and loss account	3,50,000	6,75,000			
	4,00,000	7,50,000		4,00,000	7,50,000

General Profit and Loss Account

	₹		₹
To Stock reserve required (additional:		By Profit from:	
Stock in Deptt. A		Deptt. A	3,50,000
50% of (₹ 20,000 - ₹ 10,000) (W.N.1)	5,000	Deptt. B	6,75,000
Stock in Deptt. B			
40% of (₹ 30,000 - ₹ 15,000) (W.N.2)	6,000		
To Net Profit	10,14,000		
	10,25,000		10,25,000

Working Notes:

1. Stock of department A will be adjusted according to the rate applicable to department B = [(7,50,000 ÷ 15,00,000) x 100] = 50%
2. Stock of department B will be adjusted according to the rate applicable to department A = [(4,00,000 ÷ 10,00,000) x 100] = 40%

15. **In the books of ABC Ltd.**

New York Branch Trial Balance in (₹)
as on 31st March, 2017

	Conversion rate per US $ (₹)	*Dr.* ₹	*Cr.* ₹
Stock on 1.4.16	40	6,000	–
Purchases and sales	41	16,400	30,750
Sundry debtors and creditors	42	8,400	6,300
Bills of exchange	42	2,520	5,040
Sundry expenses	41	22,140	–
Bank balance	42	8,820	–
Delhi head office A/c	–	–	22,190
		64,280	64,280

16. (a) (1) Users of financial statements:

Investors, Employees, Lenders, Supplies/Creditors, Customers, Government & Public

(2) Qualitative Characteristics of Financial Statements:

Understandability, Relevance, Comparability, Reliability & Faithful Representation

(3) Elements of Financial Statements:

Asset, Liability, Equity, Income/Gain and Expense/Loss

(b) Fundamental Accounting Assumptions:

Accrual, Going Concern and Consistency

17. (a) According to para 8 of AS 4, the unexpected increase in sale price of petrol by the government after the balance sheet date cannot be regarded as an event occurring after the Balance Sheet date, which requires an adjustment at the Balance Sheet date, since it does not represent a condition present at the balance sheet date. The revenue should be recognized only in the subsequent year with proper disclosures.

(b) As per para 31 of AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy.

(i) Accordingly, introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is not a change in an accounting policy.

(ii) The adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial will not be treated as a change in an accounting policy.

18. (a) As per AS 11 (revised 2003), 'The Effects of Changes in Foreign Exchange Rates', monetary items denominated in a foreign currency should be reported using the closing rate at each balance sheet date. The effect of exchange difference should be taken into profit and loss account. Trade payables is a monetary item, hence should be valued at the closing rate i.e., ₹ 48 at 31st March, 2017 irrespective of the payment for the same subsequently at lower rate in the next financial year. The difference of ₹ 5 (₹ 48 less ₹ 43) per US dollar should be shown as an exchange loss in the profit and loss account for the year ended 31st March, 2017 and is not to be adjusted against the cost of raw materials. In the subsequent year, the company would record an exchange gain of ₹1 per US dollar, i.e., the difference between ₹ 48 and ₹ 47 per US dollar. Hence, the accounting treatment adopted by the company is incorrect.

(b) As per AS 12 'Accounting for Government Grants', Government grants sometimes become refundable because certain conditions are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item as per AS 5.

The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

In the present case, the amount of refund of government grant should be shown in the profit and loss account of the company as an extraordinary item during the year 2016-17.

19. (a) According to para 6 of AS 16 "Borrowing Costs", borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

Also para 10 of AS 16 “Borrowing Costs” states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Thus, eligible borrowing cost

= ₹ 11,00,000 – ₹ 2,00,000

= ₹ 9,00,000

Sr. No.	*Particulars*	*Nature of assets*	*Interest to be Capitalized (₹)*	*Interest to be charged to Profit & Loss Account (₹)*
i	Construction of factory building	Qualifying Asset*	9,00,000x40/100 = ₹ 3,60,000	NIL
ii	Purchase of Machinery	Not a Qualifying Asset	NIL	9,00,000x35/100 = ₹ 3,15,000
iii	Working Capital	Not a Qualifying Asset	NIL	9,00,000x25/100 = ₹ 2,25,000
	Total		₹ 3,60,000	₹ 5,40,000

* A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

(b) As per para 44 of AS 26, costs incurred in creating a computer software product should be charged to research and development expense when incurred until technological feasibility/asset recognition criteria has been established for the product. Technological feasibility/asset recognition criteria have been established upon completion of detailed programme design or working model. In this case, ₹ 45,000 would be recorded as an expense (₹ 25,000 for completion of detailed program design and ₹ 20,000 for coding and testing to establish technological feasibility/asset recognition criteria). Cost incurred from the point of technological feasibility/asset recognition criteria until the time when products costs are incurred are capitalized as software cost (₹ 42,000 + ₹ 12,000 + ₹ 13,000) ₹ 67,000.

20. (a) Computation of earnings per share

EPS for the year 2015-16 as originally reported

= ₹ 22,00,000/1,10,000 shares = ₹ 20

EPS for the year 2015-16 restated for rights issue

= ₹ 22,00,000/ (1,10,000 shares x 1.07) = ₹ 18.69

EPS for the year 2016-17 including effects of rights issue

Adjusted No. of Shares = (1,10,000 x 1.07 x 4/12) + (1,37,500 x 8/12) = 1,30,900

EPS $= \dfrac{33,00,000}{1,30,900} = 25.21$

Working Note:

1. Calculation of Theoretical ex-rights fair value per share

$$\frac{\text{Fair value of shares immediately prior to exercise of rights + Total amount received from exercise}}{\text{Number of shares outstanding prior to exercise + Number of shares issued in the exercise}}$$

$$\frac{(₹\ 270 \times 1,10,000 \text{ shares}) + (₹\ 180 \times 27,500 \text{ Shares})}{1,10,000 + 27,500 \text{ Shares}} = 3,46,50,000/1,37,500$$

Theoretical ex-rights fair value per share = ₹ 252

2. Calculation of Computation of adjustment factor:

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}}$$

$$\frac{₹\ (270)}{₹\ (252)} = 1.071$$

(b) A provision should be recognized only when an enterprise has a present obligation arising from a past event or obligation. In the given case, there is no present obligation but a future one, therefore no provision is recognized as per AS 29.

The cost of overhauling aircraft is not recognized as a provision because it is a future obligation and the incurring of the expenditure depends on the company's decision to continue operating the aircrafts. Even a legal requirement to overhaul does not require the company to make a provision for the cost of overhaul because there is no present obligation to overhaul the aircrafts. Further, the enterprise can avoid the future expenditure by its future action, for example by selling the aircraft. However, an obligation might arise to pay fines or penalties under the legislation after completion of five years. Assessment of probability of incurring fines and penalties depends upon the provisions of the legislation and the stringency of the enforcement regime. A provision should be recognized for the best estimate of any fines and penalties if airline continues to operate aircrafts for more than five years.

PAPER – 6: AUDITING AND ASSURANCE

PART – I : ACADEMIC UPDATE

(Legislative Amendments / Notifications / Circulars / Rules / Guidelines issued by Regulating Authority)

1. Duty to report on Frauds

I. Reporting to the Central Government- As per sub-section (12) of section 143 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 of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

In this regard, Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has been prescribed. Sub-rule (1) of the said rule states that if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

The manner of reporting the matter to the Central Government is as follows:

(a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;

(b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;

(c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;

(d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;

(e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and

(f) the report shall be in the form of a statement as specified in Form ADT-4.

II. Reporting to the Audit Committee or Board - Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.

In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub-rule (1) [i.e. less than ₹ 1 crore], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:

(a) Nature of Fraud with description;

(b) Approximate amount involved; and

(c) Parties involved.

III. Disclosure in the Board's Report: Sub-section (12) of section 143 of the Companies Act, 2013 furthermore prescribes that the companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.

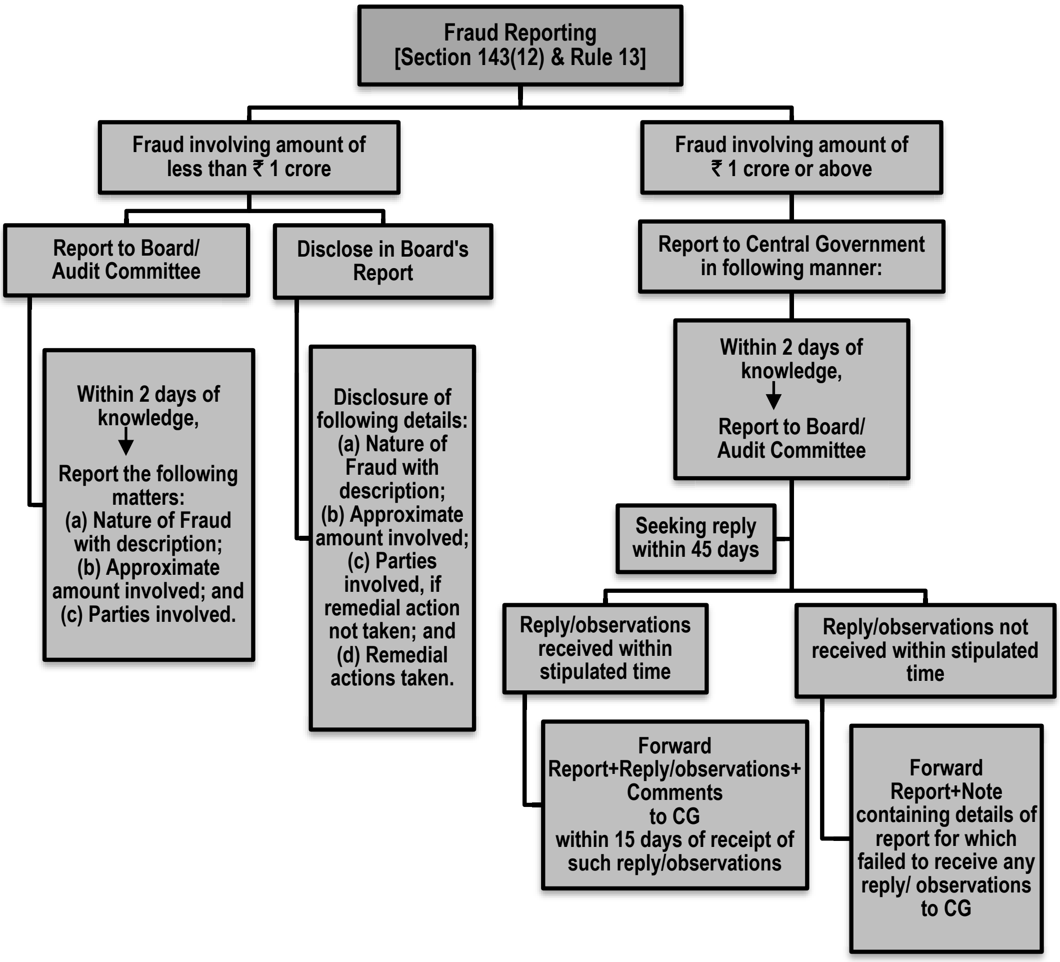
In this regard, sub-rule (4) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that the auditor is also required to disclose in the Board's Report the following details of each of the fraud reported to the Audit Committee or the Board under sub-rule (3) during the year:

(a) Nature of Fraud with description;

(b) Approximate Amount involved;

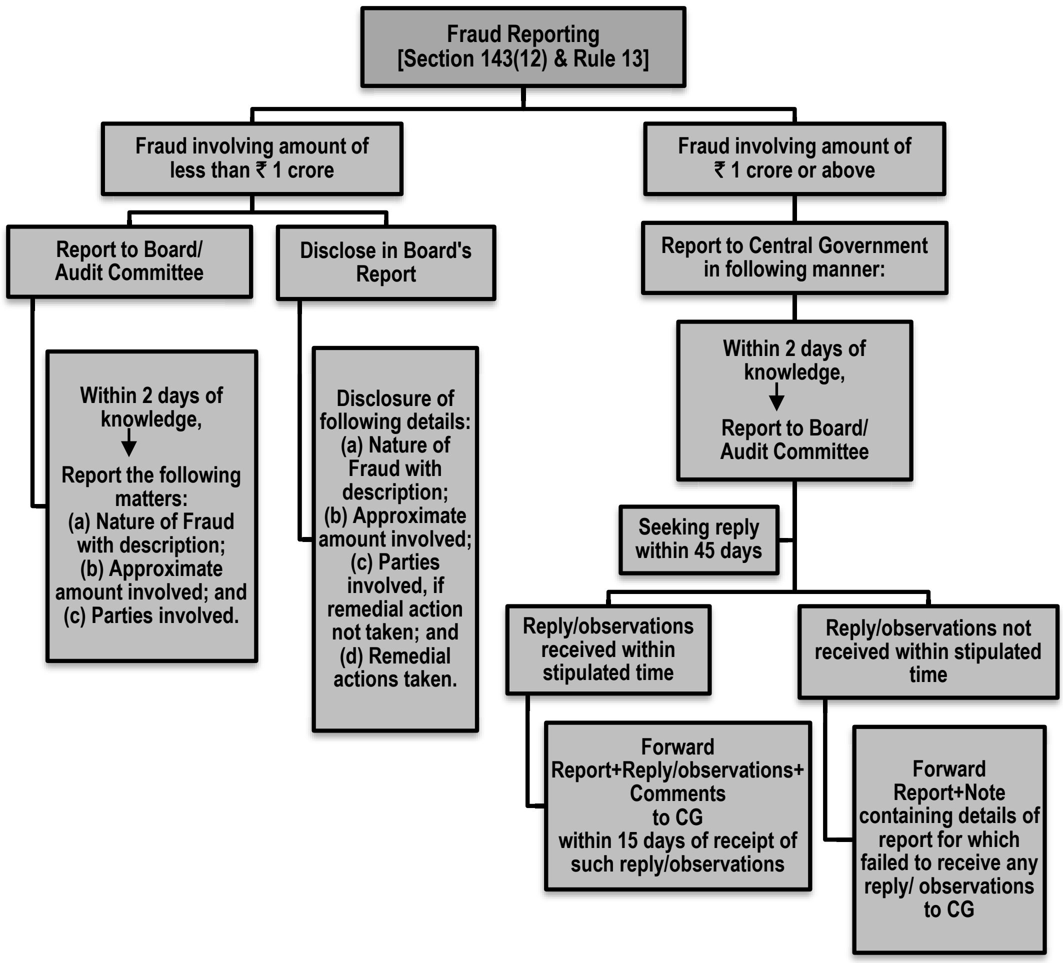
(c) Parties involved, if remedial action not taken; and

(d) Remedial actions taken.



2. Ceiling on Number of Company Audits

As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty



2. **Ceiling on Number of Company Audits**

As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies, other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore.

3. Reporting under Companies (Auditor's Report) Order, 2016 [CARO, 2016]

In exercise of the powers conferred by sub-section (11) of section 143 of the Companies Act, 2013 (18 of 2013) and in supersession of the Companies (Auditor's Report) Order, 2015 published in the Gazette of India, Extraordinary, Part II, Section 3, Sub-section (ii), vide number S.O. 990 (E), dated the 10th April, 2015, except as respects things done or omitted to be done before such supersession, the Central Government, after consultation with the, committee constituted under proviso to sub-section (11) of section 143 of the Companies Act, 2013 hereby makes the following Order dated 29th March, 2016, namely:—

I. Short title, application and commencement-

(1) This Order may be called the Companies (Auditor's Report) Order, 2016.

(2) **Applicability of the Order:** The CARO, 2016 is an additional reporting requirement Order. The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2O13 [hereinafter referred to as the Companies Act],

However, the Order specifically <u>exempts</u> the following class of companies-

(i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);

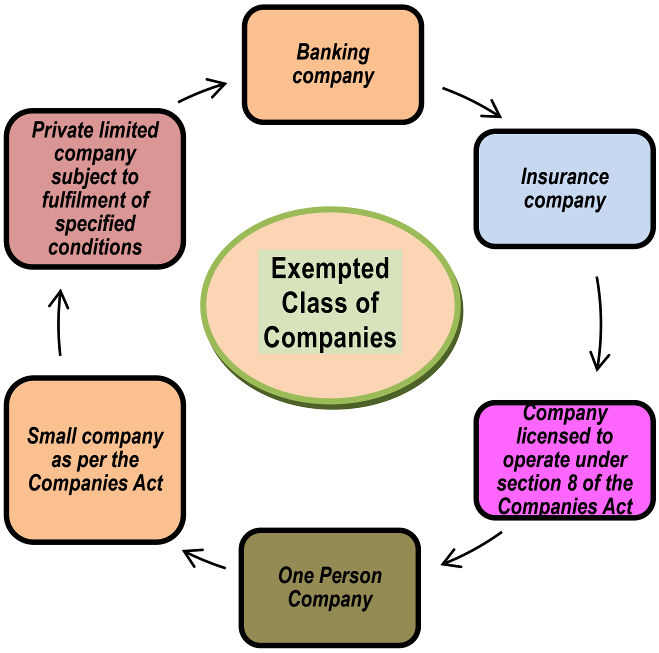
(ii) an insurance company as defined under the Insurance Act,1938 (4 of 1938);

(iii) a company licensed to operate under section 8 of the Companies Act;

(iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act and a small company as defined under clause (85) of section 2 of the Companies Act; and

(v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements.

Exempted Class of Companies



II. **Auditor's report to contain matters specified in paragraphs 3 and 4 -** Every report made by the auditor under section 143 of the Companies Act, 2013 on the accounts of every company audited by him, to which this Order applies, for the financial years commencing on or after 1st April, 2015, shall in addition, contain the matters specified in paragraphs 3 and 4, as may be applicable:

It may be noted that the Order shall not apply to the auditor's report on consolidated financial statements.

III. **Matters to be included in the auditor's report -** The auditor's report on the accounts of a company to which this Order applies shall include a statement on the following matters, namely:-

(i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;

(b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

(c) whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof;

(ii) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account;

(iii) whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so,

(a) whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;

(b) whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;

(c) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;

(iv) in respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.

(v) in case, the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?

(vi) whether maintenance of cost records has been specified by the Central Government under section 148(1) of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.

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

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

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

(ix) whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;

(x) whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;

(xi) whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provisions of section 197 read with Schedule V to the Companies Act? If not, state the amount involved and steps taken by the company for securing refund of the same;

(xii) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1: 20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;

(xiii) whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards;

(xiv) whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;

(xv) whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with;

(xvi) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

IV. Reasons to be stated for unfavourable or qualified answers -

(1) Where, in the auditor's report, the answer to any of the questions referred to in paragraph 3 is unfavourable or qualified, the auditor's report shall also state the basis for such unfavourable or qualified answer, as the case may be.

(2) Where the auditor is unable to express any opinion on any specified matter, his report shall indicate such fact together with the reasons as to why it is not possible for him to give his opinion on the same.

4. Amendment in Companies (Cost Records and Audit) Rules, 2014

(I) Maintenance of Cost Records: Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, having an overall turnover from all its products and services of ₹ 35 crore or more during the immediately preceding financial year, required to include cost records in their books of account. These companies include Foreign Companies defined in sub-section (42) of section 2 of the Act, but exclude a company classified as a Micro enterprise or a Small enterprise including as per the turnover criteria provided under Micro, Small and Medium Enterprises Development Act, 2006.

The said rule has divided the list of companies into regulated sectors (Part A) and non-regulated sectors (Part B).

Additionally, as per clause (vi) to Paragraph 3 of the CARO, 2016, where maintenance of cost records has been specified by the Government under section 148(1) of the Companies Act, 2013, the auditor has to report whether such accounts and records have been made and maintained.

(II) Appointment of Cost Auditor: Rule 6 of the Companies (Cost Records and Audit) Rules, 2014 requires the companies prescribed under the said Rules to appoint an auditor within one hundred and eighty days of the commencement of every financial year. However, before such appointment is made, the written consent of the cost auditor to such appointment and a certificate from him or it shall be obtained.

The certificate to be obtained from the cost auditor shall certify that the-

(a) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Companies Act, 2013, the Cost and

Works Accountants Act, 1959 and the rules or regulations made thereunder;

(b) the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Companies Act, 2013 so far as may be applicable;

(c) the proposed appointment is within the limits laid down by or under the authority of the Companies Act, 2013; and

(d) the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

(III) Removal of Cost Auditor: The cost auditor may be removed from his office before the expiry of his term, through a board resolution after giving a reasonable opportunity of being heard to the cost auditor and recording the reasons for such removal in writing.

It may be noted that the Form CRA-2 to be filed with the Central Government for intimating appointment of another cost auditor shall enclose the relevant Board Resolution to the effect.

It may further be noted that the above provisions shall not prejudice the right of the cost auditor to resign from such office of the company.

(IV) Submission of Cost Audit Report to the Central Government: A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein, in Form CRA-4 in Extensible Business Reporting Language (XBRL) format in the manner as specified in the Companies (Filing of Documents and Forms in Extensible Business Reporting language) Rules, 2015 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.

(V) Cost Audit Rules not to apply in certain cases: The requirement for cost audit under these rules shall not be applicable to a company which is covered under rule 3, and,

(i) whose revenue from exports, in foreign exchange, exceeds 75% of its total revenue; or

(ii) which is operating from a special economic zone.

(iii) which is engaged in generation of electricity for captive consumption through Captive Generating Plant.

5. Direction by Tribunal in case auditor acted in a fraudulent manner

As per sub-section (5) of the section 140, the Tribunal either *suo motu* or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors.

However, if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place.

It may be noted that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447.

It is hereby clarified that the case of a firm, the liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers.

6. Curtailing right of the auditor regarding circulation of copy of representation in the case of appointment of Auditor other than retiring Auditor under section 140(4) of the Companies Act, 2013

If the Tribunal is satisfied on an application either of the company or of any other aggrieved person that the rights conferred by section 140(4) of the Companies Act, 2013 are being abused by the auditor, then, the copy of the representation may not be sent and the representation need not be read out at the meeting.

7. Re-opening of accounts on Court's or Tribunal's Orders

Section 130 of the Companies Act, 2013 states that a company shall not re-open its books of account and not recast its financial statements, unless an application in this regard is made by the Central Government, the Income-tax authorities, the Securities and Exchange Board, any other statutory regulatory body or authority or any person concerned and an order is made by a court of competent jurisdiction or the Tribunal to the effect that—

(i) the relevant earlier accounts were prepared in a fraudulent manner; or

(ii) the affairs of the company were mismanaged during the relevant period, casting a doubt on the reliability of financial statements.

However, a notice shall be given by the Court or Tribunal in this regard and shall take into consideration the representations, if any.

8. Voluntary revision of financial statements or Board's report

Section 131 of the Companies Act, 2013 states that if it appears to the directors of a company that—

(a) the financial statement of the company; or

(b) the report of the Board,

do not comply with the provisions of section 129 (Financial statement) or section 134 (Financial statement, Board's report, etc.) they may prepare revised financial statement or a revised report in respect of any of the three preceding financial years after obtaining approval of the Tribunal on an application made by the company in such form and manner as may be prescribed and a copy of the order passed by the Tribunal shall be filed with the Registrar.

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

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

10. Guidance Note on Reporting under section 143(3)(f) and (h) of the Companies Act, 2013: This Guidance Note is intended to assist the auditors in discharging their duties in respect of clauses (f) and (h) of sub-section (3) of section 143 of the Act. Clause (f) of the said sub-section creates a requirement for the auditor to consider observations or comments of the auditor on financial transactions or matters which have an adverse effect on the functioning of the company. Such observations or comments would ordinarily lead to the modification of or an emphasis of matter in the auditor's report on financial statements. It may be noted that the matters that lead to modification in the auditor's report on financial statements are matters that give rise to a qualified opinion, adverse opinion or a disclaimer of opinion. Further, matters that lead to an emphasis of matter paragraphs are matters appropriately presented or disclosed in the financial statements that, in the auditor's judgement, are of such importance that they are fundamental to the users' understanding of the financial statements. If the matter leading to the modification of the auditor's opinion or an emphasis of matter in the auditor's report on financial statements is likely to have an adverse effect on the functioning of the company, the auditor is required to report such matter.

Under clause (h) of sub-section (3) of section 143 of the Act, the auditor is required to state whether any matter leading to a qualification, reservation or adverse remark, that is, effectively the modification of the auditor's report on financial statements, relates to the maintenance of accounts and other matters connected therewith.

For Complete Guidance Note refer below mentioned link:

http://220.227.161.86/37392aasb26881.pdf

11. Quality Control and Engagement Standards: The Council of the ICAI has revised following Quality Control and Engagement Standards which are applicable for November 2017 and onward examination:

S. No.	No. of Standard	Title of the Standard
(I)	SA 260	Communication with Those Charged with Governance
(II)	SA 570	Going Concern
(III)	SA 610	Using the Work of Internal Auditors

(I) SA 260 (Revised), Communication with Those Charged with Governance

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements. Although this SA applies irrespective of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity, and for listed entities. This SA does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.

2. This SA is written in the context of an audit of financial statements, but may also be applicable, adapted as necessary in the circumstances, to audits of other historical financial information when those charged with governance have a responsibility to oversee the preparation of the other historical financial information.

3. Recognizing the importance of effective two-way communication in an audit of financial statements, this SA provides an overarching framework for the auditor's communication with those charged with governance, and identifies some specific matters to be communicated with them. Additional matters to be communicated, which complement the requirements of this SA, are identified in other SAs (see Appendix 1). In addition, SA 265[1] establishes specific requirements regarding the communication of significant deficiencies in internal control the auditor has identified during the audit to those charged with governance. Further matters, not required by this or other SAs, may be required to be communicated by law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement, for

[1] SA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management.*

example, the standards of a national professional accountancy body. Nothing in this SA precludes the auditor from communicating any other matters to those charged with governance. (Ref: Para. A33–A36)

The Role of Communication

4. This SA focuses primarily on communications from the auditor to those charged with governance. Nevertheless, 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.

5. Although the auditor is responsible for communicating matters required by this SA, management also has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of this responsibility.

Similarly, communication by management with those charged with governance of matters that the auditor is required to communicate does not relieve the auditor of the responsibility to also communicate them. Communication of these matters by management may, however, affect the form or timing of the auditor's communication with those charged with governance.

6. Clear communication of specific matters required to be communicated by SAs is an integral part of every audit. SAs do not, however, require the auditor to perform procedures specifically to identify any other matters to communicate with those charged with governance.

7. Law or regulation may restrict the auditor's communication of certain matters with those charged with governance. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider obtaining legal advice.

Effective Date

8. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2017.

Objectives

9. The objectives of the auditor are:

(a) To communicate clearly with those charged with governance the 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.

Definitions

10. For purposes of the SAs, the following terms have the meanings attributed below:

(a) **Those charged with governance** – 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 overseeing the financial reporting process. For some 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. For discussion of the diversity of governance structures, see paragraphs A1–A8.

(b) **Management** – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

Requirements

Those Charged with Governance

11. The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate. (Ref: Para. A1–A4)

Communication with a Subgroup of Those Charged with Governance

12. If the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body. (Ref: Para. A5–A7)

When All of Those Charged with Governance Are Involved in Managing the Entity

13. In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this SA are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role. These matters are noted in paragraph 16(c). The auditor shall nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. (Ref: Para. A8)

Matters to Be Communicated

The Auditor's Responsibilities in Relation to the Financial Statement Audit

14. 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. (Ref: Para. A9–A10)

Planned Scope and Timing of the Audit

15. 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. (Ref: Para. A11–A16)

Significant Findings from the Audit

16. The auditor shall communicate with those charged with governance: (Ref: Para. A17–A18)

(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 acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A19–A20)

(b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A21)

(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; and (Ref: Para. A22)

   ii. Written representations the auditor is requesting;

(d) Circumstances that affect the form and content of the auditor's report, if any; and (Ref: Para. A23–A25)

(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. (Ref: Para. A26–A28)

Auditor Independence

17. 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

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. (Ref: Para. A29–A32)

The Communication Process

Establishing the Communication Process

18. The auditor shall communicate with those charged with governance the form, timing and expected general content of communications. (Ref: Para. A37–A45)

Forms of Communication

19. 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. (Ref: Para. A46–A48)

20. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required by paragraph 17.

Timing of Communications

21. The auditor shall communicate with those charged with governance on a timely basis. (Ref: Para. A49–A50)

Adequacy of the Communication Process

22. 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. (Ref: Para. A51–A53)

Documentation

23. Where matters required by this SA 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.[2] (Ref: Para. A54)

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[2] SA 230, *Audit Documentation*, paragraphs 8–11, and A6.

Application and Other Explanatory Material

Those Charged with Governance (Ref: Para. 11)

A1. Governance structures vary by entities, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. For example:

- In some entities, a supervisory (wholly or mainly non-executive) board exists that is legally separate from an executive (management) board (a "two-tier board" structure). In other entities, both the supervisory and executive functions are the legal responsibility of a single, or unitary, board (a "one-tier board" structure).
- 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 others, for example, some government entities, a body that is not part of the entity is charged with governance.
- 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 some cases, those charged with governance are responsible for approving[3] the entity's financial statements (in other cases management has this responsibility).

A2. 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, a council of governors, 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. When governance is a collective responsibility, a subgroup such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities. Alternatively, a subgroup or individual may have specific, legally identified responsibilities that differ from those of the governing body.

A3. Such diversity means that it is not possible for this SA to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate person(s) 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, some not-for-profit organizations, and some government entities. In such cases, the auditor may need to discuss and agree with the engaging party the relevant person(s) 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[4] is relevant. The appropriate person(s) with whom to communicate may vary depending on the matter to be communicated.

