

Intermediate Course

Study Material

(Modules 1 to 2)

PAPER 6

AUDITING AND ASSURANCE

Module - 1



BOARD OF STUDIES

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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Edition : July, 2019

Website : www.icaai.org

E-mail : bosnoida@icaai.in

Committee/Department : Board of Studies

ISBN No. :

Price : ₹

Published by : The Publication Department on behalf of
The Institute of Chartered Accountants of India,
ICAI Bhawan, Post Box No. 7100, Indraprastha
Marg, New Delhi 110 002, India.

Printed by :

BEFORE WE BEGIN...

Evolving role of a CA - Shift towards strategic decision making

The traditional role of a chartered accountant restricted to accounting and auditing, has now changed substantially and there has been a marked shift towards strategic decision making and entrepreneurial roles that add value beyond traditional financial reporting. The primary factors responsible for the change are the increasing business complexities on account of plethora of laws, borderless economies consequent to giant leap in e-commerce, emergence of new financial instruments, emphasis on corporate social responsibility, significant developments in information technology, to name a few. These factors necessitate an increase in the competence of chartered accountants to take up the role of not merely an accountant or auditor, but a global solution provider. Towards this end, the scheme of education and training is being continuously reviewed so that it is in sync with the requisites of the dynamic global business environment; the competence requirements are being continuously reviewed to enable aspiring chartered accountants to acquire the requisite professional competence to take on new roles.

Skill requirements at Intermediate Level

Under the Revised Scheme of Education and Training, at the Intermediate Level, you are expected to not only acquire professional knowledge but also the ability to apply such knowledge in problem solving. The process of learning should also help you inculcate the requisite professional skills, i.e., the intellectual skills and communication skills, necessary for achieving the desired professional competence.

Auditing – Core and Practical subject

Auditing is, perhaps, one of the most practical-oriented subjects in the C.A. curriculum. This paper aims to provide knowledge of generally accepted auditing procedures and of techniques and skills needed to apply them in audit engagements. A good knowledge of the subject would provide a strong foundation to students while pursuing the Chartered Accountancy course. A good understanding of the theoretical concepts, particularly, in the context of auditing standards would make practical training an enriching and enjoying experience. While studying this paper, students are advised to integrate the knowledge acquired in other subjects, specifically, accounting and corporate laws in a meaningful manner. Such learning would only help a student to become a better professional.

Know your Syllabus

The study material deals with the conceptual theoretical framework in detail.

In each chapter, the topic has been covered in a step by step approach. The text has been explained, where appropriate, through illustrations, diagrams, tables, flowcharts, screenshots etc. You should go through the chapter carefully ensuring that you understand the topic and then can tackle the MCQs, Correct/Incorrect and other question.

For understanding the coverage of the syllabus, it is important to read the study material along with the Study Guidelines.

The entire syllabus has been divided into thirteen chapters.

Chapter-1 discusses the basics of audit such as nature, scope, objectives, advantages, limitations etc. of audit. Also, Audit Engagement; Auditor's Independence; Role of International Auditing and Assurance Standards Board (IAASB) & Auditing and Assurance Standards Board (AASB) have been discussed.

Chapter-2 is devoted to Audit Strategy; Audit planning and Audit programme;

Chapter-3 focusses on Audit Documentation; Audit evidence; Related Party Transactions, Written Representations, External Confirmations, Subsequent Events, Going Concern.

Chapter-4 is devoted to Audit Risk, Identifying and Assessing the Risk of Material Misstatement, Risk Assessment procedures; Understanding the entity and its environment; Internal Control.

Chapter-5 discusses the Responsibility for the Prevention and Detection of Fraud; Fraud Risk Factors; Risks of Material Misstatement Due to Fraud; Communication of Fraud.

Chapter-6 extensively deals with the Impact of IT related Risks, Impact on Controls, Internal Financial Controls, Audit approach, Understanding and documenting Automated environment, data analytics for audit.

Chapter-7 discusses about Audit Sampling.

Chapter-8 deals with analytical procedures.

Chapter-9 is devoted to the Audit of Items of Financial Statements. **Chapter-10** discusses about the provisions of the Company Audit. **Chapter-11** discusses about various aspects of Auditor's Report.

Chapter-12 deals with the Audit of Banks.

Chapter-13 extensively deals with the Appointment of Auditor, Audit Procedure and Audit Report in respect of different Category of Entities.