A4. SA 600 includes specific matters to be communicated by group auditors with those charged with governance. When the entity is a component of a group, the appropriate person(s)

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[3] As described in paragraph A60 of SA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, having responsibility for approving in this context means having the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared.

[4] SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.

with whom the component auditor communicates depends on the engagement circumstances and the matter to be communicated. In some cases, a number of components may be conducting the same businesses within the same system of internal control and using the same accounting practices. Where those charged with governance of those components are the same (e.g., common board of directors), duplication may be avoided by dealing with these components concurrently for the purpose of communication.

Communication with a Subgroup of Those Charged with Governance (Ref: Para. 12)

A5. When considering communicating with a subgroup of those charged with governance, the auditor may take into account such matters as:

- The respective responsibilities of the subgroup and the governing body.
- The nature of the matter to be communicated.
- Relevant legal or regulatory requirements.
- Whether the subgroup has the authority to take action in relation to the information communicated, and can provide further information and explanations the auditor may need.

A6. When deciding whether there is also a need to communicate information, in full or in summary form, with the governing body, the auditor may be influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor may make explicit in agreeing the terms of engagement that, unless prohibited by law or regulation, the auditor retains the right to communicate directly with the governing body.

A7. Audit committees (or similar subgroups with different names) exist in many entities. Although their specific authority and functions may differ, communication with the audit committee, where one exists, has become a key element in the auditor's communication with those charged with governance. Good governance principles suggest that:

- The auditor will be invited to regularly attend meetings of the audit committee.
- The chair of the audit committee and, when relevant, the other members of the audit committee, will liaise with the auditor periodically.
- The audit committee will meet the auditor without management present at least annually.

When All of Those Charged with Governance Are Involved in Managing the Entity (Ref: Para.13)

A8. In some cases, all of those charged with governance are involved in managing the entity, and the application of communication requirements is modified to recognize this position. In such cases, communication with person(s) with management responsibilities may not adequately inform all of those with whom the auditor would otherwise communicate in their governance capacity. For example, in a company where all directors are involved in managing the entity, some of those directors (e.g., one responsible for marketing) may be unaware of significant matters discussed with another director (e.g., one responsible for the preparation of the financial statements).

Matters to Be Communicated

The Auditor's Responsibilities in Relation to the Financial Statement Audit (Ref: Para. 14)

A9. 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.[5] 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 regarding such matters as:

- The auditor's responsibility for performing the audit in accordance with SAs, which is directed towards the expression of an opinion on the financial statements. The matters that SAs require to be communicated, therefore, include significant matters arising during the audit of the financial statements that are relevant to those charged with governance in overseeing the financial reporting process.
- The fact that SAs do not require the auditor to design procedures for the purpose of identifying supplementary matters to communicate with those charged with governance.
- When SA 701[6] applies, the auditor's responsibilities to determine and communicate key audit matters in the auditor's report.
- When applicable, the auditor's responsibility for communicating particular matters required by law or regulation, by agreement with the entity or by additional requirements applicable to the engagement, for example, the standards of a national professional accountancy body.

A10. Law or regulation, an agreement with the entity or additional requirements applicable to the engagement may provide for broader communication with those charged with governance. For example, (a) an agreement with the entity may provide for particular matters to be communicated when they arise from services provided by a firm or network firm other than the financial statement audit; or (b) the mandate of a public sector auditor may provide for matters to be communicated that come to the auditor's attention as a result of other work, such as performance audits.

Planned Scope and Timing of the Audit (Ref: Para. 15)

A11. 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.

[5] See paragraph 10 of SA 210, *Agreeing the Terms of Audit Engagements*.

[6] SA 701, *Communicating Key Audit Matters in the Independent Auditor's Report.*

A12. 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.

A13. Matters communicated may include:

(a) How the auditor plans to address the significant risks of material misstatement, whether due to fraud or error.

(b) How the auditor plans to address areas of higher assessed risks of material misstatement.

(c) The auditor's approach to internal control relevant to the audit.

(d) The application of the concept of materiality in the context of an audit.[7]

(e) The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results, including the use of an auditor's expert.[8]

(f) When SA 701 applies, the auditor's preliminary views about matters that may be areas of significant auditor attention in the audit and therefore may be key audit matters.

A14. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, how the external auditor and internal auditors can work together in a constructive and complementary manner, including any planned use of the work of the internal audit function, and the nature and extent of any planned use of internal auditors to provide direct assistance.9
- The views of those charged with governance of:
  - ➢ The appropriate person(s) in the entity's governance structure with whom to communicate.
  - ➢ The allocation of responsibilities between those charged with governance and management.
  - ➢ The entity's objectives and strategies, and the related business risks that may result in material misstatements.
  - ➢ Matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
  - ➢ Significant communications with regulators.
  - ➢ Other matters those charged with governance consider may influence the audit of the financial statements.
- The attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged

[7] SA 320, *Materiality in Planning and Performing an Audit.*

[8] See SA 620, 'Using the Work of an Auditor's Expert'.

[9] SA 610 (Revised), 'Using the Work of Internal Auditors', paragraph 31.

with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.

- The actions of those charged with governance in response to developments in accounting standards, corporate governance practices, exchange listing rules, and related matters.
- The responses of those charged with governance to previous communications with the auditor.

A15. 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.

A16. 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.

Significant Findings from the Audit (Ref: Para. 16)

A17. 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.

A18. When SA 701 applies, the communications with those charged with governance required by paragraph 16, as well as the communication about the significant risks identified by the auditor required by paragraph 15, are particularly relevant to the auditor's determination of matters that required significant auditor attention and which therefore may be key audit matters.[10]

Significant Qualitative Aspects of Accounting Practices (Ref: Para. 16(a))

A19. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures, for example, in relation to the use of key assumptions in the development of accounting estimates for which there is significant measurement uncertainty. In addition, law, regulation or financial reporting frameworks may require disclosure of a summary of significant accounting policies or make reference to "critical accounting estimates" or "critical accounting policies and practices" to identify and provide additional information to users about the most difficult, subjective or complex judgments made by management in preparing the financial statements.

A20. As a result, the auditor's views on the subjective aspects of the financial statements may be particularly relevant to those charged with governance in discharging their responsibilities for oversight of the financial reporting process. For example, in relation to the matters described in paragraph A19, those charged with governance may be interested in the auditor's evaluation

[10] SA 701, paragraphs 9–10.

of the adequacy of disclosures of the estimation uncertainty relating to accounting estimates that give rise to significant risks. Open and constructive communication about significant qualitative aspects of the entity's accounting practices also may include comment on the acceptability of significant accounting practices. Appendix 2 identifies matters that may be included in this communication.

Significant Difficulties Encountered during the Audit (Ref: Para. 16(b))

A21. Significant difficulties encountered during the audit may include such matters as:

(i) Significant delays by management, the unavailability of entity personnel, or an unwillingness by management to provide information necessary for the auditor to perform the auditor's procedures.

(ii) An unreasonably brief time within which to complete the audit.

(iii) Extensive unexpected effort required to obtain sufficient appropriate audit evidence.

(iv) The unavailability of expected information.

(v) Restrictions imposed on the auditor by management.

(vi) Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.[11]

Significant Matters Discussed, or Subject to Correspondence with Management (Ref: Para. 16(c)(i))

A22. Significant matters 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.

Circumstances that Affect the Form and Content of the Auditor's Report (Ref: Para 16(d))

[11] SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report.*

A23. SA 210 requires the auditor to agree the terms of the audit engagement with management or those charged with governance, as appropriate.[12] 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.[13] As explained in paragraph A9, if the terms of engagement are not agreed with those charged with governance, the auditor may provide those charged with governance with a copy of the engagement letter to communicate about matters relevant to the audit. The communication required by paragraph 16(d) 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.

A24. 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 (Revised).[14]
- A material uncertainty related to going concern is reported in accordance with SA 570 (Revised).[15]
- Key audit matters are communicated in accordance with SA 701.[16]
- The auditor considers it necessary to include an Emphasis of Matter paragraph or Other Matters paragraph in accordance with SA 706 (Revised)[17] or is required to do so by other SAs.

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.

A25. In the rare circumstances that the auditor intends not to include the name of the engagement partner in the auditor's report in accordance with SA 700 (Revised), the auditor is required to discuss this intention with those charged with governance to inform the auditor's assessment of the likelihood and severity of a significant personal security threat. The auditor also may communicate with those charged with governance in circumstances when the auditor elects not to include the description of the auditor's responsibilities in the body of the auditor's report as permitted by SA 700 (Revised).[18]

Other Significant Matters Relevant to the Financial Reporting Process (Ref: Para. 16(e))

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[12] SA 210, paragraph 9.

[13] SA 210, paragraph 10.

[14] SA 705 (Revised), paragraph 30.

[15] SA 570 (Revised), 'Going Concern', paragraph 25(d).

[16] SA 701, paragraph 17.

[17] SA 706 (Revised), 'Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report', paragraph 12.

[18] SA 700 (Revised), paragraph 40.

A26. SA 300[19] notes that, as a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. The auditor may communicate with those charged with governance about such matters, for example, as an update to initial discussions about the planned scope and timing of the audit.

A27. Other significant matters arising from the audit that are directly relevant to those charged with governance in overseeing the financial reporting process may include such matters as material misstatements of fact or material inconsistencies in information accompanying the audited financial statements that have been corrected.

A28. To the extent not already addressed by the requirements in paragraphs 16(a)–(d) and related application material, the auditor may consider communicating about other matters discussed with, or considered by, the engagement quality control reviewer, if one has been appointed, in accordance with SA 220.[20]

Auditor Independence (Ref: Para. 17)

A29. The auditor is required to comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements.[21]

A30. The relationships and other matters, and safeguards to be communicated, vary with the circumstances of the engagement, but generally address:

(a) Threats to independence, which may be categorized as: self-interest threats, self-review threats, advocacy threats, familiarity threats, and intimidation threats; and

(b) Safeguards created by the profession, legislation or regulation, safeguards within the entity, and safeguards within the firm's own systems and procedures.

A31. Relevant ethical requirements or law or regulation may also specify particular communications to those charged with governance in circumstances where breaches of independence requirements have been identified. For example, the Code of Ethics issued by ICAI requires the auditor to communicate with those charged with governance in writing about any breach and the action the firm has taken or proposes to take.

A32. The communication requirements relating to auditor independence that apply in the case of listed entities may also be appropriate in the case of some other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business. Examples of such entities may include financial institutions (such as banks, insurance companies, and pension funds), and other entities such as charities. On the other hand, there may be situations where communications regarding independence may not be relevant, for example, where all of those

[19] SA 300, 'Planning an Audit of Financial Statements', paragraph A14.

[20] See paragraphs 19–21 and A23–A31 of SA 220, *Quality Control for an Audit of Financial Statements.*

[21] SA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing*, paragraph 14.

charged with governance have been informed of relevant facts through their management activities. This is particularly likely where the entity is owner-managed, and the auditor's firm and network firms have little involvement with the entity beyond a financial statement audit.

Supplementary Matters (Ref: Para. 3)

A33. The oversight of management by those charged with governance includes ensuring that the entity designs, implements and maintains appropriate internal control with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

A34. The auditor may become aware of supplementary matters that do not necessarily relate to the oversight of the financial reporting process but which are, nevertheless, likely to be significant to the responsibilities of those charged with governance in overseeing the strategic direction of the entity or the entity's obligations related to accountability. Such matters may include, for example, significant issues regarding governance structures or processes, and significant decisions or actions by senior management that lack appropriate authorization.

A35. In determining whether to communicate supplementary matters with those charged with governance, the auditor may discuss matters of this kind of which the auditor has become aware with the appropriate level of management, unless it is inappropriate to do so in the circumstances.

A36. If a supplementary matter is communicated, it may be appropriate for the auditor to make those charged with governance aware that:

(a) Identification and communication of such matters is incidental to the purpose of the audit, which is to form an opinion on the financial statements;

(b) No procedures were carried out with respect to the matter other than any that were necessary to form an opinion on the financial statements; and

(c) No procedures were carried out to determine whether other such matters exist.

The Communication Process

Establishing the Communication Process (Ref: Para. 18)

A37. Clear communication of the auditor's responsibilities, the planned scope and timing of the audit, and the expected general content of communications helps establish the basis for effective two-way communication.

A38. Matters that may also contribute to effective two-way communication include discussion of:

- The purpose of communications. When the purpose is clear, the auditor and those charged with governance are better placed to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
- The form in which communications will be made.
- The person(s) in the engagement team and among those charged with governance who will communicate regarding particular matters.

- The auditor's expectation that communication will be two-way, and that those charged with governance will communicate with the auditor matters they consider relevant to the audit, for example, strategic decisions that may significantly affect the nature, timing and extent of audit procedures, the suspicion or the detection of fraud, and concerns with the integrity or competence of senior management.
- The process for taking action and reporting back on matters communicated by the auditor.
- The process for taking action and reporting back on matters communicated by those charged with governance.

A39. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor's view of the significance of matters to be communicated. Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and those charged with governance is not adequate for the purpose of the audit (see paragraph A52).

Considerations Specific to Smaller Entities

A40. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of listed or larger entities.

Communication with Management

A41. Many matters may be discussed with management in the ordinary course of an audit, including matters required by this SA to be communicated with those charged with governance. Such discussions recognize management's executive responsibility for the conduct of the entity's operations and, in particular, management's responsibility for the preparation of the financial statements.

A42. Before communicating matters with those charged with governance, the auditor may discuss them with management, unless that is inappropriate. For example, it may not be appropriate to discuss questions of management's competence or integrity with management. In addition to recognizing management's executive responsibility, these initial discussions may clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with the internal auditor before communicating with those charged with governance.

Communication with Third Parties

A43. Those charged with governance may be required by law or regulation, or may wish, to provide third parties, for example, bankers or certain regulatory authorities, with copies of a written communication from the auditor. In some cases, disclosure to third parties may be illegal or otherwise inappropriate. When a written communication prepared for those charged with governance is provided to third parties, it may be important in the circumstances that the third parties be informed that the communication was not prepared with them in mind, for example, by stating in written communications with those charged with governance:

- That the communication has been prepared for the sole use of those charged with governance and, where applicable, the group management and the group auditor, and should not be relied upon by third parties;

- That no responsibility is assumed by the auditor to third parties; and
- Any restrictions on disclosure or distribution to third parties.

A44. In some entities, the auditor may be required by law or regulation to, for example:

- Notify a regulatory or enforcement body of certain matters communicated with those charged with governance. For example, in some countries the auditor has a duty to report misstatements to authorities where management and those charged with governance fail to take corrective action;
- Submit copies of certain reports prepared for those charged with governance to relevant regulatory or funding bodies, or other bodies such as a central authority in the case of some public sector entities; or
- Make reports prepared for those charged with governance publicly available.

A45. Unless required by law or regulation to provide a third party with a copy of the auditor's written communications with those charged with governance, the auditor may need the prior consent of those charged with governance before doing so.

Forms of Communication **(Ref: Para. 19)**

A46. Effective communication may involve structured presentations and written reports as well as less structured communications, including discussions. The auditor may communicate matters other than those identified in paragraphs 19–20 either orally or in writing. Written communications may include an engagement letter that is provided to those charged with governance.

A47. In addition to the significance of a particular matter, the form of communication (e.g., whether to communicate orally or in writing, the extent of detail or summarization in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:

(a) Whether a discussion of the matter will be included in the auditor's report. For example, when key audit matters are communicated in the auditor's report, the auditor may consider it necessary to communicate in writing about the matters determined to be key audit matters.

(b) Whether the matter has been satisfactorily resolved.

(c) Whether management has previously communicated the matter.

(d) The size, operating structure, control environment, and legal structure of the entity.

(e) In the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.

(f) Legal requirements. In some entities, a written communication with those charged with governance is required in a prescribed form by local law.

(g) The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.

(h) The amount of ongoing contact and dialogue the auditor has with those charged with governance.

(i) Whether there have been significant changes in the membership of a governing body.

A48. When a significant matter is discussed with an individual member of those charged with governance, for example, the chair of an audit committee, it may be appropriate for the auditor to summarize the matter in later communications so that all of those charged with governance have full and balanced information.

Timing of Communications **(Ref: Para. 21)**

A49. Timely communication throughout the audit contributes to the achievement of robust two-way dialogue between those charged with governance and the auditor. However, the appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by those charged with governance. For example:

(a) Communications regarding planning matters may often be made early in the audit engagement and, for an initial engagement, may be made as part of agreeing the terms of the engagement.

(b) It may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion. Similarly, the auditor may communicate orally to those charged with governance as soon as practicable significant deficiencies in internal control that the auditor has identified, prior to communicating these in writing as required by SA 265.[22]

- When SA 701 applies, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit (see paragraph A13), and the auditor also may have more frequent communications to further discuss such matters when communicating about significant audit findings.
- Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards, for example, when accepting an engagement to provide non-audit services, and at a concluding discussion.
- Communications regarding findings from the audit, including the auditor's views about the qualitative aspects of the entity's accounting practices, may also be made as part of the concluding discussion.
- When auditing both general purpose and special purpose financial statements, it may be appropriate to coordinate the timing of communications.

A50. Other factors that may be relevant to the timing of communications include:

- The size, operating structure, control environment, and legal structure of the entity being

[22] SA 265, paragraphs 9 and A14.

audited.

- Any legal obligation to communicate certain matters within a specified timeframe.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The time at which the auditor identifies certain matters, for example, the auditor may not identify a particular matter (e.g., noncompliance with a law) in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.

Adequacy of the Communication Process **(Ref: Para. 22)**

A51. The auditor need not design specific procedures to support the evaluation of the two-way communication between the auditor and those charged with governance; rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include:

- The appropriateness and timeliness of actions taken by those charged with governance in response to matters raised by the auditor. Where significant matters raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire as to why appropriate action has not been taken, and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.
- The apparent openness of those charged with governance in their communications with the auditor.
- The willingness and capacity of those charged with governance to meet with the auditor without management present.
- The apparent ability of those charged with governance to fully comprehend matters raised by the auditor, for example, the extent to which those charged with governance probe issues, and question recommendations made to them.
- Difficulty in establishing with those charged with governance a mutual understanding of the form, timing and expected general content of communications.
- Where all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.
- Whether the two-way communication between the auditor and those charged with governance meets applicable legal and regulatory requirements.

A52. As noted in paragraph 4, effective two-way communication assists both the auditor and those charged with governance. Further, SA 315 identifies participation by those charged with governance, including their interaction with internal audit, if any, and external auditors, as an element of the entity's control environment.[23] Inadequate two-way communication may indicate an unsatisfactory control environment and influence the auditor's assessment of the risks of

[23] SA 315, paragraph A70.

material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.

A53. If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take such actions as:

- Modifying the auditor's opinion on the basis of a scope limitation.
- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (e.g., a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (e.g., shareholders in a general meeting), or the responsible government minister or parliament in the public sector.
- Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.

Documentation (Ref: Para. 23)

A54. Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

Appendix 1

(Ref: Para. 3)

Specific Requirements in SQC 1 and Other SAs that Refer to Communications with Those Charged With Governance

This appendix identifies paragraphs in SQC 1[1] and other SAs that require communication of specific matters with those charged with governance. The list is not a substitute for considering the requirements and related application and other explanatory material in SAs.

- SQC 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements* – paragraph 42(a).
- SA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* – paragraphs 21, 38(c)(i) and 40-42.
- SA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraphs 14, 19 and 22–24.
- SA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* – paragraph 9.
- SA 450, *Evaluation of Misstatements Identified during the Audit* – paragraphs 12-13.
- SA 505, *External Confirmations* – paragraph 9.
- SA 510*, Initial Audit Engagements—Opening Balances* – paragraph 7.

[1] SQC 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

- SA 550, *Related Parties* – paragraph 27.
- SA 560, *Subsequent Events*– paragraphs 7(b)-(c), 10(a), 13(b), 14(a) and 17.
- SA 570 (Revised), *Going Concern* – paragraph 25.
- SA 610 (Revised), *Using the Work of Internal Auditors* – paragraphs 20 and 31.
- SA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* – paragraph 17.
- SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report* – paragraphs 12, 14, 23 and 30.
- SA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* – paragraph 12.
- SA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements* - paragraph 18.
- SA 720, *The Auditor's Responsibilities in Relation to Other Information in Documents Containing Audited Financial Statements* – paragraphs 10, 13 and 16.

Appendix 2

(Ref: Para. 16(a), A19–A20)

Qualitative Aspects of Accounting Practices

The communication required by paragraph 16(a), and discussed in paragraphs A19–A20, may include such matters as:

Accounting Policies

- The appropriateness of the accounting policies to the particular circumstances of the entity, having regard to the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements. Where acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant accounting policies as well as information on accounting policies used by similar entities.
- The initial selection of, and changes in, significant accounting policies, including the application of new accounting pronouncements. The communication may include: the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity; and the timing of a change in accounting policies in relation to expected new accounting pronouncements.
- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative guidance or consensus).
- The effect of the timing of transactions in relation to the period in which they are recorded.

Accounting Estimates

- For items for which estimates are significant, issues discussed in SA 540,[1] including, for example:
  - How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements.
  - Changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
  - Whether management's decision to recognize, or to not recognize, the accounting estimates in the financial statements is in accordance with the applicable financial reporting framework.
  - Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates and, if so, why, as well as the outcome of accounting estimates in prior periods.
  - Management's process for making accounting estimates (e.g., when management has used a model), including whether the selected measurement basis for the accounting estimate is in accordance with the applicable financial reporting framework.
  - Whether the significant assumptions used by management in developing the accounting estimate are reasonable.
  - Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.
  - Risks of material misstatement.
  - Indicators of possible management bias.
  - How management has considered alternative assumptions or outcomes and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.
  - The adequacy of disclosure of estimation uncertainty in the financial statements.

Financial Statement Disclosures

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (e.g., disclosures related to revenue recognition, remuneration, going concern, subsequent events, and contingency issues).

[1] SA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.

- The overall neutrality, consistency and clarity of the disclosures in the financial statements.

Related Matters

- The potential effect on the financial statements of significant risks, exposures and uncertainties, such as pending litigation, that are disclosed in the financial statements.
- The extent to which the financial statements are affected by significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. This communication may highlight:
  - The non-recurring amounts recognized during the period.
  - The extent to which such transactions are separately disclosed in the financial statements.
  - Whether such transactions appear to have been designed to achieve a particular accounting or tax treatment, or a particular legal or regulatory objective.
  - Whether the form of such transactions appears overly complex or where extensive advice regarding the structuring of the transaction has been taken.
  - Where management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets. The communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements.
- The selective correction of misstatements, for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings.

(II) SA 570 (Revised), Going Concern

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report. (Ref: Para. A1)

Going Concern Basis of Accounting

2. Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Special purpose financial statements may or may not

be prepared in accordance with a financial reporting framework for which the going concern basis of accounting is relevant (e.g., the going concern basis of accounting is not relevant for some financial statements prepared on a tax basis). When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. (Ref: Para. A2)

Responsibility for Assessment of the Entity's Ability to Continue as a Going Concern

3. Some financial reporting frameworks contain an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern, and standards regarding matters to be considered and disclosures to be made in connection with going concern. The detailed requirements regarding management's responsibility to assess the entity's ability to continue as a going concern and related financial statement disclosures may also be set out in law or regulation.

4. In other financial reporting frameworks, there may be no explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. Nevertheless, where the going concern basis of accounting is a fundamental principle in the preparation of financial statements as discussed in paragraph 2, the preparation of the financial statements requires management to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so.

5. Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. The following factors are relevant to that judgment:

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

Responsibilities of the Auditor

6. The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as

a going concern. These responsibilities exist even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

7. However, as described in SA 200,[24] the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Effective Date

8. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2017.

Objectives

9. The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;

(b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and

(c) To report in accordance with this SA.

Requirements

Risk Assessment Procedures and Related Activities

10. When performing risk assessment procedures as required by SA 315,[25] the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and: (Ref: Para. A3–A6)

(a) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as

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[24] SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, paragraphs A51–A52

[25] SA 315 , *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 5

a going concern and, if so, management's plans to address them; or

(b) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

11. The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. (Ref: Para. A7)

Evaluating Management's Assessment

12. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. (Ref: Para. A8–A10, A12–A13)

13. In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation if it specifies a longer period. If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the date of the financial statements as defined in SA 560,26 the auditor shall request management to extend its assessment period to at least twelve months from that date. (Ref: Para. A11–A13)

14. In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

Period beyond Management's Assessment

15. The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern. (Ref: Para. A14–A15)

Additional Audit Procedures When Events or Conditions Are Identified

16. If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern (hereinafter referred to as "material uncertainty") through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include: (Ref: Para. A16)

(a) Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.

(b) Evaluating management's plans for future actions in relation to its going concern

[26] SA 560, *Subsequent Events*, paragraph 5(a)

assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances. (Ref: Para. A17)

(c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions: (Ref: Para. A18–A19)

  (i) Evaluating the reliability of the underlying data generated to prepare the forecast; and

  (ii) Determining whether there is adequate support for the assumptions underlying the forecast.

(d) Considering whether any additional facts or information have become available since the date on which management made its assessment.

(e) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans. (Ref: Para. A20)

Auditor Conclusions

17. The auditor shall evaluate whether sufficient appropriate audit evidence has been obtained regarding, and shall conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.

18. Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for: (Ref: Para. A21−A22)

(a) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or

(b) In the case of a compliance framework, the financial statements not to be misleading.

Adequacy of Disclosures When Events or Conditions Have Been Identified and a Material Uncertainty Exists

19. If the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements: (Ref: Para. A22–A23)

(a) Adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

Adequacy of Disclosures When Events or Conditions Have Been Identified but No Material Uncertainty Exists

20. If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions. (Ref: Para. A24–A25)

Implications for the Auditor's Report

Use of Going Concern Basis of Accounting Is Inappropriate

21. If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion. (Ref: Para. A26–A27)

Use of Going Concern Basis of Accounting Is Appropriate but a Material Uncertainty Exists

Adequate Disclosure of a Material Uncertainty Is Made in the Financial Statements

22. If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to: (Ref: Para. A28–A31, A34)

(a) Draw attention to the note in the financial statements that discloses the matters set out in paragraph 19; and

(b) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

Adequate Disclosure of a Material Uncertainty Is Not Made in the Financial Statements

23. If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall: (Ref: Para. A32–A34)

(a) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised)[27]; and

(b) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

[27] SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report.*

Management Unwilling to Make or Extend Its Assessment

24. If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report. (Ref: Para. A35)

Communication with Those Charged with Governance

25. Unless all those charged with governance are involved in managing the entity,[28] the auditor shall communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. Such communication with those charged with governance shall include the following:

(a) Whether the events or conditions constitute a material uncertainty;

(b) Whether management's use of the going concern basis of accounting is appropriate in the preparation of the financial statements;

(c) The adequacy of related disclosures in the financial statements; and

(d) Where applicable, the implications for the auditor's report.

Significant Delay in the Approval of Financial Statements

26. If there is significant delay in the approval of the financial statements by management or those charged with governance after the date of the financial statements, the auditor shall inquire as to the reasons for the delay. If the auditor believes that the delay could be related to events or conditions relating to the going concern assessment, the auditor shall perform those additional audit procedures necessary, as described in paragraph 16, as well as consider the effect on the auditor's conclusion regarding the existence of a material uncertainty, as described in paragraph 18.

Application and Other Explanatory Material

Scope of this SA (Ref: Para 1)

A1. SA 701[29] deals with the auditor's responsibility to communicate key audit matters in the auditor's report. That SA acknowledges that, when SA 701 applies, matters relating to going concern may be determined to be key audit matters, and explains that a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern is, by its nature, a key audit matter.[30]

Going Concern Basis of Accounting (Ref: Para. 2)

Considerations Specific to Public Sector Entities

A2. Management's use of the going concern basis of accounting is also relevant to public sector entities. Going concern risks may arise, but are not limited to, situations where public

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[28] SA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13.

[29] SA 701, Communicating Key Audit Matters in the Independent Auditor's Report.

[30] See paragraphs 15 and A41 of SA 701.

sector entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatization. Events or conditions that may cast significant doubt on an entity's ability to continue as a going concern in the public sector may include situations where the public sector entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by the public sector entity.

Risk Assessment Procedures and Related Activities

Events or Conditions That May Cast Significant Doubt on the Entity's Ability to Continue as a Going Concern (Ref: Para. 10)

A3. The following are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists.

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labor difficulties.
- Shortages of important supplies.

- Emergence of a highly successful competitor.

Other

- Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

A4. The risk assessment procedures required by paragraph 10 help the auditor to determine whether management's use of the going concern basis of accounting is likely to be an important issue and its impact on planning the audit. These procedures also allow for more timely discussions with management, including a discussion of management's plans and resolution of any identified going concern issues.

Considerations Specific to Smaller Entities (Ref: Para. 10)

A5. The size of an entity may affect its ability to withstand adverse conditions. Small entities may be able to respond quickly to exploit opportunities, but may lack reserves to sustain operations.

A6. Conditions of particular relevance to small entities include the risk that banks and other lenders may cease to support the entity, as well as the possible loss of a principal supplier, major customer, key employee, or the right to operate under a license, franchise or other legal agreement.

Remaining Alert throughout the Audit for Audit Evidence about Events or Conditions (Ref: Para. 11)

A7. SA 315 requires the auditor to revise the auditor's risk assessment and modify the further planned audit procedures accordingly when additional audit evidence is obtained during the course of the audit that affects the auditor's assessment of risk.[31] If events or conditions that may cast significant doubt on the entity's ability to continue as a going concern are identified after the auditor's risk assessments are made, in addition to performing the procedures in paragraph 16, the auditor's assessment of the risks of material misstatement may need to be revised. The existence of such events or conditions may also affect the nature, timing and extent

[31] SA 315, paragraph 31

of the auditor's further procedures in response to the assessed risks. SA 330[32] establishes requirements and provides guidance on this issue.

Evaluating Management's Assessment

Management's Assessment and Supporting Analysis and the Auditor's Evaluation (Ref: Para. 12)

A8. Management's assessment of the entity's ability to continue as a going concern is a key part of the auditor's consideration of management's use of the going concern basis of accounting.

A9. It is not the auditor's responsibility to rectify the lack of analysis by management. In some circumstances, however, the lack of detailed analysis by management to support its assessment may not prevent the auditor from concluding whether management's use of the going concern basis of accounting is appropriate in the circumstances. For example, when there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis. In this case, the auditor's evaluation of the appropriateness of management's assessment may be made without performing detailed evaluation procedures if the auditor's other audit procedures are sufficient to enable the auditor to conclude whether management's use of the going concern basis of accounting in the preparation of the financial statements is appropriate in the circumstances.

A10. In other circumstances, evaluating management's assessment of the entity's ability to continue as a going concern, as required by paragraph 12, may include an evaluation of the process management followed to make its assessment, the assumptions on which the assessment is based and management's plans for future action and whether management's plans are feasible in the circumstances.

The Period of Management's Assessment (Ref: Para. 13)

A11. Most financial reporting frameworks requiring an explicit management assessment specify the period for which management is required to take into account all available information.

Considerations Specific to Smaller Entities (Ref: Para. 12–13)

A12. In many cases, the management of smaller entities may not have prepared a detailed assessment of the entity's ability to continue as a going concern, but instead may rely on in-depth knowledge of the business and anticipated future prospects. Nevertheless, in accordance with the requirements of this SA, the auditor needs to evaluate management's assessment of the entity's ability to continue as a going concern. For smaller entities, it may be appropriate to discuss the medium and long-term financing of the entity with management, provided that management's contentions can be corroborated by sufficient documentary evidence and are not inconsistent with the auditor's understanding of the entity. Therefore, the requirement in paragraph 13 for the auditor to request management to extend its assessment may, for example, be satisfied by discussion, inquiry and inspection of supporting documentation, for

[32] SA 330, *The Auditor's Responses to Assessed Risks*

example, orders received for future supply, evaluated as to their feasibility or otherwise substantiated.

A13. Continued support by owner-managers is often important to smaller entities' ability to continue as a going concern. Where a small entity is largely financed by a loan from the owner-manager, it may be important that these funds are not withdrawn. For example, the continuance of a small entity in financial difficulty may be dependent on the owner-manager subordinating a loan to the entity in favor of banks or other creditors, or the owner-manager supporting a loan for the entity by providing a guarantee with his or her personal assets as collateral. In such circumstances, the auditor may obtain appropriate documentary evidence of the subordination of the owner-manager's loan or of the guarantee. Where an entity is dependent on additional support from the owner-manager, the auditor may evaluate the owner-manager's ability to meet the obligation under the support arrangement. In addition, the auditor may request written confirmation of the terms and conditions attaching to such support and the owner-manager's intention or understanding.

Period beyond Management's Assessment (Ref: Para. 15)

A14. As required by paragraph 11, the auditor remains alert to the possibility that there may be known events, scheduled or otherwise, or conditions that will occur beyond the period of assessment used by management that may bring into question the appropriateness of management's use of the going concern basis of accounting in preparing the financial statements. Since the degree of uncertainty associated with the outcome of an event or condition increases as the event or condition is further into the future, in considering events or conditions further in the future, the indications of going concern issues need to be significant before the auditor needs to consider taking further action. If such events or conditions are identified, the auditor may need to request management to evaluate the potential significance of the event or condition on its assessment of the entity's ability to continue as a going concern. In these circumstances, the procedures in paragraph 16 apply.

A15. Other than inquiry of management, the auditor does not have a responsibility to perform any other audit procedures to identify events or conditions that may cast significant doubt on the entity's ability to continue as a going concern beyond the period assessed by management, which, as discussed in paragraph 13, would be at least twelve months from the date of the financial statements.

Additional Audit Procedures When Events or Conditions Are Identified (Ref: Para.16)

A16. Audit procedures that are relevant to the requirement in paragraph 16 may include the following:

- Analyzing and discussing cash flow, profit and other relevant forecasts with management.
- Analyzing and discussing the entity's latest available interim financial statements.
- Reading the terms of debentures and loan agreements and determining whether any have been breached.

- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Evaluating the entity's plans to deal with unfilled customer orders.
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.
- Confirming the existence, terms and adequacy of borrowing facilities.
- Obtaining and reviewing reports of regulatory actions.
- Determining the adequacy of support for any planned disposals of assets.

Evaluating Management's Plans for Future Actions (Ref: Para. 16(b))

A17. Evaluating management's plans for future actions may include inquiries of management as to its plans for future action, including, for example, its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital.

The Period of Management's Assessment (Ref: Para. 16(c))

A18. In addition to the procedures required in paragraph 16(c), the auditor may compare:

- The prospective financial information for recent prior periods with historical results; and
- The prospective financial information for the current period with results achieved to date.

A19. Where management's assumptions include continued support by third parties, whether through the subordination of loans, commitments to maintain or provide additional funding, or guarantees, and such support is important to an entity's ability to continue as a going concern, the auditor may need to consider requesting written confirmation (including of terms and conditions) from those third parties and to obtain evidence of their ability to provide such support.

Written Representations (Ref: Para. 16(e))

A20. The auditor may consider it appropriate to obtain specific written representations beyond those required in paragraph 16 in support of audit evidence obtained regarding management's plans for future actions in relation to its going concern assessment and the feasibility of those plans.

Auditor Conclusions

Material Uncertainty Related to Events or Conditions that May Cast Significant Doubt on the

Entity's Ability to Continue as a Going Concern (Ref: Para. 18-19)

A21. The phrase "material uncertainty" means the uncertainties related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern that should be disclosed in the financial statements. In some other financial reporting frameworks the phrase "significant uncertainty" is used in similar circumstances.

Adequacy of Disclosure when Events or Conditions Have Been Identified and a Material Uncertainty Exists

A22. Paragraph 18 explains that a material uncertainty exists when the magnitude of the potential impact of the events or conditions and the likelihood of occurrence is such that appropriate disclosure is necessary to achieve fair presentation (for fair presentation frameworks) or for the financial statements not to be misleading (for compliance frameworks). The auditor is required by paragraph 18 to conclude whether such a material uncertainty exists regardless of whether or how the applicable financial reporting framework defines a material uncertainty.

A23. Paragraph 19 requires the auditor to determine whether the financial statement disclosures address the matters set forth in that paragraph. This determination is in addition to the auditor determining whether disclosures about a material uncertainty, required by the applicable financial reporting framework, are adequate. Disclosures required by some financial reporting frameworks that are in addition to matters set forth in paragraph 19 may include disclosures about:

- Management's evaluation of the significance of the events or conditions relating to the entity's ability to meet its obligations; or
- Significant judgments made by management as part of its assessment of the entity's ability to continue as a going concern.

Some financial reporting frameworks may provide additional guidance regarding management's consideration of disclosures about the magnitude of the potential impact of the principal events or conditions, and the likelihood and timing of their occurrence.

Adequacy of Disclosures When Events or Conditions Have Been Identified but No Material Uncertainty Exists (Ref: Para. 20)

A24. Even when no material uncertainty exists, paragraph 20 requires the auditor to evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosure about events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Some financial reporting frameworks may address disclosures about:

- Principal events or conditions;
- Management's evaluation of the significance of those events or conditions in relation to the entity's ability to meet its obligations;

- Management's plans that mitigate the effect of these events or conditions; or
- Significant judgments made by management as part of its assessment of the entity's ability to continue as a going concern.

A25. When the financial statements are prepared in accordance with a fair presentation framework, the auditor's evaluation as to whether the financial statements achieve fair presentation includes the consideration of the overall presentation, structure and content of the financial statements, and whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.[33] Depending on the facts and circumstances, the auditor may determine that additional disclosures are necessary to achieve fair presentation. This may be the case, for example, when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained, the auditor concludes that no material uncertainty exists, and no disclosures are explicitly required by the applicable financial reporting framework regarding these circumstances.

Implications for the Auditor's Report

Use of Going Concern Basis of Accounting is Inappropriate (Ref: Para. 21)

A26. If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the financial statements is inappropriate, the requirement in paragraph 21 for the auditor to express an adverse opinion applies regardless of whether or not the financial statements include disclosure of the inappropriateness of management's use of the going concern basis of accounting.

A27. When the use of the going concern basis of accounting is not appropriate in the circumstances, management may be required, or may elect, to prepare the financial statements on another basis (e.g., liquidation basis). The auditor may be able to perform an audit of those financial statements provided that the auditor determines that the other basis of accounting is acceptable in the circumstances. The auditor may be able to express an unmodified opinion on those financial statements, provided there is adequate disclosure therein about the basis of accounting on which the financial statements are prepared, but may consider it appropriate or necessary to include an Emphasis of Matter paragraph in accordance with SA 706 (Revised)[34] in the auditor's report to draw the user's attention to that alternative basis of accounting and the reasons for its use.

Use of the Going Concern Basis of Accounting Is Appropriate but a Material Uncertainty Exists (Ref: Para. 22-23)

A28. The identification of a material uncertainty is a matter that is important to users'

[33] SA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements,* paragraph 14

[34] SA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

understanding of the financial statements. The use of a separate section with a heading that includes reference to the fact that a material uncertainty related to going concern exists alerts users to this circumstance.

A29. The Appendix to this SA provides illustrations of the statements that are required to be included in the auditor's report on the financial statements when "the Accounting Principles generally accepted in India" is the applicable financial reporting framework. If an applicable financial reporting framework other than abovementioned framework is used, the illustrative statements presented in the Appendix to this SA may need to be adapted to reflect the application of the other financial reporting framework in the circumstances.

A30. Paragraph 22 establishes the minimum information required to be presented in the auditor's report in each of the circumstances described. The auditor may provide additional information to supplement the required statements, for example to explain:

- That the existence of a material uncertainty is fundamental to users' understanding of the financial statements;[35] or
- How the matter was addressed in the audit. (Ref: Para. A1)

Adequate Disclosure of a Material Uncertainty Is Made in the Financial Statements (Ref: Para. 22)

A31. Illustration 1 of the Appendix to this SA is an example of an auditor's report when the auditor has obtained sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern basis of accounting but a material uncertainty exists and disclosure is adequate in the financial statements. The Appendix of SA 700 (Revised) also includes illustrative wording to be included in the auditor's report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements (Ref: Para. 23)

A32. Illustrations 2 and 3 of the Appendix to this SA are examples of auditor's reports containing qualified and adverse opinions, respectively, when the auditor has obtained sufficient appropriate audit evidence regarding the appropriateness of the management's use of the going concern basis of accounting but adequate disclosure of a material uncertainty is not made in the financial statements.

A33. In situations involving multiple uncertainties that are significant to the financial statements as a whole, the auditor may consider it appropriate in extremely rare cases to express a disclaimer of opinion instead of including the statements required by paragraph 22. SA 705

[35] SA 706(Revised), paragraph A2

(Revised) provides guidance on this issue.[36]

Communication with Regulators (Ref: Para. 22−23)

A34. When the auditor of a regulated entity considers that it may be necessary to include a reference to going concern matters in the auditor's report, the auditor may have a duty to communicate with the applicable regulatory, enforcement or supervisory authorities.

Management Unwilling to Make or Extend Its Assessment (Ref: Para. 24)

A35. In certain circumstances, the auditor may believe it necessary to request management to make or extend its assessment. If management is unwilling to do so, a qualified opinion or a disclaimer of opinion in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements, such as audit evidence regarding the existence of plans management has put in place or the existence of other mitigating factors.

Appendix

(Ref: Para. A29, A31–A32)

Illustrations of Auditor's Reports Relating to Going Concern

- Illustration 1: An auditor's report containing an unmodified opinion when the auditor has concluded that a material uncertainty exists and disclosure in the financial statements is adequate.
- Illustration 2: An auditor's report containing a qualified opinion when the auditor has concluded that a material uncertainty exists and that the financial statements are materially misstated due to inadequate disclosure.
- Illustration 3: An auditor's report containing an adverse opinion when the auditor has concluded that a material uncertainty exists and the financial statements omit the required disclosures relating to a material uncertainty.

Illustration 1 – Unmodified Opinion When a Material Uncertainty Exists and Disclosure in the Financial Statements Is Adequate

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed company (registered under the Companies Act, 2013) using a fair presentation framework. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the

[36] SA 705(Revised), paragraph 10

accounting Standards prescribed under section 133 of the Companies Act, 2013.

- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.37
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. The disclosure of the material uncertainty in the financial statements is adequate.
- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements[38]

Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at 31st March 20XX, and the statement of Profit and Loss, *(statement of changes in equity)*[39] and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information [in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)][40].

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles

[37] SA 210, *Agreeing the Terms of Audit Engagements*

[38] The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

[39] Where applicable.

[40] Where applicable.

generally accepted in India, of the state of affairs of the Company as at March 31, 20XX, and profit/loss, *(changes in equity)*[41] and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the *Code of Ethics* issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Material Uncertainty Related to Going Concern

We draw attention to Note XX in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note XX, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Material Uncertainty Related to Going Concern* section, we have determined the matters described below to be the key audit matters to be communicated in our report.

[*Description of each key audit matter in accordance with SA 701.*]

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[Reporting in accordance with SA 700 (Revised)–see Illustration 1 in SA 700 (Revised).[42]]

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[41] Where applicable

[42] Paragraphs 33 and 38 of SA 700 (Revised) require wording to be included in the auditor's report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

Auditor's Responsibilities for the Audit of the Financial Statements

[*Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised)*.]

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised)*.]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member signing the Audit Report)
(Designation[43])
(Membership No. XXXXX)

Place of Signature:

Date:

Illustration 2 – Qualified Opinion When a Material Uncertainty Exists and the Financial Statements Are Materially Misstated Due to Inadequate Disclosure

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed company using a fair presentation framework. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the accounting Standards prescribed under section 133 of the Companies Act, 2013.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Note YY to the financial statements discusses the magnitude of financing arrangements, the expiration and the total financing arrangements; however the financial statements do not include discussion on the impact or the availability of refinancing or characterize this situation as a material uncertainty.
- The financial statements are materially misstated due to the inadequate disclosure of the material uncertainty. A qualified opinion is being expressed because the auditor concluded that the effects on the financial statements of this inadequate disclosure are material but

[43] Partner or Proprietor, as the case may be

not pervasive to the financial statements.

- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements[44]

Qualified Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at 31st March 20XX, and the statement of Profit and Loss, *(statement of changes in equity)*[45] and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information [in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)][46].

In our opinion and to the best of our information and according to the explanations given to us, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion section of our report, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31, 20XX, and profit/loss, *(changes in equity)*[47] and its cash flows for the year ended on that date.

Basis for Qualified Opinion

As discussed in Note YY, the Company's financing arrangements expire and amounts outstanding are payable on April 30, 20X2. The Company has been unable to conclude re-negotiations or obtain replacement financing. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not adequately disclose this matter.

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are

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44 The sub-title "Report on the Audit of the Standalone Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

45 Where applicable.

46 Where applicable.

47 Where applicable

further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the *Code of Ethics* issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Basis for Qualified Opinion* section, we have determined the matters described below to be the key audit matters to be communicated in our report.

[*Descriptions of each key audit matter in accordance with SA 701*.]

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[*Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised)*.[48]]

Auditor's Responsibilities for the Audit of the Financial Statements

[*Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised)*.]

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised)*.]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member signing the Audit Report)
(Designation[49])
(Membership No. XXXXX)

Place of Signature:

Date:

[48] Paragraphs 33 and 38 of SA 700 (Revised) require wording to be included in the auditor's report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

[49] Partner or Proprietor, as the case may be

<u>Illustration 3 – Adverse Opinion When a Material Uncertainty Exists and Is Not Disclosed in the Financial Statements</u>

For purposes of the illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a non corporate entity using a fair presentation framework. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, and the entity is considering bankruptcy. The financial statements omit the required disclosures relating to the material uncertainty. An adverse opinion is being expressed because the effects on the financial statements of such omission are material and pervasive.
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

To the Partners of ABC & Associates [or other Appropriate Addressee]

Report on the Audit of the Financial Statements[50]

Adverse Opinion

We have audited the financial statements of ABC & Associates (the entity), which comprise the balance sheet at March 31st 20XX, and the profit and loss account, *(and statement of cash flows)*[51] for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, because of the omission of the information mentioned in the *Basis for Adverse Opinion* section of our report, the accompanying financial statements do not present fairly (or *do not give a true and fair view of*), the financial position of the entity as at March 31, 20X1, and

[50] The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

[51] Where applicable.

of its financial performance and its cash flows for the year then ended in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.

Basis for Adverse Opinion

The entity's financing arrangements expired and the amount outstanding was payable on March 31,20X1. The entity has been unable to conclude re-negotiations or obtain replacement financing and is considering filing for bankruptcy. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not adequately disclose this fact.

Basis for Opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) issued by ICAI. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the entity in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of Management and Those Charged with Governance for the Financial Statements[52]

[*Reporting in accordance with SA 700 (Revised) – see Illustration 4 in SA 700 (Revised).*[53]]

Auditor's Responsibilities for the Audit of the Financial Statements

[*Reporting in accordance with SA 700 (Revised) – see Illustration 4 in SA 700 (Revised).]*

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with SA 700 (Revised) – see Illustration 4 in SA 700 (Revised).*]

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Name of the Member signing the Audit Report)
(Designation[54])
(Membership No. XXXXX)

Place of Signature:

Date:

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[52] Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction.

[53] Paragraphs 33 and 38 of SA 700 (Revised) require wording to be included in the auditor's report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

[54] Partner or Proprietor, as the case may be

(III) SA 610 (Revised), Using the Work of Internal Auditors

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the external auditor's responsibilities if using the work of internal auditors. This includes (a) using the work of the internal audit function in obtaining audit evidence and (b) using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.

2. This SA does not apply if the entity does not have an internal audit function. (Ref: Para. A2)

3. If the entity has an internal audit function, the requirements in this SA relating to using the work of that function do not apply if:

(a) The responsibilities and activities of the function are not relevant to the audit; or

(b) Based on the auditor's preliminary understanding of the function obtained as a result of procedures performed under SA 315,[55] the external auditor does not expect to use the work of the function in obtaining audit evidence.

Nothing in this SA requires the external auditor to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor; it remains a decision of the external auditor in establishing the overall audit strategy.

4. Furthermore, the requirements in this SA relating to direct assistance do not apply if the external auditor does not plan to use internal auditors to provide direct assistance.

5. In some cases, the external auditor may be prohibited, or restricted to some extent, by law or regulation from using the work of the internal audit function or using internal auditors to provide direct assistance. The SAs do not override laws or regulations that govern an audit of financial statements.[56] Such prohibitions or restrictions will therefore not prevent the external auditor from complying with the SAs. (Ref: Para. A31)

Relationship between SA 315 and SA 610 (Revised)

6. Many entities establish internal audit functions as part of their internal control and governance structures. The objectives and scope of an internal audit function, the nature of its responsibilities and its organizational status, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

[55] Please see the conforming amendments to Revised SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment, arising pursuant to issuance of this SA 610 (Revised). These are given at the end of the document.

[56] SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, paragraph A55.

7. SA 315 addresses how the knowledge and experience of the internal audit function can inform the external auditor's understanding of the entity and its environment and identification and assessment of risks of material misstatement. SA 315[57] also explains how effective communication between the internal and external auditors also creates an environment in which the external auditor can be informed of significant matters that may affect the external auditor's work.

8. Depending on whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competency of the internal audit function, and whether the function applies a systematic and disciplined approach, the external auditor may also be able to use the work of the internal audit function in a constructive and complementary manner. This SA addresses the external auditor's responsibilities when, based on the external auditor's preliminary understanding of the internal audit function obtained as a result of procedures performed under SA 315, the external auditor expects to use the work of the internal audit function as part of the audit evidence obtained[58]. Such use of that work modifies the nature or timing, or reduces the extent, of audit procedures to be performed directly by the external auditor.

9. In addition, this SA also addresses the external auditor's responsibilities if considering using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.

10. There may be individuals in an entity that perform procedures similar to those performed by an internal audit function. However, unless performed by an objective and competent function that applies a systematic and disciplined approach, including quality control, such procedures would be considered internal controls and obtaining evidence regarding the effectiveness of such controls would be part of the auditor's responses to assessed risks in accordance with SA 330[59].

The External Auditor's Responsibility for the Audit

11. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement. Although they may perform audit procedures similar to those performed by the external auditor, neither the internal audit function nor the internal auditors are independent of the entity as is required of the external auditor in an audit of financial statements in accordance with SA 200[60]. This SA, therefore, defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate

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[57] Please see the conforming amendments to Revised SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment, arising pursuant to issuance of this SA 610 (Revised). These are given at the end of the document. (Para A116 of SA 315 in those conforming amendments)

[58] See paragraphs 15–25

[59] SA 330,The Auditor's Responses to Assessed Risks.

[60] SA 200, paragraph 14.

evidence that the work of the internal audit function, or internal auditors providing direct assistance, is adequate for the purposes of the audit. The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of internal auditors to prevent over or undue use of such work.

Effective Date

12. This SA is effective for audits of financial statements for periods beginning on or after 01st April, 2016.

Objectives

13. The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor, or to use internal auditors to provide direct assistance, are:

(a) To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent; and having made that determination:

(b) If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and

(c) If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

Definitions

14. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Internal audit function – A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes. (Ref: Para. A1–A4)

(b) Direct assistance – The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

Requirements

Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

Evaluating the Internal Audit Function

15. The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:

(a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; (Ref: Para. A5–A9)

(b) The level of competence of the internal audit function; and (Ref: Para. A5–A9)

(c) Whether the internal audit function applies a systematic and disciplined approach, including quality control. (Ref: Para. A10–A11)

16. The external auditor shall not use the work of the internal audit function if the external auditor determines that:

(a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;

(b) The function lacks sufficient competence; or

(c) The function does not apply a systematic and disciplined approach, including quality control. (Ref: Para. A12–A14)

Determining the Nature and Extent of Work of the Internal Audit Function that Can Be *Used*

17. As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the external auditor shall consider the nature and scope of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the external auditor's overall audit strategy and audit plan. (Ref: Para. A15–A17)

18. The external auditor shall make all significant judgments in the audit engagement and, to prevent undue use of the work of the internal audit function, shall plan to use less of the work of the function and perform more of the work directly: (Ref: Para. A15–A17)

(a) The more judgment is involved in:

   (i) Planning and performing relevant audit procedures; and

   (ii) Evaluating the audit evidence gathered; (Ref: Para. A18–A19)

(b) The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant; (Ref: Para. A20–A22)

(c) The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and

(d) The lower the level of competence of the internal audit function.

19. The external auditor shall also evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed. (Ref: Para. A15–A22)

20. The external auditor shall, in communicating with those charged with governance an overview of the planned scope and timing of the audit in accordance with SA 260[61],communicate how the external auditor has planned to use the work of the internal audit function. (Ref: Para. A23)

[61] SA 260, Communication with Those Charged with Governance, paragraph 11.

Using the Work of the Internal Audit Function

21. If the external auditor plans to use the work of the internal audit function, the external auditor shall discuss the planned use of its work with the function as a basis for coordinating their respective activities. (Ref: Para. A24–A26)

22. The external auditor shall read the reports of the internal audit function relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.

23. The external auditor shall perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit, including evaluating whether:

(a) The work of the function had been properly planned, performed, supervised, reviewed and documented;

(b) Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions; and

(c) Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed. (Ref: Para. A27–A30)

24. The nature and extent of the external auditor's audit procedures shall be responsive to the external auditor's evaluation of:

(a) The amount of judgment involved;

(b) The assessed risk of material misstatement;

(c) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; and

(d) The level of competence of the function;[62] (Ref: Para. A27–A29) and shall include reperformance of some of the work. (Ref: Para. A30)

25. The external auditor shall also evaluate whether the external auditor's conclusions regarding the internal audit function in paragraph 15 of this SA and the determination of the nature and extent of use of the work of the function for purposes of the audit in paragraphs 18–19 of this SA remain appropriate.

Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance

Determining Whether Internal Auditors Can Be Used to Provide Direct Assistance for Purposes of the Audit

26. The external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. If so, paragraphs 27–35 and 37 do not apply. (Ref: Para. A31)

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[62] See paragraph 18.

27. If using internal auditors to provide direct assistance is not prohibited by law or regulation, and the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance. The external auditor's evaluation of the existence and significance of threats to the internal auditors' objectivity shall include inquiry of the internal auditors regarding interests and relationships that may create a threat to their objectivity. (Ref: Para. A32–A34)

28. The external auditor shall not use an internal auditor to provide direct assistance if:

(a) There are significant threats to the objectivity of the internal auditor; or

(b) The internal auditor lacks sufficient competence to perform the proposed work. (Ref: Para. A32–A34)

Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance

29. In determining the nature and extent of work that may be assigned to internal auditors and the nature, timing and extent of direction, supervision and review that is appropriate in the circumstances, the external auditor shall consider:

(a) The amount of judgment involved in:

   (i) Planning and performing relevant audit procedures; and

   (ii) Evaluating the audit evidence gathered;

(b) The assessed risk of material misstatement; and

(c) The external auditor's evaluation of the existence and significance of threats to the objectivity and level of competence of the internal auditors who will be providing such assistance. (Ref: Para. A35–A39)

30. The external auditor shall not use internal auditors to provide direct assistance to perform procedures that:

(a) Involve making significant judgments in the audit; (Ref: Para. A19)

(b) Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited; (Ref: Para. A38)

(c) Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or

(d) Relate to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance. (Ref: Para. A35–A39)

31. Having appropriately evaluated whether and, if so, to what extent internal auditors can be used to provide direct assistance on the audit, the external auditor shall, in communicating with

those charged with governance an overview of the planned scope and timing of the audit in accordance with SA 260,[63] communicate the nature and extent of the planned use of internal auditors to provide direct assistance so as to reach a mutual understanding that such use is not excessive in the circumstances of the engagement. (Ref: Para. A39)

32. The external auditor shall evaluate whether, in aggregate, using internal auditors to provide direct assistance to the extent planned, together with the planned use of the work of the internal audit function, would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

Using Internal Auditors to Provide Direct Assistance

33. Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall:

(a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and

(b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

34. The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with SA 220[64]. In so doing:

(a) The nature, timing and extent of direction, supervision, and review shall recognize that the internal auditors are not independent of the entity and be responsive to the outcome of the evaluation of the factors in paragraph 29 of this SA; and

(b) The review procedures shall include the external auditor checking back to the underlying audit evidence for some of the work performed by the internal auditors.

The direction, supervision and review by the external auditor of the work performed by the internal auditors shall be sufficient in order for the external auditor to be satisfied that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work. (Ref: Para. A40–A41)

35. In directing, supervising and reviewing the work performed by internal auditors, the external auditor shall remain alert for indications that the external auditor's evaluations in paragraph 27 are no longer appropriate.

Documentation

36. If the external auditor uses the work of the internal audit function, the external auditor shall include in the audit documentation:

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[63] SA 260, paragraph 11.

[64] SA 220, Quality Control for an Audit of Financial Statements.

(a) The evaluation of:

  (i) Whether the function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors;

  (ii) The level of competence of the function; and

  (iii) Whether the function applies a systematic and disciplined approach, including quality control;

(b) The nature and extent of the work used and the basis for that decision; and

(c) The audit procedures performed by the external auditor to evaluate the adequacy of the work used.

37. If the external auditor uses internal auditors to provide direct assistance on the audit, the external auditor shall include in the audit documentation:

(a) The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance;

(b) The basis for the decision regarding the nature and extent of the work performed by the internal auditors;

(c) Who reviewed the work performed and the date and extent of that review in accordance with SA 230[65];

(d) The written agreements obtained from an authorized representative of the entity and the internal auditors under paragraph 33 of this SA; and

(e) The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.

Application and Other Explanatory Material

Definition of Internal Audit Function (Ref: Para. 2, 14(a))

A1. The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the following:

Activities Relating to Governance

- The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

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[65] SA 230, Audit Documentation.

Activities Relating to Risk Management

- The internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process).
- The internal audit function may perform procedures to assist the entity in the detection of fraud.

Activities Relating to Internal Control

- Evaluation of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.
- Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
- Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non- financial activities of an entity.
- Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

A2. Activities similar to those performed by an internal audit function may be conducted by functions with other titles within an entity. Some or all of the activities of an internal audit function may also be outsourced to a third-party service provider. Neither the title of the function, nor whether it is performed by the entity or a third-party service provider, are sole determinants of whether or not the external auditor can use the work of the function. Rather, it is the nature of the activities; the extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; competence; and systematic and disciplined approach of the function that are relevant. References in this SA to the work of the internal audit function include relevant activities of other functions or third-party providers that have these characteristics.

A3. In addition, those in the entity with operational and managerial duties and responsibilities outside of the internal audit function would ordinarily face threats to their objectivity that would preclude them from being treated as part of an internal audit function for the purpose of this SA, although they may perform control activities that can be tested in accordance with SA 330[66]. For this reason, monitoring controls performed by an owner- manager would not be considered equivalent to an internal audit function.