Structure of the Study Material

The content for each chapter/unit at the Intermediate level has been structured in the following manner –

	Components of each Chapter	About the component
1.	Learning Outcomes	Learning outcomes which you need to demonstrate after learning each topic have been detailed in the first page of each chapter/unit. Demonstration of these learning outcomes would help you to achieve the desired level of technical competence.
2.	Chapter Overview	As the name suggests, this chart/table would give a broad outline of the contents covered in the chapter.
3.	Introduction	A brief introduction is given at the beginning of each chapter/unit which would help you get a feel of the topic.
4.	Content	The concepts and provisions of law/standard are explained in student-friendly manner with the aid of Examples/illustrations/diagrams/flow charts. These value additions would help you develop conceptual clarity and get a good grasp of the topic. Diagrams and Flow charts would help you understand the concept/ provision in a better manner. Illustrations would help you understand the application of concepts/provisions.
5.	Exercise Questions with Answers	The exercise questions and answers would help you to apply what you have learnt in problem solving. In effect, it would sharpen your application skills and test your understanding as well as your application of concepts/ provisions.
6.	Let Us Recapitulate	A summary of the chapter is given at the end to help you revise what you have learnt. It would especially help you to revise the chapter quickly the day before the examination.

7.	Test Your Knowledge	This comprises of Multiple Choice Questions, Correct/incorrect and other questions which test the breadth and depth of your understanding of the topic.

We hope that these student-friendly features in the Study Material makes your learning process more enjoyable, enriches your knowledge and sharpens your application skills.

Happy Reading and Best Wishes!

SYLLABUS

PAPER 6: AUDITING AND ASSURANCE (100 MARKS)

(One paper – Three hours – 100 Marks)

Objective:

To develop an understanding of the concepts in auditing and of the generally accepted auditing procedures, techniques and skills and acquire the ability to apply the same in audit and attestation engagements.

1. Nature, Objective and Scope of Audit

Auditing Concepts: Nature, objective and scope of Audit; Relationship of auditing with other disciplines;

Standard Setting Process: Overview, Standard-setting process, Role of International Auditing and Assurance Standards Board (IAASB) & Auditing and Assurance Standards Board (AASB); Standards on Auditing, Guidance Note(s) issued by the ICAI;

Engagement Standards: Qualities of Auditor, Elements of System of Quality Control (SQC 1 Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements); Ethical requirements relating to an audit of financial statements; Inherent Limitations of an audit (SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing); Preconditions for an audit; Audit Engagement; Agreement on Audit Engagement Terms; Terms of Engagement in Recurring Audits (SA 210 Agreeing the Terms of Audit Engagements); Leadership Responsibilities for Quality on Audits; Concept of Auditor's Independence; Threats to Independence; Acceptance and Continuance of Client Relationships and Audit Engagements (SA 220 Quality Control for an Audit of Financial Statements).

2. Audit Strategy, Audit Planning and Audit Programme:

Audit Strategy; Audit planning (SA 300 Planning an Audit of Financial statements); Audit programme; Development of Audit Plan and Programme, Control of quality of audit work - Delegation and supervision of audit work; Materiality and Audit Plan; Revision of Materiality; Documenting the Materiality; Performance Materiality (SA 320 Materiality in Planning and Performing an Audit).

- 3. Audit Documentation and Audit Evidence:** Concept of Audit Documentation; Nature & Purpose of Audit Documentation; Form, Content & Extent of Audit Documentation; Completion Memorandum; Ownership and custody of Audit Documentation (SA 230 Audit Documentation); Audit procedures for obtaining audit evidence; Sources of evidence; Relevance and Reliability of audit evidence; Sufficient appropriate audit evidence, Evaluation of Audit Evidence (SA 500 Audit Evidence); Written Representations as Audit Evidence; Objective of Auditor regarding Written Representation; Management from whom Written Representations may be requested; Written Representations about Management's Responsibilities (SA 580 Written Representations); Obtaining evidence of existence of inventory; Audit procedure to identify litigation & claims (SA 501 Audit Evidence - Specific Considerations for Selected Items); External confirmation procedures; Management's refusal to allow the auditor to send a confirmation request; Negative Confirmations (SA 505 External Confirmations); Audit evidence about opening balances; Accounting policies relating to opening balances; Reporting with regard to opening balances (SA 510 Initial Audit Engagements-Opening Balances); Meaning of Related Party; Nature of Related Party Relationships & Transactions; Understanding the Entity's Related Party Relationships & Transactions (SA 550 Related Parties); Meaning of Subsequent Events; Auditor's obligations in different situations of subsequent events (SA 560 Subsequent Events); Responsibilities of the Auditor with regard to Going Concern Assumption; Objectives of the Auditor regarding Going Concern; Events or Conditions that may cast doubt about Going Concern Assumption; Audit Procedures when events or conditions are identified (SA 570 Going Concern).
- 4. Risk Assessment and Internal Control:** Audit Risk, Identifying and Assessing the Risk of Material Misstatement, Risk Assessment procedures; Understanding the entity and its environment; Internal control, Documenting the Risks; Evaluation of internal control system; Testing of Internal control; Internal Control and IT Environment (SA 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment); Materiality and audit risk (SA 320 Materiality in Planning and Performing an Audit); Internal audit, Basics of Standards on Internal Audit (SIAs) issued by the ICAI; Basics of Internal Financial Control and reporting requirements; Distinction between Internal Financial Control and Internal Control over Financial Reporting.
- 5. Fraud and Responsibilities of the Auditor in this Regard:** Responsibility for the Prevention and Detection of Fraud; Fraud Risk Factors; Risks of Material Misstatement Due to Fraud; Communication of Fraud (SA 240 The