A4. While the objectives of an entity's internal audit function and the external auditor differ, the function may perform audit procedures similar to those performed by the external auditor in an audit of financial statements. If so, the external auditor may make use of the function for purposes of the audit in one or more of the following ways:

- To obtain information that is relevant to the external auditor's assessments of the risks of material misstatement due to error or fraud. In this regard, SA 315[67] requires the external auditor to obtain an understanding of the nature of the internal audit function's responsibilities, its status within the organization, and the activities performed, or to be performed, and make inquiries of appropriate individuals within the internal audit function (if the entity has such a function); or
- Unless prohibited, or restricted to some extent, by law or regulation, the external auditor, after appropriate evaluation, may decide to use work that has been performed by the internal audit function during the period in partial substitution for audit evidence to be obtained directly by the external auditor[68].14

In addition, unless prohibited, or restricted to some extent, by law or regulation, the external auditor may use internal auditors to perform audit procedures under the direction, supervision and review of the external auditor (referred to as "direct assistance" in this SA)[69].

Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

Evaluating the Internal Audit Function

Objectivity and Competence (Ref: Para. 15(a)–(b))

A5. The external auditor exercises professional judgment in determining whether the work of the internal audit function can be used for purposes of the audit, and the nature and extent to which the work of the internal audit function can be used in the circumstances.

A6. The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors and the level of competence of the function are particularly important in determining whether to use and, if so, the nature and extent of the use of the work of the function that is appropriate in the circumstances.

[66] See paragraph 10.

[67] Please see the conforming amendments to Revised SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment, arising pursuant to issuance of this SA 610 (Revised). These are given at the end of the document.(please see SA 315, paragraph 6(a) therein)

[68] See paragraphs 15–25.

[69] See paragraphs 26–35

A7. Objectivity refers to the ability to perform those tasks without allowing bias, conflict of interest or undue influence of others to override professional judgments. Factors that may affect the external auditor's evaluation include the following:

- Whether the organizational status of the internal audit function, including the function's authority and accountability, supports the ability of the function to be free from bias, conflict of interest or undue influence of others to override professional judgments. For example, whether the internal audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.
- Whether the internal audit function is free of any conflicting responsibilities, for example, having managerial or operational duties or responsibilities that are outside of the internal audit function.
- Whether those charged with governance oversee employment decisions related to the internal audit function, for example, determining the appropriate remuneration policy.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance, for example, in communicating the internal audit function's findings to the external auditor.
- Whether the internal auditors are members of relevant professional bodies and their memberships obligate their compliance with relevant professional standards relating to objectivity, or whether their internal policies achieve the same objectives.

A8. Competence of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards. Factors that may affect the external auditor's determination include the following:

- Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations.
- Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.
- Whether the internal auditors have adequate technical training and proficiency in auditing. Relevant criteria that may be considered by the external auditor in making the assessment may include, for example, the internal auditors' possession of a relevant professional designation and experience.
- Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework and whether the internal audit function possesses the necessary skills (for example, industry-specific knowledge) to perform work related to the entity's financial statements.
- Whether the internal auditors are members of relevant professional bodies that oblige them to comply with the relevant professional standards including continuing professional

development requirements.

A9. Objectivity and competence may be viewed as a continuum. The more the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the higher the level of competence of the function, the more likely the external auditor may make use of the work of the function and in more areas. However, an organizational status and relevant policies and procedures that provide strong support for the objectivity of the internal auditors cannot compensate for the lack of sufficient competence of the internal audit function. Equally, a high level of competence of the internal audit function cannot compensate for an organizational status and policies and procedures that do not adequately support the objectivity of the internal auditors.

Application of a Systematic and Disciplined Approach (Ref: Para. 15(c))

A10. The application of a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities distinguishes the activities of the internal audit function from other monitoring control activities that may be performed within the entity.

A11. Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following:

- The existence, adequacy and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.
- Whether the internal audit function has appropriate quality control policies and procedures, for example, such as those policies and procedures in SQC 1[70] that would be applicable to an internal audit function (such as those relating to leadership, human resources and engagement performance) or quality control requirements in standards set by the relevant professional bodies for internal auditors. Such bodies may also establish other appropriate requirements such as conducting periodic external quality assessments.

Circumstances When Work of the Internal Audit Function Cannot Be Used (Ref: Para. 16)

A12. The external auditor's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competence of the internal audit function, and whether it applies a systematic and disciplined approach may indicate that the risks to the quality of the work of the function are too significant and therefore it is not appropriate to use any of the work of the function as audit evidence.

A13. Consideration of the factors in paragraphs A7, A8 and A11 of this SA individually and in aggregate is important because an individual factor is often not sufficient to conclude that the

[70] Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

work of the internal audit function cannot be used for purposes of the audit. For example, the internal audit function's organizational status is particularly important in evaluating threats to the objectivity of the internal auditors. If the internal audit function reports to management, this would be considered a significant threat to the function's objectivity unless other factors such as those described in paragraph A7 of this SA collectively provide sufficient safeguards to reduce the threat to an acceptable level.

A14. In addition, a self-review threat[71] is created when the external auditor accepts an engagement to provide internal audit services to an audit client, and the results of those services will be used in conducting the audit. This is because of the possibility that the engagement team will use the results of the internal audit service without properly evaluating those results or without exercising the same level of professional skepticism as would be exercised when the internal audit work is performed by individuals who are not members of the firm. Paragraph 290.173 of the Code of Ethics, issued by the Institute of Chartered Accountants of India therefore in the context of provision of internal audit service to financial statement audit clients, specifically provides that "a statutory auditor of an entity cannot be its internal auditor as it will not be possible for him to give an independent and objective opinion". The said Code of Ethics discusses the threats and the safeguards that can be applied to reduce the threats to an acceptable level in other circumstances.

Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used

Factors Affecting the Determination of the Nature and Extent of the Work of the Internal Audit Function that Can Be Used (Ref: Para. 17–19)

A15. Once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, a first consideration is whether the planned nature and scope of the work of the internal audit function that has been performed, or is planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established in accordance with SA 300[72].18

A16. Examples of work of the internal audit function that can be used by the external auditor include the following:

- Testing of the operating effectiveness of controls.
- Substantive procedures involving limited judgment.
- Observations of inventory counts.
- Tracing transactions through the information system relevant to financial reporting.

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[71] Attention of the members is also invited to paragraph 2.1 of the Guidance Note on Independence of Auditors, issued by the Institute of Chartered Accountants of India.

[72] SA 300, Planning an Audit of Financial Statements.

- Testing of compliance with regulatory requirements.
- In some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group (where this does not conflict with the requirements of SA 600)[73].

A17. The external auditor's determination of the planned nature and extent of use of the work of the internal audit function will be influenced by the external auditor's evaluation of the extent to which the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the level of competence of the internal audit function in paragraph 18 of this SA. In addition, the amount of judgment needed in planning, performing and evaluating such work and the assessed risk of material misstatement at the assertion level are inputs to the external auditor's determination. Further, there are circumstances in which the external auditor cannot use the work of the internal audit function for purpose of the audit as described in paragraph 16 of this SA.

Judgments in planning and performing audit procedures and evaluating results (Ref: Para. 18(a), 30(a))

A18. The greater the judgment needed to be exercised in planning and performing the audit procedures and evaluating the audit evidence, the external auditor will need to perform more procedures directly in accordance with paragraph 18 of this SA, because using the work of the internal audit function alone will not provide the external auditor with sufficient appropriate audit evidence.

A19. Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement in accordance with paragraph 18. Significant judgments include the following:

- Assessing the risks of material misstatement;
- Evaluating the sufficiency of tests performed;
- Evaluating the appropriateness of management's use of the going concern assumption;
- Evaluating significant accounting estimates; and
- Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.

Assessed risk of material misstatement (Ref: Para. 18(b))

A20. For a particular account balance, class of transaction or disclosure, the higher an assessed risk of material misstatement at the assertion level, the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In such circumstances, the external auditor will need to perform more procedures directly in accordance with paragraph 18 of this SA, and accordingly, make less use of the work of the internal audit

[73] SA 600, Using the Work of Another Auditor.

function in obtaining sufficient appropriate audit evidence. Furthermore, as explained in SA 200[74], the higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be, and, therefore, the external auditor will need to perform more of the work directly.

A21. As explained in SA 315[75], significant risks require special audit consideration and therefore the external auditor's ability to use the work of the internal audit function in relation to significant risks will be restricted to procedures that involve limited judgment. In addition, where the risks of material misstatement is other than low, the use of the work of the internal audit function alone is unlikely to reduce audit risk to an acceptably low level and eliminate the need for the external auditor to perform some tests directly.

A22. Carrying out procedures in accordance with this SA may cause the external auditor to revaluate the external auditor's assessment of the risks of material misstatement. Consequently, this may affect the external auditor's determination of whether to use the work of the internal audit function and whether further application of this SA is necessary.

Communication with Those Charged with Governance (Ref: Para. 20)

A23. In accordance with SA 260[76], the external auditor is required to communicate with those charged with governance an overview of the planned scope and timing of the audit. The planned use of the work of the internal audit function is an integral part of the external auditor's overall audit strategy and is therefore relevant to those charged with governance for their understanding of the proposed audit approach.

Using the Work of the Internal Audit Function

Discussion and Coordination with the Internal Audit Function (Ref: Para. 21)

A24. In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:

- The timing of such work.
- The nature of the work performed.
- The extent of audit coverage.
- Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality.
- Proposed methods of item selection and sample sizes.
- Documentation of the work performed.

[74] SA 200, paragraph A29.

[75] SA 315, paragraph 4(e).

[76] SA 260, paragraph 11.

- Review and reporting procedures.

A25. Coordination between the external auditor and the internal audit function is effective when, for example:

- Discussions take place at appropriate intervals throughout the period.
- The external auditor informs the internal audit function of significant matters that may affect the function.
- The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

A26. SA 200[77] discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring matters that may affect the work of the external auditor to the external auditor's attention.[78] The external auditor is then able to take such information into account in the external auditor's identification and assessment of risks of material misstatement. In addition, if such information may be indicative of a heightened risk of a material misstatement of the financial statements or may be regarding any actual, suspected or alleged fraud, the external auditor can take this into account in the external auditor's identification of risk of material misstatement due to fraud in accordance with SA 240[79].

Procedures to Determine the Adequacy of Work of the Internal Audit Function (Ref: Para. 23–24)

A27. The external auditor's audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use provide a basis for evaluating the overall quality of the function's work and the objectivity with which it has been performed.

A28. The procedures the external auditor may perform to evaluate the quality of the work performed and the conclusions reached by the internal audit function, in addition to reperformance in accordance with paragraph 24, include the following:

- Making inquiries of appropriate individuals within the internal audit function.
- Observing procedures performed by the internal audit function.
- Reviewing the internal audit function's work program and working papers.

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[77] SA 200, paragraphs 15 and A18.

[78] Please see the conforming amendments to Revised SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment, arising pursuant to issuance of this SA 610 (Revised). These are given at the end of the document. (please see SA 315, paragraph A116 therein).

[79] SA 315, paragraph A11 (as given in the conforming amendments) in relation to SA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.

A29. The more judgment involved, the higher the assessed risk of material misstatement, the less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, or the lower the level of competence of the internal audit function, the more audit procedures are needed to be performed by the external auditor on the overall body of work of the function to support the decision to use the work of the function in obtaining sufficient appropriate audit evidence on which to base the audit opinion.

Reperformance (Ref: Para. 24)

A30. For purposes of this SA, reperformance involves the external auditor's independent execution of procedures to validate the conclusions reached by the internal audit function. This objective may be accomplished by examining items already examined by the internal audit function or, where it is not possible to do so, the same objective may also be accomplished by examining sufficient other similar items not actually examined by the internal audit function. Reperformance provides more persuasive evidence regarding the adequacy of the work of the internal audit function compared to other procedures the external auditor may perform in paragraph A28. While it is not necessary for the external auditor to do reperformance in each area of work of the internal audit function that is being used, some reperformance is required on the body of work of the internal audit function as a whole that the external auditor plans to use in accordance with paragraph 24. The external auditor is more likely to focus reperformance in those areas where more judgment was exercised by the internal audit function in planning, performing and evaluating the results of the audit procedures and in areas of higher risk of material misstatement.

Determining Whether, in Which Areas and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance

Determining Whether Internal Auditors Can Be Used to Provide Direct Assistance for Purposes of the Audit (Ref: Para. 5, 26–28)

A31. In case where the external auditor is prohibited by law or regulation from using internal auditors to provide direct assistance, it is relevant for the principal auditors to consider whether the prohibition also extends to component auditors and, if so, to address this in the communication to the component auditors.

A32. As stated in paragraph A7 of this SA, objectivity refers to the ability to perform the proposed work without allowing bias, conflict of interest or undue influence of others to override professional judgments. In evaluating the existence and significance of threats to the objectivity of an internal auditor, the following factors may be relevant:

- The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors[80].
- Family and personal relationships with an individual working in, or responsible for, the aspect of the entity to which the work relates.

[80] See paragraph A7.

- Association with the division or department in the entity to which the work relates.
- Significant financial interests in the entity other than remuneration on terms consistent with those applicable to other employees at a similar level of seniority.

Material issued by relevant professional bodies for internal auditors may provide additional useful guidance.

A33. There may also be some circumstances in which the significance of the threats to the objectivity of an internal auditor is such that there are no safeguards that could reduce them to an acceptable level. For example, because the adequacy of safeguards is influenced by the significance of the work in the context of the audit, paragraph 30(a) and (b) prohibits the use of internal auditors to provide direct assistance in relation to performing procedures that involve making significant judgments in the audit or that relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited. This would also be the case where the work involved creates a self-review threat, which is why internal auditors are prohibited from performing procedures in the circumstances described in paragraph 30(c) and (d).

A34. In evaluating the level of competence of an internal auditor, many of the factors in paragraph A8 of this SA may also be relevant, applied in the context of individual internal auditors and the work to which they may be assigned.

Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance (Ref: Para. 29–31)

A35. Paragraphs A15–A22 of this SA provide relevant guidance in determining the nature and extent of work that may be assigned to internal auditors.

A36. In determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned. Examples of activities and tasks that would not be appropriate to use internal auditors to provide direct assistance include the following:

- Discussion of fraud risks. However, the external auditors may make inquiries of internal auditors about fraud risks in the organization in accordance with SA 315[81].
- Determination of unannounced audit procedures as addressed in SA 240.

A37. Similarly, since in accordance with SA 505[82] the external auditor is required to maintain control over external confirmation requests and evaluate the results of external confirmation procedures, it would not be appropriate to assign these responsibilities to internal auditors. However, internal auditors may assist in assembling information necessary for the external auditor to resolve exceptions in confirmation responses.

A38. The amount of judgment involved and the risk of material misstatement are also relevant in determining the work that may be assigned to internal auditors providing direct assistance.

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[81] SA 315, paragraph 6(a).

[82] SA 505, External Confirmations, paragraphs 7 and 16.

For example, in circumstances where the valuation of accounts receivable is assessed as an area of higher risk, the external auditor could assign the checking of the accuracy of the aging to an internal auditor providing direct assistance. However, because the evaluation of the adequacy of the provision based on the aging would involve more than limited judgment, it would not be appropriate to assign that latter procedure to an internal auditor providing direct assistance.

A39. Notwithstanding the direction, supervision and review by the external auditor, excessive use of internal auditors to provide direct assistance may affect perceptions regarding the independence of the external audit engagement.

Using Internal Auditors to Provide Direct Assistance (Ref: Para. 34)

A40. As individuals in the internal audit function are not independent of the entity as is required of the external auditor when expressing an opinion on financial statements, the external auditor's direction, supervision and review of the work performed by internal auditors providing direct assistance will generally be of a different nature and more extensive than if members of the engagement team perform the work.

A41. In directing the internal auditors, the external auditor may, for example, remind the internal auditors to bring accounting and auditing issues identified during the audit to the attention of the external auditor. In reviewing the work performed by the internal auditors, the external auditor's considerations include whether the evidence obtained is sufficient and appropriate in the circumstances, and that it supports the conclusions reached.

RELATED CONFORMING AMENDMENTS

Note: The following are conforming amendments to SQC 1 and other SAs as a result of SA 610 (Revised), *Using the Work of Internal Auditors*. The footnote numbers within these amendments do not align with the SAs that will be amended, and reference should be made to those SAs.

***SQC 1,* Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements**

Definitions

6. In this SQC, the following terms have the meanings attributed below:

(e) Engagement team – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement. The term "engagement team" excludes individuals within the client's internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of SA 610 (Revised)[83].

[83] SA 610 (Revised), Using the Work of Internal Auditors, establishes limits on the use of direct assistance. It also acknowledges that the external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. Therefore, the use of direct assistance is restricted to situations where it is permitted.

***SA 220,* Quality Control for an Audit of Financial Statements**

Definitions

7. For purposes of the SAs, the following terms have the meanings attributed below:

(d) Engagement team – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement. The term "engagement team" excludes individuals within the client's internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of SA 610 (Revised)[84].

SA 260, Communication with Those Charged with Governance

A18. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, the extent to which the auditor will use the work of internal audit, and how the external and internal auditors can best work together in a constructive and complementary manner, and the nature and extent of any planned use of internal auditors to provide direct assistance[85].
- SA 300, Planning an Audit of Financial Statements

Appendix

Characteristics of the Engagement

- The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work, or internal auditors can be used to provide direct assistance.

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

6. The risk assessment procedures shall include the following:

   (a) Inquiries of management, of appropriate individuals within the internal audit function (if the function exists), and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6-A13)

23. If the entity has an internal audit function[86], the auditor shall obtain an understanding of ~~the following in order to determine whether the internal audit function is likely to be relevant to the audit:~~

[84] SA 610 (Revised), Using the Work of Internal Auditors, establishes limits on the use of direct assistance. It also acknowledges that the external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. Therefore, the use of direct assistance is restricted to situations where it is permitted.

[85] SA 610 (Revised), paragraphs 20 and 31.

[86] SA 610(Revised),"Using the Work of Internal Auditors", paragraph ~~7(a)~~14(a), defines the term "internal audit function" for purposes of the SAs.

~~(a) T~~the nature of the internal audit function's responsibilities, ~~and how the internal audit function fits in the entity's~~ its organisational ~~structure~~status, ~~;~~ and

~~(b) T~~ the activities performed, or to be performed. ~~, by the internal audit function.~~ (Ref: Para. A~~101~~ 109 -A~~103~~ 116)

Inquiries of Management, the Internal Audit Function and Others Within the Entity *(Ref: Para. 6(a))*

A6. Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. Information may also be obtained by the auditor through inquiries with the internal audit function, if the entity has such a function, and others within the entity.

A7. ~~However, t~~The auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:

- ……………………………
- ~~Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.~~
- …………………………..
- ……………………………
- ………………………

Inquiries of the Internal Audit Function

A9. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's understanding of the entity, the auditor's risk assessments or other aspects of the audit. The auditor's inquiries are therefore made whether or not the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed[87]. Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.

[87] The relevant requirements are contained in SA 610 (Revised).

A10. If, based on responses to the auditor's inquiries, it appears that there are findings that may be relevant to the entity's financial reporting and the audit, the auditor may consider it appropriate to read related reports of the internal audit function. Examples of reports of the internal audit function that may be relevant include the function's strategy and planning documents and reports that have been prepared for management or those charged with governance describing the findings of the internal audit function's examinations.

A11. In addition, in accordance with SA 240[88], if the internal audit function provides information to the auditor regarding any actual, suspected or alleged fraud, the auditor takes this into account in the audito's idenficiation of risk of material misstatement due to fraud.

A12. Appropriate individuals within the internal audit function with whom inquiries are made are those who, in the auditor's judgment, have the appropriate knowledge, experience and authority, such as the chief internal audit executive or, depending on the circumstances, other personnel within the function. The auditor may also consider it appropriate to have periodic meetings with these individuals.

Considerations specific to public sector entities (Ref: Para 6(a))

A13. Auditors of public sector entities often have additional responsibilities with regard to internal control and compliance with applicable laws and regulations. Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying the risk of material noncompliance with applicable laws and regulations and the risk of deficiencies in internal control over financial reporting.

A79. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies in internal control relevant to the audit, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.

The Entity's Internal Audit Functions~~s~~ (Ref: Para 23)

A109~~101~~. If the ~~The~~ entity~~'s~~ has an internal audit function, obtaining an understanding of that function contributes to the auditor's understanding of the entity and its environment, including internal control in particular the role that the function plays in the entity's monitoring of internal control over financial reporting. This understanding, together with the information obtained from the auditor's inquiries in paragraph 6(a) of this SA, may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement.~~is likely to be relevant to the audit if the nature of the internal audit function's responsibilities and activities are related to the entity's financial reporting, and the auditor expects to use the work of the internal auditors to modify the nature or timing, or reduce the extent, of audit procedures to be performed. When the auditor determines that the internal audit function is likely to be relevant to the audit, SA 610 applies.~~

[88] SA 240, paragraph 19.

A110102. The objectives and scope of an internal audit function, and therefore the nature of its responsibilities and its status within the organisation, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The responsibilities of an internal audit function may include, for example, monitoring of internal control, risk management, and review of compliance with laws and regulations. On the other hand, the responsibilities of the internal audit function may be limited to the review of the economy, efficiency and effectiveness of operations, for example, and accordingly, may not relate to the entity's financial reporting. These matters may be set out in an internal audit charter or terms of reference.

A111. The responsibilities of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, internal control and governance processes. If so, the internal audit function may play an important role in the entity's monitoring of internal control over financial reporting. However, the responsibilities of the internal audit function may be focussed on evaluating the economy, efficiency and effectiveness of operations and, if so, the work of the function may not directly relate to the entity's financial reporting.

A112. The auditor's inquiries of appropriate individuals within the internal audit function in accordance with paragraph 6(a) of this SA help the auditor obtain an understanding of the nature of the internal audit function's responsibilities. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function.

A113103. If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting, the auditor may also be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the auditor in obtaining audit evidence. Auditors may be more likely to be able to use the work of an entity's internal audit function when it appears, for example, based on experience in previous audits or the auditor's risk assessment procedures, that the entity has an internal audit function that is adequately and appropriately resourced relative to the size of the entity and the nature of its operations, and has a direct reporting relationship to those charged with governance the external auditor's consideration of the activities performed, or to be performed by, the internal audit function may include review of the internal audit function's audit plan for the period, if any, and discussion of that plan with the internal auditors.

A114. If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, SA 610 (Revised) applies.

A115. As is further discussed in SA 610 (Revised), the activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.

A116. Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the auditor can be informed of significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. SA 200 discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the auditor's attention. The auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.

Note: Students are advised to refer RTP of Paper 1, Paper 2 and Paper 5 also for changes/amendments relevant to Auditing and Assurance.

PART – II: QUESTIONS AND ANSWERS

QUESTIONS

1. State with reasons (in short) whether the following statements are correct or incorrect:
   - (i) The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements.
   - (ii) Planning is a discrete phase of an audit.
   - (iii) Sufficiency is the measure of the quality of audit evidence.
   - (iv) The method which involves dividing the population into groups of items is knows as block sampling.
   - (v) As per the Standard on Auditing (SA) 520 "Analytical Procedures" 'the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among financial data only.
   - (vi) Director's relative can act as an auditor of the company.
   - (vii) The auditor of A Ltd. Company wanted to refer to the minute books during audit but board of directors refused to show the minute books to the auditors.
   - (viii) The first auditor of a Government company was appointed by the Board in its meeting after 10 days from the date of registration.

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

(x) The auditor shall express a qualified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Nature of Auditing

2. (a) "The auditors should consider the effect of subsequent events on the financial statement and on auditor's report"– Comment according to SA 560.

   (b) All those personal qualities required to make a good person contribute to the making of a good auditor. Explain stating the qualities of an Auditor.

3. Give your comment on the following:

   (a) Auditors of M/s Tender India (P) Ltd. were changed for the accounting year 2016-17. The closing inventory of the company as on 31.3.2016 amounting to ₹ 100 lacs continued as it is and became closing inventory as on 31.3.2017. The auditors of the company propose to exclude from their audit programme the audit of closing inventory of ₹ 100 lacs on the understanding that it pertains to the preceding year which was audited by another auditor.

   (b) What are the obvious assertions in the following items appearing in the Financial Statements?

      (i) Statement of Profit and Loss

         Travelling Expenditure ₹ 50,000

      (ii) Balance Sheet

         Trade receivable ₹ 2,00,000

4. (a) The process of auditing is such that it suffers from certain limitations, i.e. the limitation which cannot be overcome irrespective of the nature and extent of audit procedures. Explain.

   (b) "Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users." Discuss.

Basic Concepts in Auditing

5. (a) Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated. Explain.

   (b) Audit Working Papers are the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Explain stating meaning and advantages of working papers.

6. (a) The concept of "True and Fair" is a fundamental concept in auditing. Discuss.

   (b) Discuss the concept of materiality in the context of the preparation and presentation of financial statements.

7. (a) "Risk of material misstatement at the assertion level for classes of transactions, account balances and disclosures need to be considered." Explain stating the different categories of assertions used by the auditor.

   (b) Why Test of Controls are performed? Also explain what does it include.

Preparation for an Audit

8. (a) An element of surprise can significantly improve the audit effectiveness. Explain.

   (b) In performing an audit of financial statements, the auditor should have or obtain knowledge of the business. Explain in the light of SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment".

9. (a) "The auditor is faced with sampling risk in both tests of control and substantive procedures." Comment on this statement with reference to SA 530 on "Audit Sampling.

   (b) Random selection ensures that all items in the population or within each stratum have a known chance of selection. Explain.

Internal Control

10. (a) 'Doing an audit in a Computerised Information System (CIS) environment is simpler since the trial balance always tallies'. Analyse critically.

    (b) An audit trail refers to a situation where it is possible to relate 'one-to-one' basis, the original input along with the final output. Explain.

    (c) What are the different design and procedural aspects of Computerised Information Systems (CIS)?

11. (a) Explain the Internal controls in Computerised Information System (CIS) Environment.

    (b) Internal control can provide only reasonable but not absolute assurance. Explain.

Vouching & Verification of Assets and Liabilities

12. How will you vouch and verify the following:

    (a) Receipt of capital subsidy.

    (b) Wages paid to seasonal labourer.

    (c) Retirement Gratuity to Employees.

    (d) Cash at bank.

13. How will you vouch and/or verify the following:
    (a) Endowment Policies.
    (b) Discounted bill receivable dishonoured.
    (c) Deferred Tax Liability.
    (d) Goods lying with third party.

The Company Audit

14. State the circumstances which could lead to any of the following in an Auditor's Report:
    (a) A modification of opinion.
    (b) Disclaimer of opinion.
    (c) Adverse opinion.
    (d) Qualified opinion.
15. Explain the following:
    (a) Appointment of First Auditor of a Non-Government Company.
    (b) Appointment of First Auditor of a Government Company.
    (c) Appointment of Subsequent Auditor of a Non-Government Company.
    (d) Appointment of Subsequent Auditor of a Government Company.
16. (a) Explain the Director's Responsibility Statement in brief.
    (b) Briefly discuss the provisions of the Companies Act, 2013 with regard to issue of shares at a discount.
17. (a) Discuss the audit procedure for verification of payment of dividends.
    (b) XYZ& Co. Ltd. issued shares to the equity shareholders in the proportion of one bonus share for every three existing shares. As an auditor of the Company, how would you verify this issue?

Special Audit

18. (a) Draft an Audit Programme to audit the accounts of a Recreation Club with facilities for indoor games and in-house eating.
    (b) An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention six points each, peculiar to the situation, which

you will like to incorporate in your audit programme for audit of said receipts and remittances of donations.

19. What special steps will you take into consideration in auditing the accounts of a hotel?

20. What are the special audit points to be considered by the auditor during the audit of a Hospital?

SUGGESTED ANSWERS / HINTS

1. **(i)** **Correct:** As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

(ii) **Incorrect.** Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures.

(iii) **Incorrect:** Sufficiency is the measure of the quantity of audit evidence. On the other hand, appropriation is the measure of the quality of audit evidence.

(iv) **Incorrect.** The method which involves dividing the population into groups of items is known as cluster sampling whereas block sampling involves the selection of a defined block of consecutive items.

(v) **Incorrect.** As per the Standard on Auditing (SA) 520 "Analytical Procedures" 'the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.

(vi) **Incorrect:** As per section 141(3) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company whose relative is a Director or is in the employment of the Company as a director or Key Managerial Personnel.

(vii) **Incorrect:** The provisions of Companies Act, 2013 grant rights to the auditor to access books of account and vouchers of the company. He is also entitled to require information and explanations from the company. Therefore, he has a statutory right to inspect the minute book.

(viii) **Incorrect:** According to section 139(7) of the Companies Act, 2013, in the case of a Government company, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

If C&AG fails to make the appointment within 60 days, the Board shall appoint in next 30 days.

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

(x) **Incorrect**: The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

2. **(a)** **Effect of Subsequent Events:** SA 560 "Subsequent Events", establishes standards on the auditor's responsibility regarding subsequent events.

According to it, 'subsequent events' refer to those events which occur between the date of financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report. It lays down the standard that the auditor should consider the effect of subsequent events on the financial statements and on the auditor's report.

The auditor should obtain sufficient appropriate evidence that all events upto the date of the auditor's report requiring adjustment or disclosure have been identified and to identify such events.

The auditor should-

(i) obtain an understanding of any procedures management has established to ensure that subsequent events are identified.

(ii) inquire of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

Examples of inquiries of management on specific matters are:

- Whether new commitments, borrowings or guarantees have been entered into.
- Whether sales or acquisitions of assets have occurred or are planned.
- Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- Whether there have been any developments regarding contingencies.
- Whether there have been any developments regarding risk areas and contingencies.
- Whether any unusual accounting adjustments have been made or are contemplated.

- Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
- Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
- Whether any events have occurred that are relevant to the recoverability of assets.

(iii) Read minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(iv) Read the entity's latest subsequent interim financial statements, if any.

(v) Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.

(vi) Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims.

(vii) Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

When the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements. If such events have not been considered by the management and which in the opinion of the auditor are material, the auditor shall modify his report accordingly.

(b) Qualities of an Auditor: The auditor should possess specific knowledge of accountancy, auditing, taxation, etc. which are acquired by him during the course of his theoretical education.

The auditor should also have sufficient knowledge of general principles of law of contracts, partnership; specific statutes and provisions applicable, e.g. Companies Act, 2013, Co-operative Societies Act, etc.; client's nature of business and its peculiar features. Apart from the knowledge acquired by the auditor in the formal manner, the auditor should also possess certain personal qualities such as, tact; caution firmness; good temper; judgement; patience; clear headedness and common sense reliability and trust, etc.

In short, all those personal qualities required to make a good person contribute to the making of a good auditor. In addition, the auditor must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, SA 200 mentions integrity, objectivity and independence as one of the basic principles.

Auditing is a profession, calling for wide variety of knowledge to which no one has yet set a limit, the most useful part of the knowledge is probably that which cannot be learnt from books because its acquisition depends on the alertness of the mind in applying to ever varying circumstances, the fruits of his own observation and reflection; only he who is endowed with common sense in adequate measure can achieve it.

3. (a) **Verification of Inventory:** As per SA 510 "Initial Audit Engagements – Opening Balances", in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether-

(i) Opening balances contain misstatements that materially affect the current period's financial statements; and

(ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

When the financial statements for the preceding period were audited by predecessor auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the Balance Sheet date. The contention of the management that the inventory has not undergone any change cannot be accepted, it forms part of normal duties of auditor to ensure that the figures on which he is expressing opinion are correct and properly valued. Moreover, it is also quite likely that the inventory lying as it is might have deteriorated and the same need to be examined. The auditor is advised not to exclude the audit of closing inventory from his audit programme.

(b) (i) **Travelling Expenditure ₹ 50,000**

- Expenditure has been actually incurred for the purpose of travelling.
- Travelling has been undertaken during the year under consideration.

- Total amount of expenditure incurred is ₹ 50,000 during the year.
- It has been treated as revenue expenditure and charged to Statement of Profit and Loss.

(ii) Trade receivable ₹ 2,00,000

- These include all sales transaction occurred during the year.
- These have been recorded properly and occurred during the year.
- These constitute assets of the entity.
- These have been shown at proper value, i.e. after showing the deduction on account of provision for bad and doubtful debts.

4. (a) Inherent Limitations of Audit: As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the objectives of an audit of financial statements, prepared with in a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy him that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The process of auditing, however, is such that it suffers from certain limitations, i.e. the limitation which cannot be overcome irrespective of the nature and extent of audit procedures. The limitations of an audit arise from-

(i) **The Nature of Financial Reporting:** The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures.

(ii) **The Nature of Audit Procedures:** There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

(1) There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.

(2) Fraud may involve sophisticated and carefully organised schemes designed to conceal it. The auditor is neither trained as nor expected to be an expert in the authentication of documents.

(3) An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

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

(iv) **Other Matters that Affect the Limitations of an Audit:** In the case of certain assertions or subject matters, the potential effects of the limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

Because of the 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 SAs.

(b) **Fraudulent Financial Reporting:** 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.

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:

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

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

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

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.

5. (a) Disclosure of Accounting Policies: The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements.

The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated. The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by some cases.

The purpose of AS 1 is to promote better understanding of financial statements by establishing through an accounting standard and the disclosure of significant accounting policies and the manner in which such accounting policies are disclosed in the financial statements.

Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. Such disclosure should form part of the financial statements.

It would be helpful to the reader of financial statements if they are all disclosed at one place instead of being scattered over several statements, schedules and notes which form part of financial statements.

Any change in accounting policy, which has a material effect, should be disclosed. The amount by which any item is in the financial statement is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies, which has not material effect on the financial statements for the current period, which is reasonably expected to have material effect in latter periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

(b) Audit Working Papers: As per SA 230 "Audit Documentation", Audit Working Papers are the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

Working papers are the-

(a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and

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

Besides they serve a number of additional purposes, including the following:

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

Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", issued by the Institute, provides that, unless otherwise specified by law or regulation, working papers are the property of the auditor. He may at his discretion, make portions of, or extracts from, working papers available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

Retention of working papers: Working papers should be retained, long enough, for a period of time sufficient to meet the needs of his practice and satisfy any legal or professional requirement of record retention. SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

6. (a) Concept of "True and Fair": The concept of "true and fair" is a fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.

This requires that the auditor should examine the accounts with a view to verifying that all assets and liabilities, incomes and expenses are stated at the amounts which are in accordance with accounting principles and policies, and no material item has been omitted.

The importance of the concept of true and fair view can also be understood and appreciated from the facts that sections 128, 129 and 143 of the Companies Act, 2013 also discusses this concept in relation to account books, financial statements and reporting on financial statements respectively.

Section 128(1) of the said Act provides that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any. The company shall be in a position to explain the transactions effected both at the registered office and its branches. Such books of Accounts shall be kept on accrual basis and according to the double entry system of accounting.

Section 129(1) of the Companies Act, 2013 provides that the financial statements shall give a true and fair view of the state of affairsof the company or companies, comply with the accounting standards notified under section 133 of the Companies Act, 2013, (in which the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority) and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III to the said Act.

The term "financial statement" shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes under the said Act.

It may be noted that nothing contained in sub-section (1) shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company.

However, the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose-

(a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;

(b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;

(c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;

(d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

It may be noted that where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

Further, according to section 143(2) of the said Act, the auditor is required to make a report to the members of the company indicating that, to the best of his information and knowledge, the financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

SA 700 "Forming an Opinion and Reporting on Financial Statements", requires the auditor to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and express clearly that opinion through a written report that also describes the basis for the opinion. The auditor is required to express his opinion on the financial statements that it gives a true and fair view in conformity with the accounting principles generally accepted in India (a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX; (b) in the case of the Statement of Profit and Loss, of the profit/ loss for the year ended on that date; and (c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

(b) Concept of Materiality: According to SA 320 "Materiality in Planning and Performing an Audit", financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both; and

- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

  (1) Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred above provides the auditor with such a frame of reference.

  (2) The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

  (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;

  (b) Understand that financial statements are prepared, presented and audited to levels of materiality;

  (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

  (d) Make reasonable economic decisions on the basis of the information in the financial statements.

  (3) The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

7. (a) Risk of Material Misstatement at the Assertion Level: According to SA 315 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms-

(1) Assertions about classes of transactions and events for the period under audit:

(i) **Occurrence-** transactions and events that have been recorded have occurred and pertain to the entity.

(ii) **Completeness-** all transactions and events that should have been recorded have been recorded.

(iii) **Accuracy-** amounts and other data relating to recorded transactions and events have been recorded appropriately.

(iv) **Cut-off-** transactions and events have been recorded in the correct accounting period.

(v) **Classification-** transactions and events have been recorded in the proper accounts.

(2) Assertions about account balances at the period end:

(i) **Existence-** assets, liabilities, and equity interests exist.

(ii) **Rights and obligations-** the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

(iii) **Completeness-** all assets, liabilities and equity interests that should have been recorded have been recorded.

(iv) **Valuation and allocation-** assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(3) Assertions about presentation and disclosure:

(i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.

(ii) Completeness—all disclosures that should have been included in the financial statements have been included.

(iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.

(iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

(b) Tests of Control: Tests of control are performed to obtain audit evidence about the effectiveness of the -

(i) design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and

(ii) operation of the internal controls throughout the period.

Tests of control include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk.

Tests of control may include:

- Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
- Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
- Re-performance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
- Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

8. (a) Surprise Checks: Surprise checks are a part of normal audit procedures. An element of surprise can significantly improve the audit effectiveness. Wherever practical, an element of surprise should be incorporated in the audit procedures.

The element of surprise in an audit may be, both in regard to the time of audit, i.e. selection of date, when the auditor will visit the client's office for audit and selection of areas of audit.

Surprise checks are mainly intended to ascertain whether the internal control system is working effectively and whether the accounting and other records are kept up to date as per the statutory regulations. Surprise checks can exercise good moral check on the client's staff. It helps in determining whether errors or frauds exist and if they exist, brings the matter promptly to the management's attention, so that corrective action can be taken at the earliest. Surprise checks are very effective in verification of cash and investments, test checking of inventory, verification of accounting records, statutory registers and internal control system. The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.

(b) Obtaining Knowledge of the Business: The auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgment, may have significant effect on the financial information among other things.

As per SA 315 – "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", the auditor shall obtain an understanding of the following:

(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.

(b) The nature of the entity, including:

  (i) its operations;

  (ii) its ownership and governance structures;

  (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

  (iv) the way that the entity is structured and how it is financed;

  to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

(e) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

9. (a) Sampling Risk: As per SA 530 "Audit Sampling", audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements.

The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions-

(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a substantive procedure i.e. test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a substantive procedure i.e. test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

(b) **Random Sampling:** Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below–

(i) **Simple random sampling:** Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. The mechanics of selection of items may be by choosing numbers from table of random numbers by computers or picking up numbers randomly from a drum. It is considered that random number tables are simple and easy to use and also provide assurance that the bias does not affect the selection. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range. For example the population can be considered homogeneous, if say, trade receivables balances fall within the range of ₹ 5,000 to ₹ 25,000 and not in the range between ₹ 25 to ₹ 2,50,000.

(ii) **Stratified Sampling:** This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment. For example in the above case, trade receivables balances may be divided into four groups as follows -

(a) balances in excess of ₹ 1,00,000;

(b) balances in the range of ₹ 75,000 to ₹ 1,00,000;

(c) balances in the range of ₹ 25,000 to ₹ 75,000; and

(d) balances below ₹ 25,000.

10. (a) **Audit in a Computerised Information System (CIS) Environment:** Though it is true that in CIS environment the trial balance always tallies, the same cannot imply that the job of an auditor becomes simpler. There can still be some accounting errors like omission of certain entries, compensating errors, duplication of entries, errors of commission in the form of wrong account head is posted. Possibility of "Window Dressing" and/or "Creation of Secret Reserves" where the trial balance tallied. At present, due to complex business environment the importance of trial balance cannot be judged only upto the arithmetical accuracy but the nature of transactions recorded in the books and appear in the trial balance should be focused.

The emergence of new forms of financial instruments like options and futures, derivatives, off balance sheet financing etc. have given rise to further complexities in recording and disclosure of transactions. In an audit, besides the tallying of a trial balance, there are also other issue like estimation of provision for depreciation, valuation of inventories, obtaining audit evidence, ensuring compliance procedure and carrying out substantive procedure, verification of assets & liabilities their valuation etc. which still requires judgement to be exercised by the auditor.

Responsibility of expressing an audit opinion and objectives of an audit are not changed in the audit in CIS environment. Therefore, it can be said that simply because of CIS environment and the trial balance has tallied it does not mean that the audit would become simpler.

(b) **Audit Trail:** An audit trail refers to a situation where it is possible to relate 'one-to-one' basis, the original input along with the final output. The work of an auditor would be hardly affected if "Audit Trail" is maintained i.e. if it were still possible to relate, on a 'one-to-one' basis, the original input with the final output. A simplified representation of the documentation in a manually created audit trail.

For example, the particular credit notes may be located by the auditor at any time he may wish to examine them, even months after the balance sheet date. He also has the means, should he so wish, of directly verifying the accuracy of the totals and sub-totals that feature in the control listing, by reference to individual credit notes. He can, of course, check all detailed calculations, casts and postings in the accounting records, at any time.

In first and early second-generation computer systems, such a complete and trail was generally available, no doubt, to management's own healthy skepticism of what the new machine could be relied upon to achieve – an attitude obviously shared by the auditor.

It is once iterated that there is an abundance of documentation upon which the auditor can use his traditional symbols of scrutiny, in the form of colored ticks and rubber stamps. Specifically:

(i) The output itself is as complete and as detailed as in any manual system.

(ii) The trail, from beginning to end, is complete, so that all documents may be identified by located for purposes of vouching, totalling and cross-referencing.

Any form of audit checking is possible, including depth testing in either direction.

(c) Different Design and Procedural Aspects of a Computerised Information System (CIS): The development of Computerised Information Systems (CIS) will generally result in design and procedural characteristics that are different from those found in manual systems. These different design and procedural aspects of CIS are-

(i) Consistency of Performance: Computerised Information Systems (CIS) perform functions exactly as programmed and are potentially more reliable than manual systems, provided that all transaction type and conditions that could occur are anticipated and incorporated into the system.

(ii) Programmed Control Procedures: The nature of computer processing allows the design of internal control procedures in computer programs. These procedures can be designed to provide controls with limited visibility (e.g., protection of data against unauthorized access may be provided by passwords). Other procedures can be designed for use with manual intervention, such as review of reports printed for exception and error reporting, and reasonableness and limit checks of data.

(iii) Single Transaction Update of Multiple or Data Base Computer Files: A single input to the accounting system may automatically update all records associated with the transaction (e.g., shipment of goods documents may update the sales and customers' accounts receivable files as well as the inventory file). Thus, an erroneous entry in such a system may create errors in various financial accounts.

(iv) Systems Generated Transactions: Certain transactions may be initiated by the Computerised Information System (CIS) itself without the need for an input document. The authorisation of such transactions may neither be supported by visible input documentation nor documented in the same way as transactions which are initiated outside the CIS (e.g., interest may be calculated and charged automatically to customers' account balances on the basis of pre-authorized terms contained in a computer program).

(v) Vulnerability of Data and Programme Storage Media: Large volumes of data and the computer programs used to process such data may be stored on portable or fixed storage media, such as magnetic discs and tapes. These media are vulnerable to theft, or international or accidental destruction.

11. (a) Internal Controls in CIS Environment: The internal controls over computer processing, which help to achieve the overall objectives of internal control, include both manual procedures and procedures designed into computer programmes. Such manual and computer controls affect the CIS environment (general CIS controls) and the specific controls over the accounting applications (CIS application controls).

General CIS Controls: The purpose of general CIS controls is to establish a framework of overall control over the CIS activities and to provide a reasonable level of assurance that the overall objectives of internal control are achieved. These controls may include-

(1) Organisation and management controls are designed to establish an organizational framework over CIS activities, including:
   (i) Policies and procedures relating to control functions.
   (ii) Appropriate segregation of incompatible functions.

(2) Application systems development and maintenance controls are designed to establish control over:
   (i) Testing, conversion, implementation and documentation of new or revised systems.
   (ii) Changes to application systems.
   (iii) Access to systems documentation.
   (iv) Acquisition of application systems from third parties.

(3) Computer operation controls are designed to control the operation of the systems and to provide reasonable assurance that:
   (i) The systems are used for authorised purposes only.
   (ii) Access to computer operations is restricted to authorised personnel.
   (iii) Only authorised programs are used.
   (iv) Processing errors are detected and corrected.

(4) Systems software controls include:
   (i) Authorisation, approval, testing, implementation and documentation of new systems software and systems software modifications.
   (ii) Restriction of access to systems software and documentation to authorised personnel.

(5) Data entry and program controls are designed to provide reasonable assurance that:
   (i) An authorisation structure is established over transactions being entered into the system.
   (ii) Access to data and programs is restricted to authorised personnel.
   (iii) Offsite back-up of data and computer programmes.

(iv) Recovery procedures for use in the event of theft, loss or international or accidental destruction.

(v) Provision for offsite processing in the event of disaster.

CIS Application Controls: The purpose of CIS application controls is to establish specific control procedures over the accounting applications to provide reasonable assurance that all transactions are authorised and recorded, and are processed completely, accurately and on a timely basis. These include:

(a) Controls over input are designed to provide reasonable assurance that:

(i) Transactions are properly authorised before being processed by the computer.

(ii) Transactions are accurately converted into machine readable form and recorded in the computer data files.

(iii) Transactions are not lost, added, duplicated or improperly changed.

(iv) Incorrect transactions are rejected, corrected and if necessary, resubmitted on a timely basis.

(b) Controls over processing and computer data files are designed to provide reasonable assurance that:

(i) Transactions, including system generated transactions, are properly processed by the computer.

(ii) Transactions are not lost, added, duplicated or improperly changed.

(iii) Processing errors are identified and corrected on a timely basis.

(c) Controls over output are designed to provide reasonable assurance that:

(i) Results of processing are accurate.

(ii) Access to output is restricted to authorised personnel.

(iii) Output is provided to appropriate authorised personnel on a timely basis.

(b) Inherent Limitations of Internal Control System: Internal control can provide only reasonable but not absolute assurance that its objective relating to prevention and detection of errors/frauds, safeguarding of assets etc., are achieved. This is because it suffers from some inherent limitations, such as-

(i) Management's consideration that cost of an internal control does not exceeds the expected benefits.

(ii) Most controls do not tend to be directed at unusual transactions.

(iii) The potential of human error due to carelessness, misjudgment and misunderstanding of instructions.

(iv) The possibility that control may be circumvented through collusion with employees or outsiders.

(v) The possibility that a person responsible for exercising control may abuse that authority.

(vi) Compliance with procedures may deteriorate because the procedures becoming inadequate due to change in condition.

(vii) Manipulation by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

(viii) Inherent limitations of Audit.

12. (a) Receipt of Capital Subsidy:

(i) Refer to application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.

(ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.

(iii) See that conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.

(iv) Check relevant entries for receipt of subsidy.

(v) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

(b) Wages Paid to Seasonal Labourers:

(i) Ascertain and evaluate the internal control system for recruitment and usage of seasonal labourers.

(ii) Examine that these labourers are hired on proper authority and the rates of pay are authorized at appropriate levels.

(iii) Ensure that the attendance is properly checked by the Time Keeping Department.

(iv) Check that the certificate regarding work done by the labourers has been given by the proper person, in case the labourers have been appointed on a per piece basis.

(v) Check the computation of wages payable to the labourers, after taking into account the deductions.

(vi) Confirm that all the payments to the labourers have been acknowledged.

(vii) See the time and job records, to ensure that the labourers have been paid for time worked. See the treatment of abnormal idle time.

(viii) Reconcile the number of seasonal labourers on payroll as per the Personnel Department's records vis-à-vis the number of labourers to whom the wages have been paid, to ensure that there are no ghost workers. This assumes greater importance, if the seasonal labourers are hired on temporary basis, and not on permanent payroll.

(c) Retirement Gratuity to Employees:

(i) Examine the basis on which the gratuity payable to employees is worked out. The liability for gratuity may either be worked out on actuarial rules or agreement or on the presumption that all employees retire on the balance sheet date.

(ii) Verify computation of liability of gratuity on the aggregate basis.

(iii) Check the amount of gratuity paid to employees who retired during the year with reference to number of years of service rendered by them.

(iv) See that the annual premium has been charged to the Statement of Profit and Loss.

(v) Ensure that the accounting treatment is in accordance with AS 15 "Employee Benefits".

(d) Verification of Cash at Bank: While testing the authenticity of cash at bank, the following areas may be considered by the auditor-

(i) Apart from comparing the entries in the cash book with those in the Pass Book the auditor should obtain a certificate from the bank confirming the balance at the close of the year as shown in the Pass Book.

(ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.

(iii) Pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment write-off.

(iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.

(v) The auditor should examine the possibility, that even though the balance in an apparently inoperative account may have remained stagnant, transactions may have taken place in that account during the year.

(vi) In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements.

(vii) Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases.

(viii) The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.

(ix) Where material amounts are held in bank accounts which are blocked, e.g. in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases.

(x) Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances.

13. (a) Endowment Policies:

(i) Ascertain the specific purpose for which the endowment policy is taken, e.g., Sinking Fund policies for redemption of debentures, redemption of leases or policies taken for other similar purposes, etc.

(ii) Verify the terms and conditions of policies and ensure that all such conditions are in force and being followed.

(iii) Check that premium has been deposited in time and the policy is in force.

(iv) Examine that proper disclosures have been made in the financial statements in respect of items for which the policy has been taken.

(b) Discounted Bill Receivable Dishonoured:

(i) Obtain the schedule of discounted bills receivable dishonoured.

(ii) Check the entry in bank statement regarding the amount of bills dishonoured and see that the bank has debited the account of client.

(iii) Verify the bills receivable returned by the bank along with bank's advice.

(iv) See that the dishonoured bills have been noted and protested by following the proper procedure and the account of the drawee or the trade receivable is also debited.

(v) Check that bank commission, if any, charged by the bank has been recovered from the party.

(c) Deferred Tax Liability:

(i) The deferred tax liability is created when there is timing difference which results in deferred tax payable with reduction in current tax to the same extent. For example, when more depreciation amount is claimed in Income tax profits than in accounting profits, the current tax payable will be less with a liability to pay more tax in future. This is called Deferred Tax Liability.

(ii) Check the creation of Deferred Tax Liability and its actual working.

(iii) Check how much Deferred Tax Liability is reversed during the year.

(iv) Check that Deferred Tax Liability is disclosed as relating to depreciation and as relating to others.

(v) Check that the provisions of AS 22 "Accounting for Taxes on Income" have been complied with.

(d) Goods Lying with Third Party:

(i) The auditor should check that the materiality of the item under this caption included in inventories.

(ii) He should obtain confirmation of the amount of goods lying with them. The confirmation may be directly obtained by auditor or be produced by client depending upon the situation.

(iii) He should inquire into the necessity of sub contractor retaining the inventory. He should ensure the process that they do are related to the business requirement and there is no ground for suspicion on this score.

(iv) The goods lying with them for the very long period would merit auditors' special attention for making provision.

(v) The records, voucher/slips for the regulating the movement of inventory into and out of entity for sub-contracting work be reviewed by vouching for few transaction for ensuring existence and working of internal control system for them.

(vi) The excise gate pass, entry in such records, information in returns, be also cross-verified.

(vii) The valuation of inventories should be correctly made for including material cost on appropriate inventory valuation formulae and also for inclusion of proportionate processing charges for the work in process with the contractors.

(viii) The provision should be created for work done, billed for processing and also for incidence of any applicable levy like service tax payable.

14. (a) Modification of Opinion: The auditor shall modify the opinion in the auditor's report when-

(i) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(ii) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

(b) Disclaimer of Opinion: The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

(c) Adverse Opinion: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

(d) Qualified Opinion: The auditor shall express a qualified opinion when-

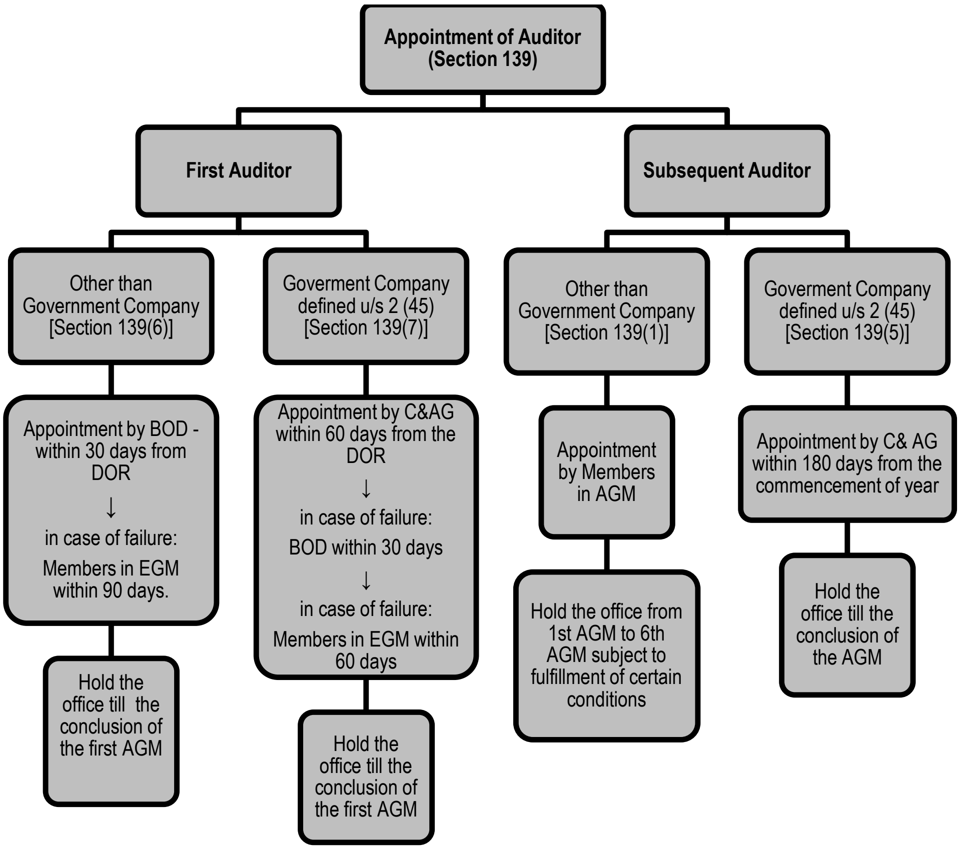
(i) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(ii) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

15. Appointment of Auditors: Section 139 of the Companies Act, 2013 contains provisions regarding appointment of Auditors. Provisions related to appointment of auditors may be grouped under two broad headings-

I Appointment of First Auditors.

II Appointment of Subsequent Auditors.



(a) Appointment of First Auditor of a Non-Government Company: As per Section 139(6) of the Companies Act, 2013, the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

(b) Appointment of First Auditor of a Government Company: Section 139(7) of the Companies Act, 2013 provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.

(c) Appointment of Subsequent Auditor of a Non-Government Company: As per section 139(1) of the Companies Act, 2013, every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

(d) Appointment of Subsequent Auditor of a Government Company: As per Section 139(5) of the Companies Act, 2013, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

16. (a) Director's Responsibility Statement: According to section 134(3)(c) of the Companies Act, 2013, the report of board of directors on annual accounts shall also include a 'Director's Responsibility Statement'. However, the provisions related to Director's Responsibility Statement are provided under section 134(5) of the Companies Act, 2013 which requires to state that-

(i) in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;

(ii) the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;

(iii) the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

(iv) the directors had prepared the annual accounts on a going concern basis;

(v) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

Here, the term "internal financial controls" means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information; and

(vi) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

(b) Issue of Shares at a Discount: According to Section 53 of the Companies Act, 2013, except sweat equity issued as mentioned in section 54, any share issued by a company at a discounted price shall be void.

Where a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

17. (a) Verification of Payment of Dividends: The procedure for the verification of payment of dividends is stated below-

(i) Examine the company's Memorandum and Articles of Association to ascertain the dividend rights of different classes of shares.

(ii) Confirm that the profits appropriated for payment of dividend are distributable having regard to the provisions contained in Section 123 of the Companies Act, 2013. If the company proposes to pay the dividend out of past profit in reserves, see that either this is in accordance with the rules framed by the Central Government in this behalf.

(iii) Inspect the Shareholders' Minute Book to verify the amount of dividend declared and confirm that the amount recommended by the directors.

(iv) If a separate bank account was opened for payment of dividends, check the transfer of the total amount of dividends payable from the Dividends Accounts.

(v) Check the particulars of members as are entered in the Dividend Register or Dividend List by reference to the Register of Members, test check the calculation of the gross amount of dividend payable to each shareholder on the basis of the number of the shares held and the amount of CDT, if applicable. Verify the casts and crosscast of the different columns.

(vi) Check the amount of dividend paid with the dividend warrants surrendered. Reconcile the amount of dividend warrants outstanding with the balance in the Dividend Bank Account.

(vii) Examine the dividend warrants in respect of previous years, presented during the year for payment and verify that by their payment, any provision contained in the Articles in the matter of period of time during which amount of unclaimed dividend can be paid had not been contravened.

(viii) It is compulsory for a company to transfer the total amount of dividend which remains unpaid or unclaimed, within thirty days of the declaration of the dividend to a special bank account entitled "Unpaid Dividend Account". Such an account is to be opened only in a scheduled bank. The transfer must be made within 7 days from the date of expiry of thirty days.

(ix) In case any money transferred to the unpaid dividend amount of a company remain unpaid or unclaimed for a period of 7 years from the date of such transfer shall be transferred to Investor Education and Protection Fund.

(x) Ensure the compliance, in case dividend is paid in case of inadequate profits.

(b) Verification of Issue of Bonus Shares: Section 63 of the Companies Act, 2013 allows a company to issue fully paid-up bonus shares to its members, in any manner whatsoever, out of-

(i) its free reserves;

(ii) the securities premium account; or

(iii) the capital redemption reserve account.

The auditor should ensure that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

Further, he should also ensure the compliance of condition for capitalization of profits or reserves for the issuing fully paid-up bonus shares like -

(i) it is authorised by its articles;

(ii) it has, on the recommendation of the Board, been authorised in the general meeting of the company;

(iii) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;

(iv) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;

(v) the partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;

(vi) it complies with such conditions as may be prescribed like the company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same;

(vii) the bonus shares shall not be issued in lieu of dividend.