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6. **Audit in an Automated Environment:** Key features, Impact of IT related Risks, Impact on Controls, Internal Financial Controls as per Regulatory requirements, Types of Controls, Audit approach, Understanding and documenting Automated environment, Testing methods, data analytics for audit, assessing and reporting audit findings.
7. **Audit Sampling:** Meaning of Audit Sampling; Designing an audit sample; Types of sampling; Sample Size and selection of items for testing; Sample selection method (SA 530 Audit Sampling).
8. **Analytical Procedures:** Meaning, nature, purpose and timing of analytical procedures; Substantive analytical procedures, Designing and performing analytical procedures prior to Audit; investigating the results of analytical procedures (SA 520 Analytical Procedures).
9. **Audit of Items of Financial Statements:** Audit of sale of Products and Services; Audit of Interest Income, Rental Income, Dividend Income, Net gain/loss on sale of Investments etc.

Audit of Purchases, Employee benefits expenses, Depreciation, Interest expense, Expenditure on Power & Fuel, Rent, Repair to building, Repair to Machinery, Insurance, Taxes, Travelling Expenses, Miscellaneous Expenses etc.

Audit of Share Capital, Reserve & Surplus, Long Term Borrowings, Trade Payables, Provisions, Short Term Borrowings & Other Current Liabilities. Audit of Land, Buildings, Plant & Equipment, Furniture & Fixtures, Vehicles, Office Equipments, Goodwill, Brand/Trademarks, Computer Software etc. Audit of Loan & Advances, Trade Receivable, Inventories, Cash & Cash Equivalent, Other Current Assets. Audit of Contingent Liabilities.

(The list of items is illustrative only)

10. **The Company Audit:** Eligibility, Qualifications and Disqualifications of Auditors; Appointment of auditors; Removal of auditors; Remuneration of Auditors; Powers and duties of auditors; Branch audit; Joint audit; Reporting requirements under the Companies Act, 2013 including CARO; Other Important Provisions under the Companies Act, 2013 relating to Audit and Auditors and Rules made thereunder.
11. **Audit Report:** Forming an opinion on the Financial Statements; Auditor's Report- basic elements (SA 700 Forming an Opinion and Reporting on Financial Statements); Types of Modified Opinion; Circumstances When a

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- 12. Audit of Banks:** Understanding of accounting system in Banks, Audit Approach, Audit of Revenue items, Special Consideration in Bank Audit with emphasis on Advances and NPAs.
- 13. Audit of Different Types of Entities:** Appointment of Auditor, Audit Procedure and Audit Report in respect of different Category of Entities: Government; Local bodies and Not-for-profit organizations; Partnership Firms, Audit of different type of undertakings, i.e., Educational institutions, Hotels, Clubs, Hospitals Basics of Limited Liability Partnerships (LLPs) audit and Co-operative Societies Audit.

Note:

- (i) The specific inclusions/exclusions, in any topic covered in the syllabus, will be effected every year by way of Study Guidelines.
- (ii) The provisions of the Companies Act, 1956 which are still in force would form part of the syllabus till the time their corresponding or new provisions of the Companies Act, 2013 are enforced.
- (iii) If new legislations/ Standards on Auditing/Guidance Notes/Statements are enacted in place of the existing legislations, the syllabus would include the corresponding provisions of such new legislations with effect from a date notified by the Institute. The changes in this regard would also form part of Study Guidelines.