18. (a) Audit Programme to Audit the Accounts of a Recreation Club:

(i) Examine the constitution, powers of governing body and relevant rules relating to preparation and finalisation of accounts. In case, it is constituted as a company limited by guarantee, application of provisions of the Companies Act, 2013 should also be seen.

(ii) Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, and minutes of the Managing Committee.

(iii) Vouch Members' subscription with the counterfoils of receipts issued to them. Trace receipts for a selected period to the Register of Members; reconcile the amount of total subscription due with the amount collected and the outstanding. Check totals of various columns of the Register of Members and tally them across. See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery. The amount considered irrecoverable, if any should be written off.

(iv) Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscription received in advance have been correctly adjusted.

(v) Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests as well as with the fees chargeable for the special service rendered such as billiards, tennis, etc. Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.

(vi) Vouch purchase of sports items, furniture, crockery, etc., and trace their entries into the respective inventory registers. Vouch purchases of food-stuffs, cigars, wines, etc. and test their sale price so as to confirm that the normal rates of profit have been earned on their sales.

The inventory of unsold provisions and stores, at the end of the year should be verified physically and its valuation checked.

(vii) Check the inventory of furniture, sports material and other assets physically with the respective inventory registers or inventories prepared at the end of the year.

(viii) Inspect the share scrips and bonds in respect of investments, check their current values for disclosure in final accounts, also ascertain that the arrangements for their safe custody are satisfactory, check the accrual of income therefrom and provision of income tax thereon.

(b) Receipt of Donations:

(i) **Internal Control System:** Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.

(ii) **Custody of Receipt Books:** Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.

(iii) **Receipt of Cheques:** Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.

(iv) **Bank Reconciliation:** Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.

(v) **Cash Receipts:** Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.

(vi) **Foreign Contributions,** if any, to receive special attention to compliance with applicable laws and regulations.

Remittance of Donations to Different NGOs:

(i) **Mode of Sending Remittance:** All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.

(ii) **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.

(iii) **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.

(iv) **Direct Confirmation Procedure:** Send confirmation letters to entities to whom donations have been paid.

(v) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.

(vi) **System of NGOs' Selection:** System for selecting NGO to whom donations have been sent.

19. Auditing the Accounts of a Hotel: The business of running a hotel is very much dissimilar to running an industrial unit for manufacturing of products. It is a service-oriented industry. The business is characterized by handling of large amounts of liquid cash, inventory of foods providing a variety of services, and keeping watch on customers to ensure that they do not leave hotel without settling the dues. In view of these, the following matters require special attention by the auditor.

(i) **Internal Control:** Pilferage is one of the greatest problems in any hotel and it is extremely important to have a proper internal control to minimize the leakage. The following points should be checked-

(a) Effectiveness of arrangement regarding receipts and disbursements of cash.

(b) Procedure for purchase and inventory stocking of various commodities and provisions.

(c) Procedure regarding billing of the customers in respect of room service, telephone, laundry, etc.

(d) System regarding recording and physical custody of edibles, wines, cigarettes, crockery and cutlery, linen, furniture, carpets, etc.

(e) Ensure that are trading accounts are prepared preferably weekly, for each sales point. A scrutiny of the percentage of profit should be made, and any deviation from the norms is to be investigated.

(ii) **Room Sales and Cash Collections:**

(a) There are various sales points scattered in a hotel and sales are both for cash and credit. The control over cash is very important. The charge for room sales is made from the guest register, and tests are to be carried out to ensure that the correct numbers of guests are charged for the exact period of stay. Any difference between the rate charged to the guests and standard room rent is to be investigated to see that it is properly authorized.

(b) The total sales reported with the total bills issued at each sales point have to be reconciled.

(c) Special care must be taken in respect of bills issued to customers who are staying in the hotel, because they may not be required to pay the bills immediately in cash but at a future date or by credit cards. Billing is to be done room-wise. It must be ensured that all customers pay their bills on leaving the hotel or within specified dates.

(iii) **Inventory:** The inventories in a hotel are all saleable item like food and beverages. Therefore, following may be noted in this regard:

(a) All movement and transfer of inventories must be properly documented.

(b) Areas where inventories are kept must be kept locked and the key retained by the departmental manager.

(c) The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.

(d) Many hotels use specialized professional valuers to count and value the inventories on a continuous basis throughout the year.

(e) The auditor should ensure that all inventories are valued at the year end and that he should himself be present at the year end physical verification, to the extent practicable, having regard to materiality consideration and nature and location of inventories

(iv) **Fixed Assets:** The fixed assets should be properly depreciated, and the Fixed Assets Register should be updated.

(v) **Casual Labour:** In case the hotel employs a casual labour, the auditor should consider, whether adequate records have been maintained in this respect and there is no manipulation taking place. The wages payment of the casual labour must also be checked thoroughly.

(vi) The compliance with all statutory provisions, and compliance with the Foreign Exchange Regulations must also be verified by the auditor, especially because hotels offer facility of conversion of foreign exchange to rupees.

(vii) **Other Special Aspects** are to be verified as under-

(a) Consumption shown in various physical inventory accounts must be traced to the customers' bills to ensure that all issues to the customers have been billed.

(b) All payments to the foreign collaborator, it any, are to be checked.

(c) Expenses and receipts are to be compared with figures of the previous year, having regard to the average occupancy of visitors and changes in rates.

(d) Special receipts on account of letting out of auditorium, banquet hall, spaces for shops, boutiques, and special shows should be verified with the arrangements made.

(e) In depth check should be carried out on the customers' ledgers to verify that all charges have been properly made and recovered.

(f) The occupancy rate should be worked out, and compared with other similar hotels, and with previous year. Material deviations should be investigated.

(g) Expenses for painting, decoration, renovation of building, etc. are to be properly checked.

(h) It is common that hotels get their bookings done through travel agents. The auditor should ensure that the money is recovered from the travel agents as per credit terms allowed. Commission paid to travel agents should be checked by reference to the agreement on that behalf.

(i) Apart from control over inventory of edibles, control over issue and physical inventory of linen crockery, cutlery, glassware, silver, toilet items, etc. should be verified.

(j) The auditor should verify the restaurant bills with reference to KOT (Kitchen Order Ticket).

(k) The auditor should ensure that all taxes have been included in the client's bills.

(l) Computation and payment of salaries and wages vis-a-vis number of employees must be checked.

20. Audit of Hospital: The audit points to be considered by the auditor during the audit of a Hospital are stated below-

(i) **Income from Services:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

(ii) **Collection of Cash:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

(iii) **Income from Investments**: See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities settled on the hospital, has been collected.

(iv) **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(v) **Reconciliation of Subscriptions:** Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

(vi) **Authorisation and Sanctions:** Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.

(vii) **Grants and TDS:** Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

(viii) **Budgets:** Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee significant variations which have taken place.

(ix) **Internal Check:** Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.

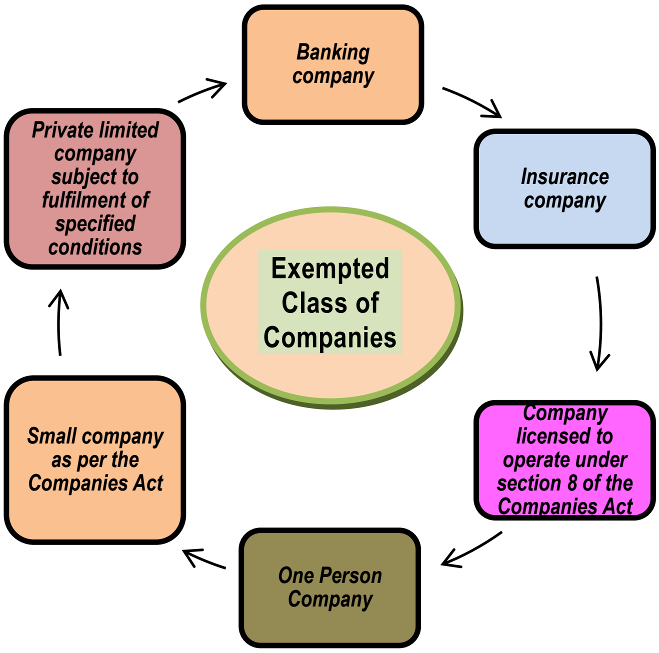
(x) **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.

(xi) **Registers:** Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

(xii) **Inventories**: Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.

(xiii) **Management Representation and Certificate:** Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

Exempted Class of Companies



II. **Auditor's report to contain matters specified in paragraphs 3 and 4 -** Every report made by the auditor under section 143 of the Companies Act, 2013 on the accounts of every company audited by him, to which this Order applies, for the financial years commencing on or after 1st April, 2015, shall in addition, contain the matters specified in paragraphs 3 and 4, as may be applicable:

It may be noted that the Order shall not apply to the auditor's report on consolidated financial statements.

III. **Matters to be included in the auditor's report -** The auditor's report on the accounts of a company to which this Order applies shall include a statement on the following matters, namely:-

(i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;

(b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

(c) whether the title deeds of immovable properties are held in the name of the

~~(a) T~~the nature of the internal audit function's responsibilities, ~~and how the internal audit function fits in the entity's~~ its organisational ~~structure~~status, ~~;~~ and

~~(b) T~~ the activities performed, or to be performed. ~~, by the internal audit function.~~ (Ref: Para. A~~101~~ 109 -A~~103~~ 116)

Inquiries of Management, the Internal Audit Function and Others Within the Entity *(Ref: Para. 6(a))*

A6. Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. Information may also be obtained by the auditor through inquiries with the internal audit function, if the entity has such a function, and others within the entity.

A7. ~~However, t~~The auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:

- ……………………………
- ~~Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.~~
- …………………………..
- ……………………………
- ………………………

Inquiries of the Internal Audit Function

A9. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's understanding of the entity, the auditor's risk assessments or other aspects of the audit. The auditor's inquiries are therefore made whether or not the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed[87]. Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.

[87] The relevant requirements are contained in SA 610 (Revised).

PAPER – 7: INFORMATION TECHNOLOGY AND STRATEGIC MANAGEMENT

SECTION – A: INFORMATION TECHNOLOGY

QUESTIONS

1. Define the following terms briefly:
   (i) Business Process
   (ii) Benefits of Business Process Automation (BPA)
   (iii) Micro Architecture
   (iv) Infrastructure as a Service (IaaS)
   (v) Extranets
   (vi) Electronic Commerce
   (vii) Examples of Management Information Systems (MIS)
   (viii) Specialized Systems
   (ix) Custom-built Application
   (x) Personal Identification Number (PIN)
2. Differentiate between the following:
   (i) Entity of Data Flow Diagram (DFD) and Process of Data Flow Diagram (DFD)
   (ii) One-to-Many Relationship (1:N) and Many-to-One (M:1) Relationship in E-R Diagram
   (iii) Connection Oriented Networks and Connectionless Networks
   (iv) Application Server and Web Server
   (v) Star Network and Mesh Network
   (vi) Transport Layer and Session Layer of OSI Model
   (vii) Transaction Processing System (TPS) and Management Information System (MIS)
   (viii) Explicit Knowledge and Tacit Knowledge
   (ix) Storage Virtualization and Hardware Virtualization
   (x) Concurrent Audit and General Audit
3. Write short note on the following:
   (i) Six Sigma
   (ii) Value Chain Automation
   (iii) Application Software
   (iv) Database Management Systems (DBMS)
   (v) Fibre Optics
   (vi) Decentralized Computing

(vii) Core Banking Systems (CBS)

(viii) Information System

(ix) Advantages of Cloud Computing

(x) TALLY

Business Process Flow

4. Discuss Order to Cash Process flow in detail.

Information Systems Life Cycle

5. Discuss Information Systems Life Cycle, in brief.

Flowchart

6. Draw a flow chart to compute and print Income-tax, Surcharge and Education Cess on the income of a person, where income is to be read from terminal and tax is to be calculated as per the following rates:

	Slab (₹)	Rate
(i)	1 to 1,00,000	No tax
(ii)	1,00,001 to 1,50,000	@ 10% of amount above 1,00,000
(iii)	1,50,001 to 2,50,000	₹ 5,000 + 20% of amount above 1,50,000
(iv)	2,50,001 onwards	₹ 25,000 + 30% of amount above 2,50,000
	Surcharge	@ 10% on the amount of total tax, if the income of a person exceeds ₹ 10,00,000
	Education cess	2% on the total tax

Impact of IT on Risks and Controls

7. Discuss the impact of Information Technology on Information Systems' Risks and Controls.

Client Server Networking

8. Discuss Client Server Networking, in detail.

Benefits of e-Commerce Application and Implementation

9. Discuss various benefits of e-Commerce application and implementation.

Network Security

10. Discuss the various aspects involved in Network Security.

Supply Chain Management

11. What do you understand by the term “Supply Chain Management (SCM)”? Discuss its core components.

Communication Controls

12. Discuss Communication Controls under Application Controls.

Grid Computing

13. Discuss the numerous benefits of Grid Computing.

Operating System

14. Discuss the various tasks performed by Operating System.

SUGGESTED ANSWERS/HINTS

1. **(i)** **Business Process:** A **Business Process** consists of a set of activities that are performed in coordination in an organizational and technical environment. These activities jointly realize a business goal. Each business process is enacted by a single organization, but it may interact with business processes performed by other organizations. To manage a process, the first task is to **define** it that involves defining the steps/tasks in the process and mapping the tasks to the roles involved in the process. Once the process is mapped and implemented, **performance measures** are established. The last piece of the process management definition describes the **organizational setup** that enables the standardization of and adherence to the process throughout the organization.

(ii) Benefits of Business Process Automation (BPA) are as follows:

- **Saving on costs:** Automation leads to saving in time and labor costs.
- **Staying ahead in competition:** Today, to survive, businesses need to adopt automation.
- **Fast service to customers:** Nowadays, business managers realize that automation help them to serve their customers faster and better.

(iii) **Micro Architecture:** Micro Architecture is a lower level detailed description of the system that is sufficient for completely describing the operation of all parts of the computing system, and how they are inter-connected and inter-operate to implement the Information Systems Architecture (ISA). This describes the data paths, data processing elements and data storage elements, and describes how they should implement ISA. The Micro architecture considers how the ISA does and what it does. It’s how everything is ultimately organized on the chip or processor.

(iv) **Infrastructure as a Service (IaaS):** It is the foundation of cloud services that provides clients with access to server hardware, storage, bandwidth and other fundamental computing resources. The service is typically paid for on a usage basis. The service may also include dynamic scaling so that if the customer needs more resources than expected, s/he can get them on the fly (probably to a given limit). It provides access to shared resources on need basis, without revealing details like location and hardware to clients.

(v) **Extranets:** Extranets are network links that use Internet technologies to interconnect the Intranet of a business with the Intranets of its customers, suppliers, or other business partners. Companies can use Extranets to perform following functions:

- Establish direct private network links between themselves, or create private secure Internet links between them called virtual private networks.
- Use the unsecured Internet as the extranet link between its intranet and consumers and others, but rely on encryption of sensitive data and its own firewall systems to provide adequate security.

(vi) **Electronic Commerce:** Electronic Commerce is the process of doing business electronically. It refers to the use of technology to enhance the processing of commercial transactions between a company, its customers and its business partners. It involves the automation of a variety of business-to-business and business-to-consumer transactions through reliable and secure connections.

(vii) Examples of Management Information Systems (MIS) are as follows:

- ♦ Airline reservations (seat, booking, payment, schedules, boarding list, special needs, etc.).
- ♦ Bank operations (deposit, transfer, withdrawal) electronically with a distinguish payment gateways.
- ♦ Integration of department with the help of contemporary software's like ERP.
- ♦ Logistics management application to streamline the transportation system.
- ♦ Train reservation.

(viii) **Specialized Systems:** Specialized Systems provide comprehensive end to end IT solutions and services including systems integration, implementation, engineering services, software application customization and maintenance to various corporations. These systems offer comprehensive solutions to various sectors to confront challenges, and convert every challenge into an opportunity. Enterprise Resource Planning (ERP), Customer Relationship Management (CRM), and Supply Chain Management (SCM) etc. are some examples of specialized systems.

(ix) **Custom-built Application:** These applications can be configured to meet a company's requirements. Customization involves additional coding while configuration is based on settings which are inputted by the user. Whether they are for one function or integrate processes across the company like an ERP – these are the easiest ones to customize. Example – Billing, Inventory, Attendance etc.

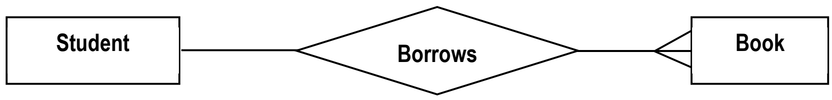
(x) **Personal Identification Number (PIN):** The Personal Identification Number is similar to a password assigned to a user by an institution based on the user characteristics and encrypted using a cryptographic algorithm. The application generates a random number stored in its database independent of user identification details or a customer selected number.

2. (i) **Entity of Data Flow Diagram (DFD):** An entity of DFD is the source or destination of data. The source in a DFD represents these entities that are outside the context of the system. Entities either provide data to the system (referred to as a source) or receive data from it (referred to as a sink). Entities are often represented as rectangles (a diagonal line across the right-hand corner means that this entity is represented somewhere else in the DFD). Entities are also referred to as agents, terminators, or source/sink.

Process of Data Flow Diagram (DFD): The process is the manipulation or work that transforms data, performing computations, making decisions (logic flow), or directing data flows based on business rules. In other words, a process receives input and generates some output. Process names (simple verbs and dataflow names, such as "Submit Payment" or "Get Invoice") usually describe the transformation, which can be performed by people or machines. Processes can be drawn as circles or a segmented rectangle on a DFD, and include a process name and process number.

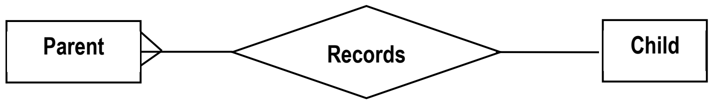
(ii) **One-to-Many relationship (1:N) –** A One-to-Many relationship is shown on the E-R Diagram by a line connecting the two entities with a "crow's foot" symbol denoting the 'many' end of the relationship.

Example: A student may borrow some books from the library. A book in the library may be borrowed by at most a student.



Many-to-One relationship (M:1) – It is the reverse of One-to-Many relationship.

Example: As in two or more parent records to a single child record. For example,



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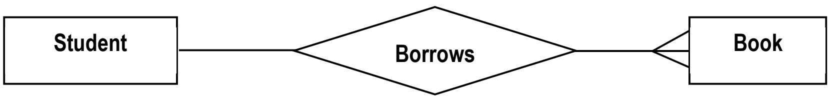

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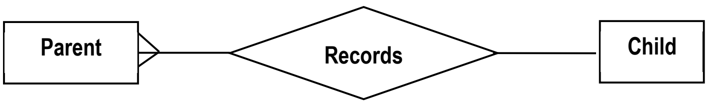


(iii) Connection Oriented Networks: The communication wherein a connection is first established and then data is exchanged between two networks are known as Connection Oriented Networks. Like it happens in case of telephone networks.

Connectionless Networks: The communication wherein no prior connection is made before data exchanges between two networks is known as Connectionless Networks. Data which is being exchanged in fact has a complete contact information of recipient and at each intermediate destination, it is decided how to proceed further like it happens in case of postal networks.

(iv) **Application Server:** This is a program that handles all application operations between users and an enterprise's backend business applications or databases.

Web Server: Web server is a computer that delivers (serves up) web pages. Every web server has an IP address and possibly a domain name. For example, if we enter the URL http://www.icai.org in our browser, this sends a request to the Web server whose domain name is icai.org. The server then fetches the home page named and sends it to our browser. Any computer can be turned into a Web server by installing server software and connecting the machine to the Internet.

(v) Difference between Star Network and Mesh Network are as follows:

	Star Network	**Mesh Network**
Concept	The star network, a popular network configuration, involves a central unit that has a number of terminals tied into it. The characteristics of a star network are: • It ties end user computers to a central computer. • The central unit in the star network acts as the traffic controller among all the other computers tied to it. The central computer is usually a mainframe (host), which acts as the file server. • A star network is well suited to companies with one large data processing facility shared by a number of smaller departments. Many star networks take the form of hierarchical	In this structure, there is random connection of nodes using communication links. A mesh network may be fully connected or connected with only partial links. In fully interconnected topology, each node is connected by a dedicated point to point link to every node. The reliability is very high as there are always alternate paths available if direct link between two nodes is down or dysfunctional. Fully connected networks are not very common because of the high cost. Only military installations, which need high degree of redundancy, may have such networks, that too with a small number of nodes.

	networks with a centralized approach.	
Advantages	• Several users can use the central unit at the same time. • It is easy to add new nodes and remove existing nodes. • A node failure does not bring down the entire network. • It is easier to diagnose network problems through a central hub.	• Yields the greatest amount of redundancy in the event that if one of the nodes fails, the network traffic can be redirected to another node. • Network problems are easier to diagnose.
Disadvantages	• The whole network is affected if the main unit "goes down," and all communications stop. • Considered less reliable than a ring network, since the other computers in the star are heavily dependent on the central host computer. If it fails, there is no backup processing and communications capability and the local computers will be cut off from the corporate headquarters and from each other. • Cost of cabling the central system and the points of the star network together are very high.	• Its high cost of installation and maintenance (more cable is required than any other configuration).

(vi) Transport Layer of OSI Model: The Transport Layer (Layer 4) ensures reliable and transparent transfer of data between user processes, assembles and disassembles message packets, and provides error recovery and flow control. Multiplexing and encryption are undertaken at this layer level. This means that the Transport Layer can keep track of the segments and retransmit those that fail.

Session Layer of OSI Model: The Session Layer (Layer 5) sets up, coordinates, and terminates conversations, exchanges, and dialogs between the applications at each end. It deals with session and connection coordination. It provides for full-duplex, half-duplex, or simplex operation, and establishes check pointing, adjournment, termination, and restart procedures. The OSI model made this layer responsible for "graceful close" of sessions also.

(vii) Transaction Processing System (TPS): A Transaction Processing System (TPS) may be defined as a type of Information System that collects, stores, modifies and retrieves the day-to-day data transactions of an enterprise. TPS systems are designed to process transactions virtually instantly to ensure that customer data is available to the processes that require it.

Management Information System (MIS): Management Information System (MIS) is an old management tool, which has been long used by people for superior management and scientific decision making. MIS is primarily dependent upon information and is an example of Management Level systems that help middle managers who are responsible for carrying out the goals set by Top Management.

(viii)Explicit Knowledge: Explicit knowledge is that which can be formalized easily and therefore is easily available across the organization. Explicit knowledge is articulated, and represented as spoken words, written material and compiled data. This type of knowledge is codified, easy to document, transfer and reproduce. For example – Online tutorials, Policy and procedural manuals.

Tacit Knowledge: Tacit knowledge, on the other hand, resides in a few often-in just one person and hasn't been captured by the organization or made available to others. Tacit knowledge is unarticulated and represented as intuition, perspective, beliefs, and values that individuals form based on their experiences. It is personal, experimental and context-specific. It is difficult to document and communicate the tacit knowledge. For example – hand-on skills, special know-how, employee experiences.

(ix) Storage Virtualization: Storage virtualization is the apparent pooling of data from multiple storage devices, even different types of storage devices, into what appears to be a single device that is managed from a central console. Storage virtualization helps the storage administrator perform the tasks of backup, archiving, and recovery more easily - and in less time - by disguising the actual complexity of a Storage Area Network (SAN). Administrators can implement virtualization with software applications or by using hardware and software hybrid appliances. The servers connected to the storage system aren't aware of where the data really is. Storage virtualization is sometimes described as "abstracting the logical storage from the physical storage".

Hardware Virtualization: Hardware Virtualization or Platform Virtualization refers to the creation of a virtual machine that acts like a real computer with an operating system. Software executed on these virtual machines is separated from the underlying hardware resources. For example, a computer that is running Microsoft Windows may host a virtual machine that looks like a computer with the Linux operating system; based software that can be run on the virtual machine. The basic idea of Hardware virtualization is to consolidate many small physical servers into one large physical server so that the processor can be used more effectively.

(x) Concurrent Audit: In this, Auditors are members of the system development team. They assist the team in improving the quality of systems development for the specific system they are building and implementing.

General Audit: In this, Auditors evaluate systems development controls overall. They seek to determine whether they can reduce the extent of substantive testing needed to form an audit opinion about management's assertions relating to the financial statements in systems effectiveness and efficiency.

3. **(i) Six Sigma:** Six Sigma is a set of strategies, techniques, and tools for process improvement. It seeks to improve the quality of process outputs by identifying and removing the causes of defects and minimizing variability in manufacturing and business processes. Each Six Sigma project carried out within an organization follows a defined sequence of steps and has quantified value targets, for example: reduce process cycle time, reduce pollution, reduce costs, increase customer satisfaction, and increase profits. It follows a life-cycle having phases: Define, Measure, Analyze, Improve and Control (or DMAIC).

(ii) Value Chain Automation: This refers to separate activities which are necessary to strengthen an organization's strategies and are linked together both inside and outside the organization. It is defined as a chain of activities that a firm operating in a specific industry performs to deliver a valuable product or service for the market.

The idea of the Value Chain is based on the process view of organizations, the idea of seeing a manufacturing (or service) organization as a system, made up of subsystems each with inputs, transformation processes and outputs. Six business functions of the value chain are Research and development; Design of products, services, or processes; Production; Marketing and sales; Distribution and Customer service.

(iii) Application Software: Application software includes all that computer software that cause a computer to perform useful tasks beyond the running of the computer itself. It is a collection of programs which address a real-life problem of its end users which may be business or scientific or any other problem. The different types of application software are as follows:

- **Application Suite:** Has multiple applications bundled together. Related functions, features and user interfaces interact with each other. E.g. MS Office 2010 which has MS Word, MS Excel, MS Access, etc.
- **Enterprise Software:** Addresses an enterprise's needs and data flow in a huge distributed environment. E.g. ERP Applications like SAP.
- **Enterprise Infrastructure Software:** Provides capabilities required to support enterprise software systems. E.g. email servers, Security software.
- **Information Worker Software:** Addresses individual needs required to manage and create information for individual projects within departments. E.g. Spreadsheets, CAAT (Computer Assisted Audit Tools) etc.
- **Content Access Software:** Used to access contents and addresses a desire for published digital content and entertainment. E.g. Media Players, Adobe Digital etc.
- **Educational Software:** Holds contents adopted for use by students. E.g. Examination Test CDs.
- **Media Development Software:** Addresses individual needs to generate and print electronic media for others to consume. E.g. Desktop Publishing, Video Editing etc.

(iv) Database Management Systems (DBMS): Every enterprise needs to manage its information in an appropriate and desired manner. The enterprise has to know its information needs; acquire that information; organize that information in a meaningful way; assure information quality; and provide software tools so that users in the enterprise can access information they require. DBMS are software that aid in organizing, controlling and using the data needed by the application programme. They provide the facility to create and maintain a well-organized database. Applications access the DBMS, which then accesses the data. Commercially available Data Base Management Systems are Oracle, My SQL, SQL Servers and DB2 etc. DBMS helps us do various operations on the files, such as adding new files to database; deleting existing files from database; inserting data in existing files; modifying data in existing files; deleting data in existing files; and retrieving or querying data from existing files.

(v) Fibre Optics: This media consists of one or more hair-thin filaments of glass fibre wrapped in a protective jacket. Signals are converted to light form and fired by laser in bursts. Optical fibres can carry digital as well as analog signals and provides increased speed and greater carrying capacity than coaxial cable and twisted-pair lines. It is not affected by electromagnetic radiation and not susceptible to electronic noise and so it has much lower error rates than twisted-pair and coaxial cable. Fibre optic cables are easy to install since they are smaller and more flexible and can be used undersea for transatlantic use. Speed of communications is 10,000 times faster than that of microwave and satellite systems. Biggest disadvantages of using fibre optic cable are that installation can be difficult and costly to purchase.

(vi) Decentralized Computing: Decentralized computing is the allocation of resources, both hardware and software, to each individual workstation, or office location. In contrast, centralized computing exists when majority of functions are carried out, or obtained from a remote centralized location. A collection of decentralized computers systems are components of a larger computer network, held together by local stations of equal importance and capability. These systems can run independently of each other. Decentralized systems enable file sharing and all computers can share peripherals such as printers and scanners as well as modems, allowing all the computers in the network to connect to the internet.

(vii) Core Banking Systems (CBS): Core Banking System may be defined as the set of basic software components that manage the services provided by a bank to its customers through its branches (branch network). In other words, the platform where communication technology and information technology are merged to suit core needs of banking is known as Core Banking Solutions (CBS). Normal core banking functions will include deposit accounts, loans, mortgages and payments. Banks make these services available across multiple channels like ATMs, Internet banking, and branches. The other various elements of core banking include making and servicing loans; opening new accounts; processing cash deposits and withdrawals; processing payments and cheques; calculating interest; Customer Relationship Management (CRM) activities; managing customer accounts; establishing criteria for minimum balances, interest rates, number of withdrawals allowed and so on; establishing interest rates; and maintaining records for all the bank's transactions.

(viii) Information System: Information System (IS) is a combination of people, hardware, software, communication devices, network and data resources that processes (can be storing, retrieving, transforming information) data and information for a specific purpose. The system needs inputs from user (key in instructions and commands, typing, scanning) which will then be processed (calculating, reporting) using technology devices such as computers, and produce output (printing reports, displaying results) that will be sent to another user or other system via a network and a feedback method that controls the operation. In general, any specific Information System aims to support operations, management and decision-making.

(ix) Advantages of Cloud Computing are as follows:

- **Cost Efficient:** Cloud computing is probably the most cost efficient method to use, maintain and upgrade.
- **Almost Unlimited Storage:** Storing information in the cloud gives us almost unlimited storage capacity.

- **Backup and Recovery:** Since all the data is stored in the cloud, backing it up and restoring the same is relatively much easier than storing the same on a physical device. Furthermore, most cloud service providers are usually competent enough to handle recovery of information.
- **Automatic Software Integration:** In the cloud, software integration is usually something that occurs automatically. Not only that, cloud computing allows us to customize the options with great ease. Hence, we can handpick just those services and software applications that we think will best suit the particular enterprise.
- **Easy Access to Information:** Once we register ourselves in the cloud, we can access the information from anywhere, where there is an Internet connection.
- **Quick Deployment:** Once we opt for this method of functioning, the entire system can be fully functional in a matter of a few minutes. Of course, the amount of time taken here will depend on the exact kind of technology that we need for our business.

(x) **TALLY:** It is an accounting application that helps entity to automate processes relating to accounting of transactions. It also helps to achieve automation of few processes in inventory management. The latest version has been upgraded to help user achieve TAX compliances also. It has features such as Remote Access Capabilities, Tax Audit and Statutory Compliance, Payroll, Excise for Manufacturers, Multilingual Support, VAT Composition Returns, TDS, VAT (Value Added Tax), Rapid Implementation, Real Time Processing, Dynamic Interactive Reports and Unique Drill-Down Facility, Unlimited Companies and Periods of Accounting.

4. Order to Cash Process Flow: Order to Cash (OTC or O2C) or Sales covers all the business processes relating to fulfilling customer requests for goods or services. It involves transactional flow of data from the initial point of documenting a customer order to the final point of collecting the cash.

The typical life cycle of a sales transaction which may include the following transactions:

(i) **Customer Order:** A purchase order is received from a customer specifying the type, quantity and agreed prices for products.

(ii) **Recording:** Availability of the items is checked and customer order is booked.

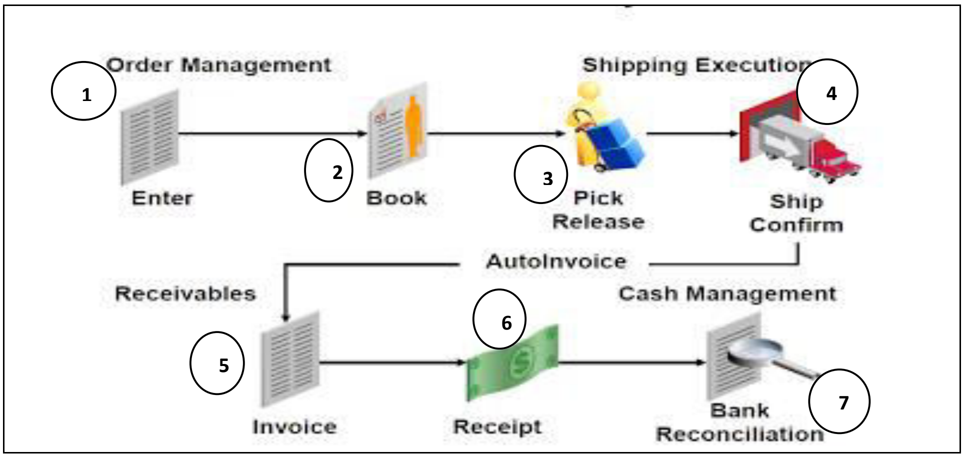
(iii) **Pick release:** The items are moved from the warehouse to the staging area.

(iv) **Shipping:** The items are loaded onto the carrier for transport to the customer.

(v) **Invoice:** Invoice of the transaction is generated and sent to the customer.

(vi) **Receipt:** Money is received from the customer against the invoices.

(vii) **Reconciliation:** The bank reconciliation of all the receipts is performed.



Order to Cash process flow

5. **Information Systems Life Cycle:** This is commonly referred as **Software/System Development Life Cycle (SDLC),** which is a methodology used to describe the process of building information systems. It is the logical starting point in the entire life cycle of a computerized system. Activities start when any enterprise decides to go for computerization or migrate from existing computerized system to a new one. SDLC framework provides a sequence of activities for system designers and developers to follow. It consists of a set of steps or phases in which each phase of the SDLC uses the results of the previous one. This serves as a guideline to the designer, who seeks to use it as template while working on a project development.

   Phase 1: System Investigation: This phase examines that 'What is the problem and is it worth solving'? the various dimensions under which Systems investigation is done are Technical feasibility, Economic feasibility, Legal feasibility, Operational feasibility and Schedule feasibility.

   Phase 2: System Analysis: This phase examines that 'What must the Information System do to solve the problem'? System analyst would be gathering details about the current system and will involve the activities like Interviewing staff, examining current business, sending out questionnaires and observation of current procedures. The Systems Analyst will examine data and information flows in the enterprise using data flow diagrams; establish what the proposed system will do (not how it will do it); analyse costs and benefits; outline system implementation options. (e.g. in-house or using consultants); consider possible hardware configurations; and make recommendations.

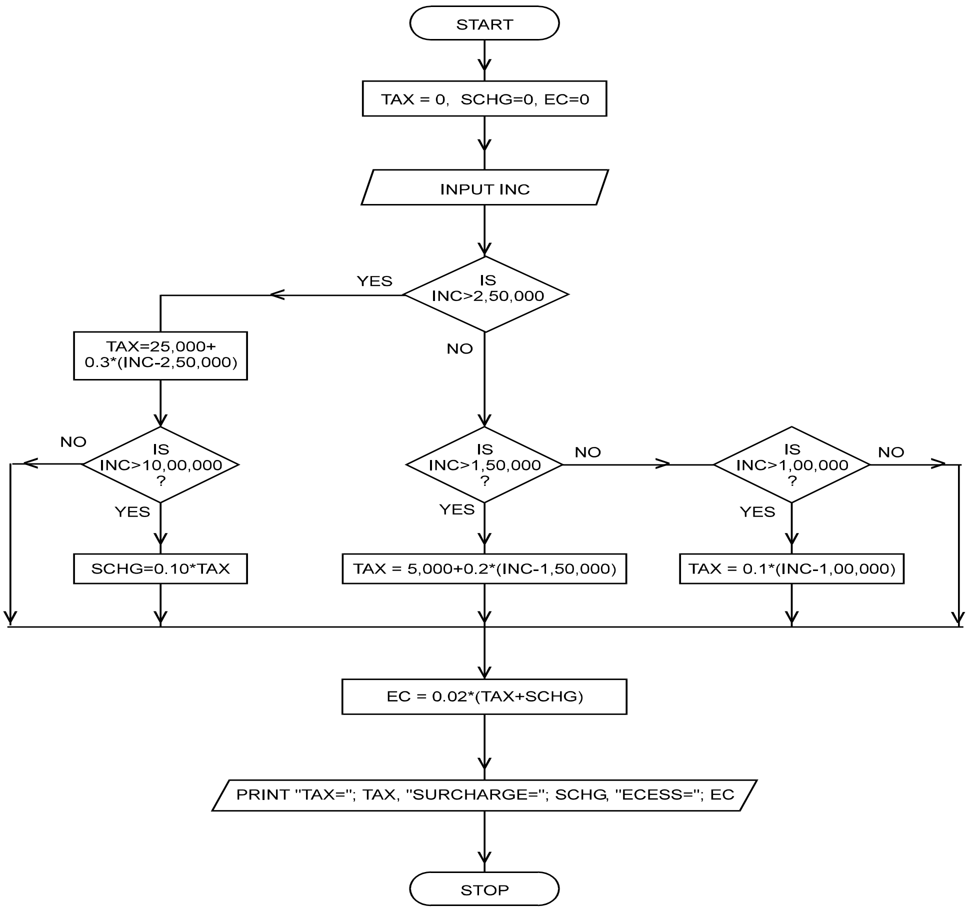
Phase 3: System Designing: This phase examines that 'How will the Information System do that it must do to obtain the solution to the problem'? This phase specifies the technical aspects of a proposed system in terms of Hardware platform, Software, Outputs, Inputs, User interface, Modular design, Test plan, Conversion plan and Documentation.

Phase 4: System Implementation: This phase examines that 'How will the Solution be put into effect'? This phase involves the steps like Coding and testing of the system; Acquisition of hardware and software; and either installation of the new system or conversion of the old system to the new one.

Phase 5: System Maintenance and Review: This phase evaluates results of solution and modifies the system to meet the changing needs. Post implementation review would be done to address programming amendments; adjustment of clerical procedures; Modification of Reports, and Request for new programs.

6. We shall define the variables first:

SCHG: Surcharge; TAX: Income Tax; EC: Education Cess; INC: Income



7. Data handling capacity of computer combined with telecommunications technology greatly increases ability of an individual to access and to manipulate large quantities of data - within a relatively short time; thus, increasing amount of potential damage or risk of exposure. The impact of Information Technology (IT) on Information Systems' Risks is as follows:

- Ready access to terminals as computerized Information Systems are highly distributed and leads to ease in perpetration of computer related crimes thereby increasing temptation for abuse.
- On-line processing of data and validation checks would help the prospective perpetrator in guessing passwords and aid in circumventing controls in inputs to computer.
- Appropriate controls are not resident within the computer systems to detect or to prevent the accidents. If threats are not anticipated and adequate controls are not designed to mitigate or counter them, system and its resources will be vulnerable.
- The greatest exposure of all is a failure to recognize risks or potential impacts of those risks. Prudence demands that contingencies are to be anticipated and planning done to handle them.

The four major areas in which controls have been affected are as follows:

- Realignment of functions data entry and source of transactions may be centralized;
- Changes in custody of files and documents. Ready access to data over telecom links complicate custodial functions of data. Data librarian may become in charge for data;
- Transfer of responsibilities Single action by user may complete the entire processing cycle of the transaction; and
- Decline of accountability Traditional functions, responsibilities and boundaries have been eliminated or are obscured by new methods.

8. **Client-Server Networking:** Client/Server network is a computer network in which one centralized powerful computer (called Server) is connected to many less powerful PCs or workstations (called Clients). The clients run programs and access data that are stored on the server. Example – WWW/E-Mail.

- **Client:** A client is a single-user workstation that provides presentation services and the appropriate computing, connectivity and the database services relevant to the business need.
- **Server:** A server is one or more multi-user processors with shared memory providing computing, connectivity and the database services and the interfaces relevant to the business need.

Some of the prominent characteristics of C/S architecture are as follows:

- **Service:** C/S provides a clean separation of function based on the idea of service. The server process is a provider of services and the client is a consumer of services.
- **Shared Resources:** A server can service many clients at the same time and regulate their access to the shared resources.
- **Transparency of Location:** C/S software usually masks the location of the server from the clients by redirecting the service calls when needed.
- **Mix-and-Match:** The ideal C/S software is independent of hardware or Operating System software platforms.
- **Scalability:** In a C/S environment, client workstations can either be added or removed and the server load can be distributed across multiple servers.
- **Integrity:** The server code and server data is centrally managed, which results in cheaper maintenance and the guarding of shared data integrity. At the same time, the clients remain personal and independent.

Issues in Client/Server Network are as follows:

(i) When the server goes down or crashes, all the computers connected to it become unavailable to use.

(ii) Simultaneous access to data and services by the user takes little more time for server to process the task.

9. The various benefits of e-Commerce application and implementation are as follows:

- ♦ Reduction in costs to buyers from increased competition in procurement as more suppliers can compete in an electronically open marketplace.
- ♦ Reduction in errors, time, and overhead costs in information processing by eliminating requirements for re-entering data.
- ♦ Reduction in costs to suppliers by electronically accessing on-line databases of bid opportunities, on-line abilities to submit bids, and on-line review of rewards.
- ♦ Reduction in time to complete business transactions, particularly from delivery to payment.
- ♦ Creation of new markets through the ability to easily and cheaply reach potential customers.
- ♦ Easier entry into new markets, especially geographically remote markets, for enterprises regardless of size and location.
- ♦ Better quality of goods as specifications are standardized and competition is increased and improved variety of goods through expanded markets and the ability to produce customized goods.

- Faster time to market as business processes are linked, thus enabling seamless processing and eliminating time delays.
- Optimization of resource selection as businesses form cooperative teams to increase the chances of economic successes, and to provide the customer products and capabilities more exactly meeting the requirements.
- Reduction in inventories and reduction of risk of obsolete inventories as the demand for goods and services is electronically linked through just-in-time inventory and integrated manufacturing techniques.
- Reduction in overhead costs through uniformity, automation, and large-scale integration of management processes.
- Reduction in use of ecologically damaging materials through electronic coordination of activities and the movement of information rather than physical objects).
- Reduction in advertising costs.

10. Based on the increasing demand and expectations, the network security involves four aspects: **Privacy, Message Authentication, Message Integrity** and **Non-repudiation**.

(a) Privacy: This means that the sender and the receiver expect confidentiality. The transmitted message should make sense to only the intended receiver and the message should be unintelligible to unauthorized users. This is achieved by cryptography and encryption techniques so that the data is secured and can only be decrypted with a special algorithm, logical key, mathematical formula and/or a combination of all of them.

(b) Message Authentication: This means that the receiver is sure of the sender's identity and that an imposter has not sent the message.

(c) Message Integrity: This means that the data must arrive at the receiver exactly as it was sent. There must not be any changes during the transmission – either accidental or malicious.

(d) Non-Repudiation: This means that a receiver must be able to prove that a received message came from a specific sender and the sender must not be able to deny sending it.

11. Supply Chain Management (SCM) is a chain that starts with customers and ends with customers. Supply Chain Management may be defined as the process of planning, implementing and controlling the operations of the supply chain with the purpose of satisfying the customer's requirement as efficiently as possible. Supply Chain spans all movement and storage of raw materials, Work-in-process, inventory and finished goods from the point of origin to the point of consumption. The main components of SCM include the following:

(a) Procurement/Purchasing: This begins with the purchasing of parts, components, or services. Procurement must ensure that the right items are delivered in the exact quantities at the correct location on the specified time schedule at minimal cost. It must address the question of assurance that these suppliers will deliver as promised.

(b) **Operations:** The second major element of supply chain management system is operations. Having received raw materials, parts, components, assemblies, or services from suppliers, the firm must transform them and produce the products or the services that meet the needs of its consumers. It must conduct this transformation in an efficient and effective manner for the benefit of the supply chain management system.

(c) **Distribution:** The third element of the supply chain management system is distribution. Distribution involves several activities - transportation (logistics), warehousing, and customer relationship management (CRM). The first and most obvious is logistics - the transportation of goods across the entire supply chain.

(d) **Integration:** The last element of supply chain management is the need for integration. It is critical that all participants in the service chain recognize the entirety of the service chain. The impact of the failure to adopt a system-wide perspective - that is, examining the totality of the chain can significantly increase costs and destroy value.

12. **Communication Controls:** Components in the communication subsystem are responsible for transporting data among all the other subsystems within a system and for transporting data to or receiving data from another system. These involve the following:

- **Physical Component Controls:** One way to reduce expected losses in the communication subsystem is to choose physical component that have characteristics that make them reliable and that incorporate features or provide controls that mitigate the possible effects of exposures. These controls involve Transmission Media - Bounded (Guided) Media or Unbounded (Unguided) Media; Communication Lines – Private (Leased) or Public; Modems; Port Protection Devices; Multiplexors and Concentrators.

- **Line Error Controls:** Whenever data is transmitted over a communication line, it can be received in error because of attenuation, distortion, or noise that occurs on the line. Error Detection (using Parity Checking, Cyclic Redundancy Checks (CRC) and Loop Check) and Error Correction (using forward Error Correcting Codes and Backward Error Correction) are the two major approaches under Line Error Controls.

- **Flow Controls:** These are needed because two nodes in a network can differ in terms of the rate at which they can send receive and process data. The simplest form of flow control is "Stop-and-Wait Flow Control" in which the sender transmits a frame of data only when the receiver is ready to accept the frame.

- **Link Controls:** This involves two common protocols – HDLC (Higher Level Data Control) and SDLC (Synchronous Data Link Control).

- **Topological Controls:** A communication network topology specifies the location of nodes within a network, the ways in which these nodes will be linked, and the data transmission capabilities of the links between the nodes. Some of the four basic topologies include Bus, Ring, Star and Tree Topology.

- **Channel Access Controls:** Two different nodes in a network can compete to use a communication channel. Whenever the possibility of contention for the channel exists, some type of channel access control technique must be used. These techniques fall into two classes – Polling methods and Contention methods.
- **Internetworking Controls:** Internetworking is the process of connecting two or more communication networks together to allow the users of one network to communicate with the users of other networks. Three types of devices are used to connect sub-networks in an Internet: Bridge, Router and Gateway.

13. Benefits of Grid Computing are as follows:

- **Making use of Underutilized Resources:** In most organizations, there are large amounts of underutilized computing resource. Grid computing provides a framework for exploiting these underutilized resources. Grid computing (more specifically, a data grid) can be used to aggregate this unused storage into a much larger virtual data store, possibly configured to achieve improved performance and reliability over that of any single machine.
- **Resource Balancing:** For applications that are grid-enabled, the grid can offer a resource balancing effect by scheduling grid jobs on machines with low utilization. This feature of grid computing handles occasional peak loads of activity in parts of a larger organization. An unexpected peak can be routed to relatively idle machines in the grid; and if the grid is already fully utilized, the lowest priority work being performed on the grid can be suspended or even cancelled and performed again later to make room for the higher priority work.
- **Parallel CPU Capacity:** The potential for usage of massive parallel CPU capacity is one of the most common visions and attractive features of a grid. A CPU-intensive grid application can be thought of as many smaller sub-jobs, each executing on a different machine in the grid. To the extent that these sub-jobs do not need to communicate with each other, the more scalable the application becomes. A perfectly scalable application will, for example, finish in one tenth of the time if it uses ten times the number of processors.
- **Virtual resources and virtual organizations for collaboration:** The users of the grid can be organized dynamically into several virtual organizations, each with different policy requirements. These virtual organizations can share their resources such as data, specialized devices, software, services, licenses, and so on, collectively as a larger grid. These resources are virtualized to give them a more uniform interoperability among heterogeneous grid participants. The participants and users of the grid can be members of several real and virtual organizations. The grid can help

in enforcing security rules among them and implement policies, which can resolve priorities for both resources and users.

- **Access to additional resources:** In addition to CPU and storage resources, a grid can provide access to other resources as well. For example, if a user needs to increase their total bandwidth to the Internet to implement a data mining search engine, the work can be split among grid machines that have independent connections to the Internet. In this way, total searching capability is multiplied, since each machine has a separate connection to the Internet.
- **Reliability:** High-end conventional computing systems use expensive hardware to increase reliability. The machines also use duplicate processors in such a way that when they fail, one can be replaced without turning the other off. Power supplies and cooling systems are duplicated. The systems are operated on special power sources that can start generators if utility power is interrupted. All of this builds a reliable system, but at a great cost, due to the duplication of expensive components.
- **Management:** The goal to virtualize the resources on the grid and more uniformly handle heterogeneous systems create new opportunities to better manage a larger, more distributed IT infrastructure. The grid offers management of priorities among different projects. Aggregating utilization data over a larger set of projects can enhance an organization's ability to project future upgrade needs. When maintenance is required, grid work can be rerouted to other machines without crippling the projects involved.

14. Variety of activities that are executed by Operating Systems (OS)include the following:

- **Performing hardware functions:** Application programs to perform tasks to obtain input from keyboards, retrieve data from disk & display output on monitors. Achieving all this is facilitated by operating system. Operating system acts as an intermediary between the application program and the hardware.
- **User Interfaces***:* An important function of any operating system is to provide user interface. Unlike DOS days, which had a command based User Interface (UI), nowadays we have Graphic User Interface (GUI) which uses icons & menus like in the case of Windows. So, how we interface with our system will be provided by Operating system.
- **Hardware Independence:** Every computer could have different specifications and configurations of hardware. These days, we have operating system, which provides Application Program Interfaces (API), which can be used by application developers to create application software, thus obviating the need to understand the inner workings of OS and hardware. Thus, OS gives us hardware independence.
- **Memory Management:** Memory Management features of Operating System allow controlling how memory is accessed and maximize available memory & storage. Operating systems also provides Virtual Memory by carving an area of hard disk to

supplement the functional memory capacity of RAM. In this way, it augments memory by creating a virtual RAM.

- **Task Management:** Task Management feature of Operating system helps in allocating resources to make optimum utilization of resources. This facilitates a user to work with more than one application at a time i.e. multitasking and allows more than one user to use the system i.e. timesharing.
- **Networking Capability:** Operating systems can provide systems with features & capabilities to help connect computer networks. Like Linux & Windows 8 give us an excellent capability to connect to internet.
- **Logical access security:** Operating systems provide logical security by establishing a procedure for identification and authentication using a User ID and Password. It can log the user access thereby providing security control.
- **File management:** The operating system keeps a track of where each file is stored and who can access it, based on which it provides the file retrieval.

PAPER 7B: STRATEGIC MANAGEMENT

Correct/Incorrect with reasoning

1. State with reasons which of the following statements are correct/incorrect:
   (a) Competition adversely hits the organizational growth.
   (b) The process of strategy avoids matching potential of the organization with the environment opportunities.
   (c) SBU concepts facilitate multi-business operations.
   (d) The management of funds can play a pivotal role in strategy implementation.
   (e) Corporate-level managers can be viewed as the guardians of shareholders.
   (f) SWOT analysis merely examines external environment of an organization.
   (g) Reengineering involves slow and gradual improvement in the existing work processes that occur over a period of time.
   (h) Successful businesses have to recognize different elements of environment.
   (i) Diversification only involves entering in new businesses that are related to the existing business of an organisation.
   (j) A company's strategy has always to be proactive in nature.

Differences between the two concepts

2. Distinguish between the following:
   (a) SWOT and TOWS Matrix
   (b) Shared Vision and Vision Shared
   (c) Strategy Formulation and Strategy Implementation
   (d) DMAIC and DMADV Methodology of Six Sigma

Short notes

3. Write short notes on the following:
   (a) Central thrust of BPR
   (b) Grand strategy alternative during recession
   (c) Strategic surveillance
   (d) Global strategy

Brief answers

4. Briefly answer the following questions:

(a) Mission statement of a company focuses on the question: 'who we are' and 'what we do'. Explain briefly.

(b) ''A strategic professional has to analyse and redesign the work flows in the context of business process reengineering'' – Briefly explain.

(c) How internet has helped business?

(d) Do you agree that control systems run parallel with strategic levels? How?

Descriptive answers

Chapter 1-Business Environment

5. Can a business succeed in the long run by focusing only on profit as its primary objective? What are other objectives of a business?

6. What do you mean by micro environment of business? Explain its elements.

Chapter 2-Business Policy and Strategic Management

7. What is Corporate Strategy? How would you argue that 'corporate strategy' ensures the correct alignment of the firm with its environment'?

8. What is Strategic Decision Making? Briefly explain the major dimensions of strategic decisions.

Chapter 3-Strategic Analysis

9. Explain GE model. How is it useful in making strategic choices?

10. Key Success Factors (KSFs) are the rules that shape whether a company will be financially and competitively successful? Do you agree with this statement? How to identify an industry's key success factors?

Chapter 4-Strategic Planning

11. Devise an ideal work plan for implementing a turnaround strategy in an organization?

12. Discuss strategic alternatives with reference to Michael Porter's strategies.

Chapter 5-Formulation of Functional Strategy

13. What is logistics strategy? What are the areas to examine while developing a logistics strategy?

14. What is meant by Functional strategies? In term of level where will you put them? Are functional strategies really important for business?

Chapter 6-Strategic Implementation and Control

15. Define Strategic business unit (SBU). Explain in brief the advantages on SBU structure.

16. Describe the importance of corporate culture.

Chapter 7-Reaching Strategic Edge

17. What are the various guiding principles of total quality management?
18. How internet is affecting the business? Explain the strategy-shaping characteristics of the E-commerce environment.

SUGGESTED ANSWERS / HINTS

1. (a) Incorrect: All organizations have competition. Multinationals and large organizations clash directly on every level of product and service. Mid-sized and small business also chase same customers and finds that prices and product quality are bounded by the moves of their competitors. Competition can challenge organizations to work better, improve and grow. Lack of competition can make organizations complacent with their present positions.

(b) Incorrect: In the process of strategic management, an organisation continuously scan its relevant environment to identify various opportunities and threats. Organisations keen to grow and expand often look for promising opportunities that match their potential. Such opportunities become a good stepping stone for achieving the goals of the organisation.

(c) Correct: Organizing business along SBU lines and creating strategic business units has become a common practice for multi-product/service and global organizations. It is a convenient and intelligent grouping of activities along distinct businesses and has replaced the conventional groupings. SBU facilitates focussed strategic planning, gaining product-related/market-related specialization, gaining cost-economies and more rational organizational structure.

(d) Correct: The management of funds can play a pivotal role in strategy implementation as it aims at the conservation and optimum utilization of funds objectives which are central to any strategic action. Organizations that implement strategies of stability, growth or retrenchment cannot escape the rigours of proper management of funds. In fact, good management of funds often creates the difference between a strategically successful and unsuccessful company.

(e) Correct: Corporate-level managers provide a link between the people who oversee the strategic development of a firm and those who own it (the shareholders). Corporate-level managers, and particularly the CEO, can be viewed as the guardians of shareholder welfare. It is their responsibility to ensure that the corporate and business strategies that the company pursues are consistent with maximizing shareholder wealth. The CEO is ultimately accountable to shareholders.

(f) Incorrect: SWOT analysis presents the information about both external and internal environment in a structured form to compare external opportunities and threats with internal strengths and weaknesses. This helps in matching external and internal environments so that strategic decision makers in an organisation can come out with suitable strategies by identifying patterns of relationship and develop suitable strategies.

(g) **Incorrect**: Reengineering does not involve slow and gradual improvement in the existing work processes. It is a revolutionary approach towards radical and total redesigning of the business processes.

(h) **Correct**: To be successful businesses have to recognise different elements of the environment. They have to respect, adapt to or have to manage and influence them. Businesses must continuously monitor and adapt to the environment to survive and prosper.

(i) **Incorrect:** Although, organisations can diversify into businesses that are vertically or horizontally related to the existing businesses, the diversification is not limited to the related businesses. In conglomerate diversification; the new businesses/products are disjointed from the existing businesses/products in every way. There is no connection between the new products and the existing ones in process, technology or function.

(j) **Incorrect:** A company's strategy is a blend of proactive actions and reactive actions by the management. Reactive actions are required to address unanticipated developments and environmental conditions. Thus, not every strategic move is the result of proactive and deliberate management actions. At times, some kind of strategic reaction or adjustments are required.

2. **(a)** TOWS Analysis is a variant of the classic business tool, SWOT Analysis. TOWS and SWOT are acronyms for different arrangements of the words Strengths, Weaknesses, Opportunities and Threats. However, the difference lies in the approach followed. By analyzing the external environment (threats and opportunities), and internal environment (weaknesses and strengths), we can use these techniques to think about the strategy of a company. Following are the some basic differences between TOWS and SWOT matrix:

- TOWS emphasise on external environment whereas SWOT emphasises on internal environment.
- TOWS matrix is about the combinations of SO, ST, WO, WT whereas SWOT matrix is about S, W, O, T.
- TOWS analysis is an action tool whereas SWOT analysis is a planning tool.
- TOWS is particularly useful in evaluating the potential impact of sudden events or developments while SWOT is usually employed in evaluating a company's business plan.

(b) Individuals in organisations relate themselves with the vision of their organisations in different manner. When the individuals are able to bring organisational vision close to their hearts and minds they have "shared vision". Shared vision is a force that creates a sense of commonality that permeates the organization and gives coherence to diverse activities. However, 'vision shared' shows imposition of vision from the top management. It may demand compliance rather than commitment. For success of organisations having shared vision is better than vision shared.

(c) Strategy formulation and implementation can be distinguished in the following ways:

Strategy Formulation	Strategy Implementation
♦ Strategy formulation focuses on effectiveness.	♦ Strategy implementation focuses on efficiency.
♦ Strategy formulation is primarily an intellectual process.	♦ Strategy implementation is primarily an operational process.
♦ Strategy formulation requires good intuitive and analytical skills.	♦ Strategy implementation requires motivation and leadership skills.
♦ Strategy formulation requires coordination among the executives at the top level.	♦ Strategy implementation requires coordination among the executives at the middle and lower levels.

(d) For implementing six sigma, there are two separate key methodologies for existing and new processes. They are known as DMAIC and DMADV.

DMAIC is an acronym for five different steps used in six sigma - Define, Measure, Analyze Improve, and control. DMAIC methodology is directed towards improvement of existing product, process or service.

- **Define:** To begin with six sigma experts define the process improvement goals that are consistent with the strategy of the organization and customer demands. They discuss different issues with the senior managers so as to define what needs to done.
- **Measure:** The existing processes are measured to facilitate future comparison. Six sigma experts collect process data by mapping and measuring relevant processes.
- **Analyze:** Verify cause-and-effect relationship between the factors in the processes. Experts need to identify the relationship between the factors. They have to make a comprehensive analysis to identify hidden or not so obvious factor.
- **Improve:** On the basis of the analysis experts make a detailed plan to improve.
- **Control:** Initial trial or pilots are run to establish process capability and transition to production. Afterwards continuously measure the process to ensure that variances are identified and corrected before they result in defects.

DMADV is an acronym for Define, Measure, Analyze, Design, and Verify. DMADV is a strategy for designing new products, processes and services.

- **Define:** As in case of DMAIC six sigma experts have to formally define goals of the design activity that are consistent with strategy of the organization and the demands of the customer.
- **Measure:** Next identify the factors that are critical to quality (CTQs). Measure factors such as product capabilities and production process capability. Also, assess the risks involved.
- **Analyze**: Develop and design alternatives. Create high-level design and evaluate to select the best design.
- **Design:** Develop details of design and optimise it. Verify designs may require using techniques such as simulations.
- **Verify**: Verify designs through simulations or pilot runs. Verified and implemented processes are handed over to the process owners.

However, in spite of different orientation in two methodologies, conceptually there is overlapping between the DMAIC and DMADV as both are essentially having similar objectives.

3. **(a)** BPR is continuous improvement process. Although BPR is a multi-dimensional approach in improving the business performance it's thrust area may be identified as "the reduction of the total cycle time of a business process." BPR aims at reducing the cycle time of process by eliminating the unwanted and redundant steps and by simplifying the systems and procedures and also by eliminating the transit and waiting times as far as possible. Even after redesigning of a process, BPR maintains a continuous effort for more and more improvement.

(b) Stability strategy is advisable option for the organisations facing recession. During recession businesses face reduced demand for their products even at low prices. Funds become scarce, expenditure on expansion is stopped, profits decline and businesses try to minimise the costs. They work hard to maintain the existing market share, so that company survives the recessionary period.

(c) Contrary to the premise control, the strategic surveillance is unfocussed. It involves general monitoring of various sources of information to uncover unanticipated information having a bearing on the organizational strategy. It involves casual environmental browsing. Reading financial and other newspapers, business magazines, meetings, conferences, discussions at clubs or parties and so on can help in strategic surveillance.

Strategic surveillance may be loose form of strategic control, but is capable of uncovering information relevant to the strategy.

(d) A global strategy assumes more standardization of products across country boundaries. Under this strategy, the company tries to focus on a low cost structure by leveraging their expertise in providing certain products and services and concentrating the production of these standard products and services at a few favourable locations around the world. Competitive strategy is centralized and controlled by the home office.

4. (a) A company's mission statement is typically focused on its present business scope—"who we are and what we do"; mission statements broadly describe an organizations present capabilities, customer focus activities and business makeup. An organisation's mission states what customers it serves, what need it satisfies, and what type of product it offers. It is an expression of the growth ambition of the organisation. It helps organisation to set its own special identity, business emphasis and path for development. Mission amplifies what brings the organisation to this business or why it is there, what existence it seeks and what purpose it seeks to achieve as a business organisation.

In other words, the mission serves as a justification for the firm's very presence and existence; it legitimizes the firm's presence.

(b) Business Process Reengineering (BPR) refers to the analysis and redesign of workflows and processes both within and between the organizations. The orientation of the redesign effort is radical. It involves total deconstruction and rethinking of a business process in its entirety.

The workflows are studied, appraised and improved in terms of time, cost, output, quality, and responsiveness to customers. The redesign effort aims to simplify and streamline a process by eliminating all extra avoidable steps, activities, and transactions. With the help of redesigning workflows, organizations can drastically reduce the number of stages of work, and improve their performance.

(c) The Internet is an integrated network of high-speed computers and servers, digital switches and routers, telecommunications equipment and lines and individual computers of users. The Internet has provided a very fast means of communication to business with no geographic limitations. Internet also makes it feasible for companies to find, negotiate and deal across the world with suppliers on one hand and customers on the other. The evolving Internet technology is altering industry value chains, spawning substantial opportunities for increasing efficiency and reducing costs, and affecting strengths and weaknesses of business organisations.

(d) There are three strategic levels – corporate, business and functional. Control systems are required at all the three levels. At the top level, strategic controls are built to check whether the strategy is being implemented as planned and the results produced by the strategy are those intended. Down the hierarchy management controls and operational controls are built in the systems. Operational controls are required for day-to-day management of business. Thus, control systems are required at all the strategic level.

5. Business enterprises pursue multiple objectives rather than a single objective; however, it is generally asserted that private enterprises are primarily motivated by the objective of profit. All other objectives are facilitative objectives and are meant to be subservient to the profit motive. However, profits cannot remain primary objective in long run. Although some profits are necessary, organizations need to pursue other objectives such as survival, stability, growth and like. These objectives also change with the changes in the environment. Organisations monitor the changes in the environment, analyse their impact on their own goals and activities and translate their assessment in terms of specific strategies. In general, all organizations aim for optimum utilization of resources and economy in operational costs. Some of the other important objectives of a business are as follows:

- **Survival:** Survival is a basic, implicit objective of most organizations. While survival is an obvious objective, it gains more value and prominence during the initial stage of the establishment of the enterprise and during general economic adversity. The ability to survive is a function of the nature of ownership, nature of business competence of management, general and industry conditions, financial strength of the enterprise and so on.
- **Stability:** Another important objective of business enterprises is stability. It is a cautious, conservative objective that is often employed when things are not very conducive. It is a strategy of least resistance in a hostile external environment.
- **Growth:** This is a promising and popular objective which is equated with dynamism, vigor, promise and success. Enterprise growth may take one or more of the forms like increase in assets, manufacturing facilities, increase in sales volume and so on. Growth may take the enterprise along relatively unknown and risky paths, full of promises and pitfalls.
- **Efficiency:** Business enterprises seek efficiency in rationally choosing appropriate means to achieve their goals. In a sense, efficiency is an economic version of the technical objective of productivity – designing and achieving suitable input output ratios of funds, resources, facilities and efforts. Efficiency is a very useful operational objective.

6. The environment of business can be categorised into two broad categories micro-environment and macro-environment. Micro-environment is related to small area or immediate periphery of an organization. Micro-environment influences an organization regularly and directly. Developments in the micro environment have direct impact on the working of organizations. Micro environment includes the company itself, its suppliers, marketing intermediaries, customer markets and competitors. The elements of micro environment are specific to the said business and affects its working on short term basis.

- **Consumers / Customers:** Customers who may or may not be consumers are the people who pay money to acquire organisational products and services. Consumer is the one who ultimately consumes or uses the product or services. The marketer has to closely monitor and analyse the changes in the consumer tastes and preferences and their buying habits. Consumer occupies the central position in the market.
- **Competitors:** Competitors are the other business entities that compete for resources as well as markets. A study of the competitive scenario is essential for the marketer, particularly threats from competition.
- **Organization:** Individuals occupying different positions or working in different capacities in organizations consists of individuals who come from outside. They have different and varied interests. An organization has several non-specific elements in form of individuals and groups that may affect its activities. Owners, board of directors and employees form part of organisation.
- **Market:** The market is larger than customers. The market is to be studied in terms of its actual and potential size, its growth prospect and also its attractiveness. The marketer should study the trends and development and the key success factors of the market.
- **Suppliers:** Suppliers form an important component of the micro environment. The suppliers provide raw materials, equipment, services and so on. Suppliers with their own bargaining power affect the cost structure of the industry. They constitute a major force, which shapes competition in the industry.
- **Market Intermediaries:** Intermediaries bridge the gap between the organisations and customers. They are in form of stockist, wholesalers and retailers. They exert considerable influence on the business organizations. In many cases the consumers are not aware of the manufacturer of the products they buy. They buy product from the local retailers or big departmental stores.

7. Corporate strategy helps an organisation to achieve and sustain success. It is basically concerned with the choice of businesses, products and markets. It is often correlated with the growth of the firm.

Corporate strategy in the first place ensures the growth of the firm and its correct alignment with the environment. Corporate strategies are concerned with the broad and long-term questions of what businesses the organization is in or wants to be in, and what it wants to do with those businesses. They set the overall direction the organization will follow. It serves as the design for filling the strategic planning gap. It also helps to build the relevant competitive advantages. A right fit between the organisation and its external environment is the primary contribution of corporate strategy. Basically, the purpose of corporate strategy is to harness the opportunities available in the environment and countering the threats embedded therein. With the help of corporate strategy, organizations match their unique capabilities with the external environment so as to achieve its vision and mission.

8. Decision making is a managerial process and a function of choosing a particular course of action out of several alternative courses for the purpose of accomplishment of the organizational goals. Strategic decisions are different in nature than all other decisions which are taken at various levels of the organization during their day-to-day working. The major dimensions of strategic decisions are given below:

- *Strategic issues require top-management decisions:* Strategic issues involve thinking in totality of the organizations and also there is lot of risk involved.
- *Strategic issues involve the allocation of large amounts of company resources:* It may require huge financial investment to venture into a new area of business or the organization may require huge manpower with new set of skills in them.
- *Strategic issues are likely to have a significant impact on the long term prosperity of the firm:* Generally the results of strategic implementation are seen on a long term basis and not immediately.
- *Strategic issues are future oriented:* Strategic thinking involves predicting the future environmental conditions and how to orient for the changed conditions.
- *Strategic issues usually have major multifunctional or multi-business consequences:* As they involve organization in totality they affect different sections of the organization with varying degree.
- *Strategic issues necessitate consideration of factors in the firm's external environment:* Strategic focus in organization involves orienting its internal environment to the changes of external environment.

9. GE model has been used by General Electric Company (developed by GE with the assistance of the consulting firm McKinsey & Company) known as "Stop-Light" Strategy Model. This model is also known as Business Planning Matrix, GE Nine-Cell Matrix and GE Model. The strategic planning approach in this model has been inspired from traffic control lights. The lights that are used at crossings to manage traffic are: green for go, amber or yellow for caution, and red for stop. This model uses two factors while taking strategic decisions: Business Strength and Market Attractiveness. The vertical axis indicates market attractiveness and the horizontal axis shows the business strength in the industry. The market attractiveness is measured by a number of factors like:

1. Size of the market.
2. Market growth rate.
3. Industry profitability.
4. Competitive intensity.
5. Availability of Technology.
6. Pricing trends.
7. Overall risk of returns in the industry.

8. Opportunity for differentiation of products and services.
9. Demand variability.
10. Segmentation.
11. Distribution structure (e.g. retail, direct, wholesale) etc.

Business strength is measured by considering the typical drivers like:

1. Market share.
2. Market share growth rate.
3. Profit margin.
4. Distribution efficiency.
5. Brand image.
6. Ability to compete on price and quality.
7. Customer loyalty.
8. Production capacity.
9. Technological capability.
10. Relative cost position.
11. Management caliber, etc.

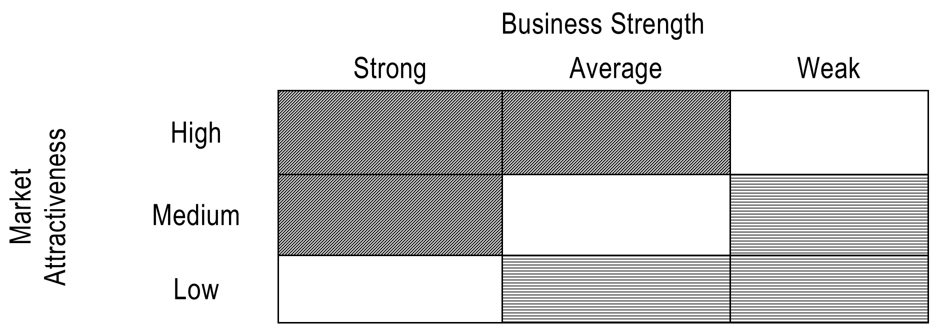
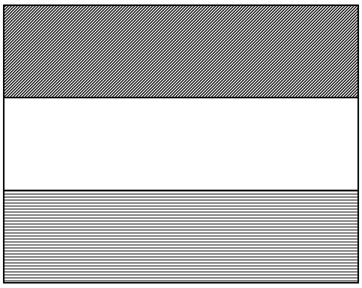


Figure: The GE Portfolio Matrix



Zone	Strategic Signals
Green	Invest/Expand
Yellow	Select/Earn
Red	Harvest/Divest

If a product falls in the green section, the business is at advantageous position. To reap the benefits, the strategic decision can be to expand, to invest and grow. If a product is in the amber or yellow zone, it needs caution and managerial discretion is called for making the strategic choices. If a product is in the red zone, it will eventually lead to losses that would make things difficult for organisations. In such cases, the appropriate strategy should be retrenchment, divestment or liquidation.

10. An industry's key success factors (KSFs) are those things or strategic elements that affect industry members' ability to prosper in a market place. For a business organization within an industry, it may include, cost structure, technology, distribution system and so on. It is correct to state that the KSFs help to shape whether a company will be financially and competitively successful.

The answers to the following three questions help identify an industry's key success factors:

- ♦ On what basis do customers choose between the competing brands of sellers? What product attributes are crucial?
- ♦ What resources and competitive capabilities does a seller need to have to be competitively successful?
- ♦ What does it take for sellers to achieve a sustainable competitive advantage?

11. Action plan for turnaround strategy, an organization can implement:

- **Stage One – *Assessment of current problems*:** The first step is to assess the current problems and get to the root causes and the extent of damage the problem has caused. Once the problems are identified, the resources should be focused toward those areas essential to efficiently work on correcting and repairing any immediate issues.
- **Stage Two** – ***Analyze the situation and develop a strategic plan***: Before you make any major changes; determine the chances of the business's survival. Identify appropriate strategies and develop a preliminary action plan. For this one should look

for the viable core businesses, adequate bridge financing and available organizational resources. Analyze the strengths and weaknesses in the areas of competitive position. Once major problems and opportunities are identified, develop a strategic plan with specific goals and detailed functional actions.

- **Stage Three – *Implementing an emergency action plan*:** If the organization is in a critical stage, an appropriate action plan must be developed to stop the bleeding and enable the organization to survive. The plan typically includes human resource, financial, marketing and operations actions to restructure debts, improve working capital, reduce costs, improve budgeting practices, prune product lines and accelerate high potential products. A positive operating cash flow must be established as quickly as possible and enough funds to implement the turnaround strategies must be raised.

- **Stage Four – *Restructuring the business***: The financial state of the organization's core business is particularly important. Prepare cash forecasts, analyze assets and debts, review profits and analyze other key financial functions to position the organization for rapid improvement.

  During the turnaround, the "product mix" may be changed, requiring the organization to do some repositioning. Core products neglected over time may require immediate attention to remain competitive. Organisations may also withdraw from some markets, close some facilities or discontinue some products.

  The 'people mix" is another important ingredient in the organization's competitive effectiveness. Reward and compensation systems that encourage dedication and creativity encourage employees to think profits and return on investments.

- **Stage Five – *Returning to normal***: In the final stage of turnaround strategy process, the organization should begin to show signs of profitability, return on investments and enhancing economic value-added. Emphasis is placed on a number of strategic efforts such as carefully adding new products and improving customer service, creating alliances with other organizations, increasing the market share, etc.

12. According to Porter, strategies allow organizations to gain competitive advantage from three different bases: cost leadership, differentiation, and focus. Porter calls these base generic strategies. Cost leadership emphasizes producing standardized products at a very low per-unit cost for consumers who are price-sensitive. Differentiation is a strategy aimed at producing products and services considered unique industry wide and directed at consumers who are relatively price-insensitive. Focus means producing products and services that fulfill the needs of small groups of consumers.

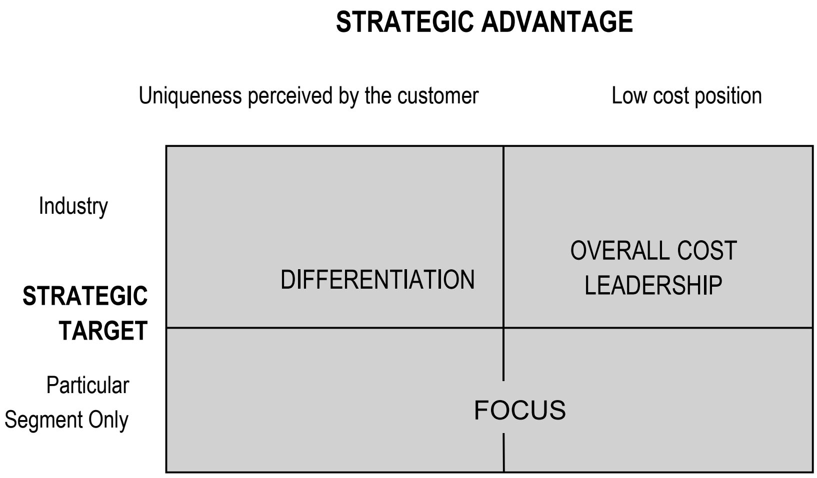


Figure: Michael Porter's Generic Strategy

Cost Leadership Strategies

A primary reason for pursuing forward, backward, and horizontal integration strategies is to gain cost leadership benefits. But cost leadership generally must be pursued in conjunction with differentiation. A number of cost elements affect the relative attractiveness of generic strategies, including economies or diseconomies of scale achieved, capacity utilization and linkages with suppliers and distributors and so on.

Differentiation Strategies

Different strategies offer different degrees of differentiation. A differentiation strategy should be pursued only after a careful study of buyers' needs and preferences to determine the feasibility of incorporating one or more differentiating features into a unique product that features the desired attributes. A successful differentiation strategy allows a firm to charge a higher price for its product and to gain customer loyalty. Special features that differentiate one's product can include superior service, spare parts availability, design, product performance, useful life, or ease of use and so on.

Focus Strategies

A successful focus strategy depends on an industry segment that is of sufficient size, has good growth potential, and is not crucial to the success of other major competitors. Strategies such as market penetration and market development offer substantial focusing advantages. Midsize and large firms can effectively pursue focus-based strategies only in conjunction with differentiation or cost leadership-based strategies. All firms in essence follow a differentiated strategy.

13. Management of logistics is a process that integrates the flow of supplies into, through and out of an organization to achieve a level of service that facilitate movement and availability of materials in a proper manner. When a company creates a logistics strategy it is defining the service levels at which its logistics is smooth and is cost effective.

A company may develop a number of logistics strategies for specific product lines, specific countries or specific customers because of constant changes in supply chains. There are different areas that should be examined for each company that should be considered and should include:

- **Transportation:** Does the current transportation strategies help service levels required by the organisation?
- **Outsourcing:** Areas of outsourcing of logistics function are to be identified. The effect of partnership with external service providers on the desired service level of organisation is also to be examined.
- **Competitors:** Review the procedures adopted by competitors. It is also to be judged whether adopting the procedures followed by the competitors will be overall beneficial to the organisation. This will also help in identifying the areas that may be avoided.
- **Availability of information:** The information regarding logistics should be timely and accurate. If the data is inaccurate then the decisions that are made will be incorrect. With the newer technologies, it is possible to maintain information on movement of fleets and materials on real time basis.
- **Strategic uniformity:** The objectives of the logistics should be in line with overall objectives and strategies of the organisation. They should aid in the accomplishment of major strategies of the business organisation.

14. Once higher level corporate and business strategies are developed, management need to formulate and implement strategies for each functional area. For effective implementation, strategists have to provide direction to functional managers regarding the plans and policies to be adopted. In fact, the effectiveness of strategic management depends critically on the manner in which strategies are implemented. Strategy of one functional area cannot be looked at in isolation, because it is the extent to which all the functional tasks are interwoven that determines the effectiveness of the major strategy.

Functional area strategy such as marketing, financial, production and human resource are based on the functional capabilities of an organisation. For each functional area, first the major sub areas are identified and then for each of these sub functional areas, contents of functional strategies, important factors, and their importance in the process of strategy implementation is identified.

In terms of the levels of strategy formulation, functional strategies operate below the SBU or business-level strategies. Within functional strategies there might be several sub-functional areas. Functional strategies are made within the higher level strategies and guidelines therein that are set at higher levels of an organisation. Functional managers need guidance from the business strategy in order to make decisions. Operational plans tell the functional managers what has to be done while policies state how the plans are to be implemented.

Major strategies need to be translated to lower levels to give holistic strategic direction to an organisation. Functional strategies provide details to business strategy & govern as to how key activities of the business will be managed. Functional strategies play two important roles. Firstly, they provide support to the overall business strategy. Secondly, they spell out as to how functional managers will work so as to ensure better performance in their respective functional areas. The reasons why functional strategies are really important and needed for business can be enumerated as follows:

- The development of functional strategies is aimed at making the strategies-formulated at the top management level-practically feasible at the functional level.
- Functional strategies facilitate flow of strategic decisions to the different parts of an organisation.
- They act as basis for controlling activities in the different functional areas of business.
- The time spent by functional managers in decision-making is reduced as plans lay down clearly what is to be done and policies provide the discretionary framework within which decisions need to be taken.
- Functional strategies help in bringing harmony and coordination as they remain part of major strategies.
- Similar situations occurring in different functional areas are handled in a consistent manner by the functional managers.

15. SBU is any part of a business organization which is treated separately for strategic management purposes. The concept of SBU is helpful in creating an SBU organizational structure. It is discrete element of the business serving product markets with readily identifiable competitors and for which strategic planning can be concluded. It is created by adding another level of management in a divisional structure after the divisions have been grouped under a divisional top management authority based on the common strategic interests.

Its advantages are:

- Establishing coordination between divisions having common strategic interests.
- Facilitates strategic management and control on large and diverse organizations.
- Fixes accountabilities at the level of distinct business units.
- Allows strategic planning to be done at the most relevant level within the total enterprise.
- Makes the task of strategic review by top executives more objective and more effective.
- Helps allocate corporate resources to areas with greatest growth opportunities.

16. A culture where creativity, embracing change, and challenging the status quo are pervasive themes is very conducive to successful execution of a product innovation and technological leadership strategy. A culture built around such business principles as listening to customers, encouraging employees to take pride in their work, and giving employees a high degree of decision-making responsibility is very conducive to successful execution of a strategy of delivering superior customer service.

A strong strategy-supportive culture nurtures and motivates people to do their jobs in ways conducive to effective strategy execution; it provides structure, standards, and a value system in which to operate; and it promotes strong employee identification with the company's vision, performance targets, and strategy. All this makes employees feel genuinely better about their jobs and work environment and the merits of what the company is trying to accomplish. Employees are stimulated to take on the challenge of realizing the company's vision, do their jobs competently and with enthusiasm, and collaborate with others as needed to bring the strategy to success.

17. Implementing TQM requires organization wide support. There are several principles that guide success of TQM. Various principles that guide the total quality management philosophy are as follows:

- A sustained management commitment to quality
- Focusing on the customer
- Preventing rather than detecting defects
- Universal quality responsibility
- Quality measurement
- Continuous improvement and learning
- Root cause corrective action
- Employee involvement and empowerment
- The synergy of teams
- Thinking statistically
- Inventory reduction
- Value improvement
- Supplier teaming
- Training

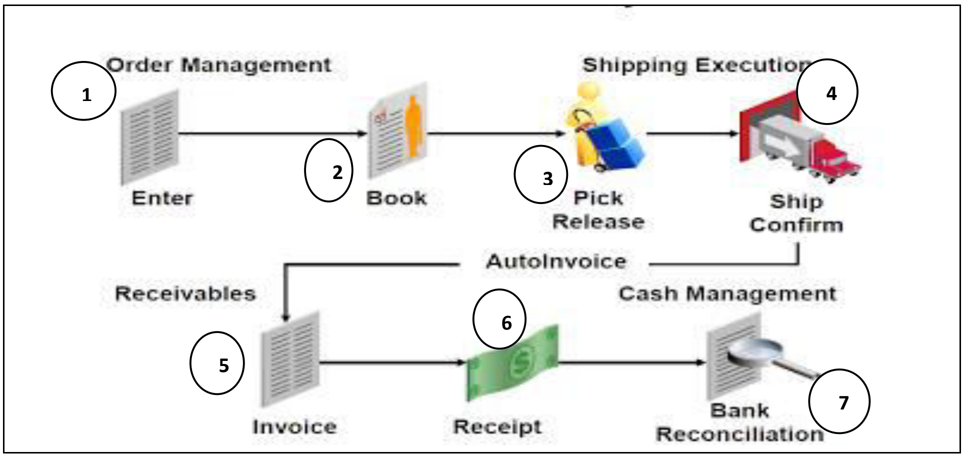
18. The impact of the Internet and the rapidly emerging e-commerce environment is profound. The advent of the Internet and online networks changes everything. There can be no doubt that the Internet is a driving force of historical and revolutionary proportions. The coming of ecommerce has changed the character of the market, created new driving forces and key success factors and bred the formation of new strategic groups. The creativeness with which a company incorporates e-commerce practices holds enormous potential for reconfiguring its value chain and affecting its company's competitiveness. Also the Internet economy presents opportunities and threats that demand strategic response and that require managers to craft bold new strategies.

We need to understand how growing use of the Internet by businesses and consumers reshapes the economic landscape and alters traditional industry boundaries. The following characteristics of the strategy-shaping E-Commerce environment are:

1. The Internet makes it feasible for companies everywhere to compete in global markets.
2. Competition in an industry is greatly intensified by the new e-commerce strategic initiatives of existing rivals and by the entry of new, enterprising e-commerce rivals.
3. Entry barriers into the e-commerce world are relatively low.
4. Online buyers gain bargaining power because they confront far fewer obstacles to comparing the products, prices, and shipping times of rival vendors.
5. The Internet makes it feasible for companies to reach beyond their borders to find the best suppliers and, further, to collaborate closely with them to achieve efficiency gains and cost savings.
6. Internet and PC technologies are advancing rapidly, often in uncertain and unexpected directions.
7. The internet results in much faster diffusion of new technology and new idea across the world.
8. The e-commerce environment demands that companies move swiftly.
9. E-commerce technology opens up a host of opportunities for reconfiguring industry and company value chains.
10. The Internet can be an economical means of delivering customer service.
11. The capital for funding potentially profitable e-commerce businesses is readily available.
12. The needed e-commerce resource in short supply is human talent-in the form of both technological expertise and managerial know-how.

(vi) **Receipt:** Money is received from the customer against the invoices.

(vii) **Reconciliation:** The bank reconciliation of all the receipts is performed.



Order to Cash process flow

5. **Information Systems Life Cycle:** This is commonly referred as **Software/System Development Life Cycle (SDLC),** which is a methodology used to describe the process of building information systems. It is the logical starting point in the entire life cycle of a computerized system. Activities start when any enterprise decides to go for computerization or migrate from existing computerized system to a new one. SDLC framework provides a sequence of activities for system designers and developers to follow. It consists of a set of steps or phases in which each phase of the SDLC uses the results of the previous one. This serves as a guideline to the designer, who seeks to use it as template while working on a project development.

   Phase 1: System Investigation: This phase examines that 'What is the problem and is it worth solving'? the various dimensions under which Systems investigation is done are Technical feasibility, Economic feasibility, Legal feasibility, Operational feasibility and Schedule feasibility.

   Phase 2: System Analysis: This phase examines that 'What must the Information System do to solve the problem'? System analyst would be gathering details about the current system and will involve the activities like Interviewing staff, examining current business, sending out questionnaires and observation of current procedures. The Systems Analyst will examine data and information flows in the enterprise using data flow diagrams; establish what the proposed system will do (not how it will do it); analyse costs and benefits; outline system implementation options. (e.g. in-house or using consultants); consider possible hardware configurations; and make recommendations.

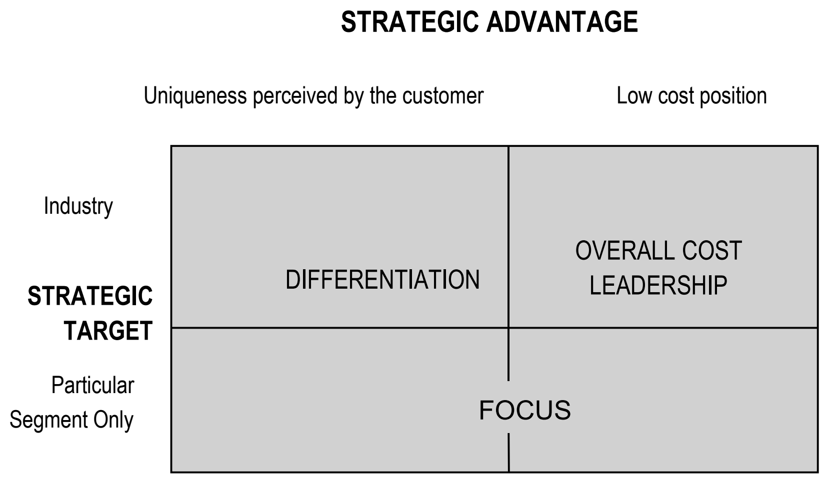


Figure: Michael Porter's Generic Strategy

Cost Leadership Strategies

A primary reason for pursuing forward, backward, and horizontal integration strategies is to gain cost leadership benefits. But cost leadership generally must be pursued in conjunction with differentiation. A number of cost elements affect the relative attractiveness of generic strategies, including economies or diseconomies of scale achieved, capacity utilization and linkages with suppliers and distributors and so on.

Differentiation Strategies

Different strategies offer different degrees of differentiation. A differentiation strategy should be pursued only after a careful study of buyers' needs and preferences to determine the feasibility of incorporating one or more differentiating features into a unique product that features the desired attributes. A successful differentiation strategy allows a firm to charge a higher price for its product and to gain customer loyalty. Special features that differentiate one's product can include superior service, spare parts availability, design, product performance, useful life, or ease of use and so on.

Focus Strategies

A successful focus strategy depends on an industry segment that is of sufficient size, has good growth potential, and is not crucial to the success of other major competitors. Strategies such as market penetration and market development offer substantial focusing advantages. Midsize and large firms can effectively pursue focus-based strategies only in conjunction with differentiation or cost leadership-based strategies. All firms in essence follow a differentiated strategy.

13. Management of logistics is a process that integrates the flow of supplies into, through and out of an organization to achieve a level of service that facilitate movement and availability