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NATURE, OBJECTIVE AND SCOPE OF AUDIT

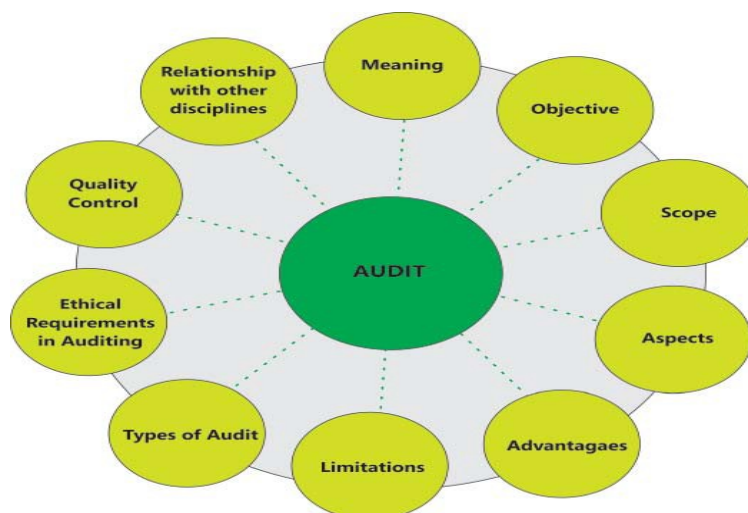


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ☐ Understand the functional classification and qualities of an auditor.
- ☐ Define audit and understand the objectives of audit, principles governing audit etc.
- ☐ Distinguish between auditing and investigation.
- ☐ Understand different types of audit and relationship of auditing with other disciplines.

CHAPTER OVERVIEW





1. MEANING AND DEFINITION OF AUDITING

"An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

Analysis of the Definition

1. Audit is Independent examination of Financial information.
2. of any entity – that entity may be profit oriented or not and irrespective of its size or legal form. For example – Profit oriented – Audit of Listed company engaged in business. On the other hand, Audit of NGO – not profit oriented.
3. The objective of the audit is to express an opinion on the financial statements.

The person conducting this task should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:

- (i) the accounts have been drawn up with reference to entries in the books of account;
- (ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence;
- (iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;
- (iv) the information conveyed by the statements is clear and unambiguous;
- (v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
- (vi) the statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.



2. OBJECTIVES OF AUDIT

As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:

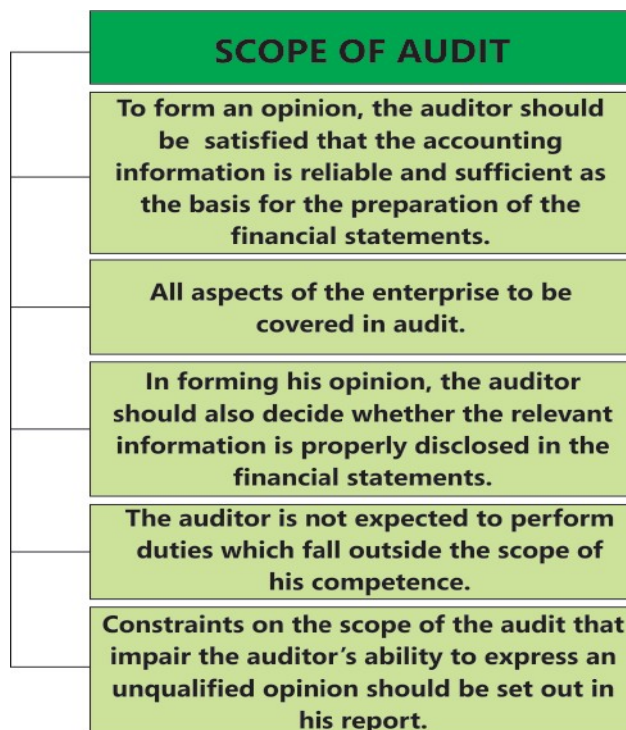
- (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement; and
- (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.



3. SCOPE OF AUDIT

The following points merit consideration in regard to scope of audit:

1. The audit should **be organized to cover adequately all aspects of the enterprise** relevant to the financial statements being audited.
2. To form an opinion on the financial statements, the auditor should be reasonably satisfied as to whether **the information contained in the underlying accounting records and other source data is reliable** and sufficient as the basis for the preparation of the financial statements.
3. In forming his opinion, the auditor should also **decide whether the relevant information is properly disclosed in the financial statements** subject to statutory requirements, where applicable.
4. The auditor assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by:
 - (a) making a study and evaluation of accounting systems and internal controls and
 - (b) carrying out such other tests, enquiries and other verification procedures of accounting transactions and account balances as he considers appropriate in the particular circumstances.
5. **The auditor determines whether the relevant information is properly disclosed in the financial statements by:**
 - (a) **comparing the financial statements with the underlying accounting records and other source data** to see whether they properly summarize the transactions and events recorded therein; and

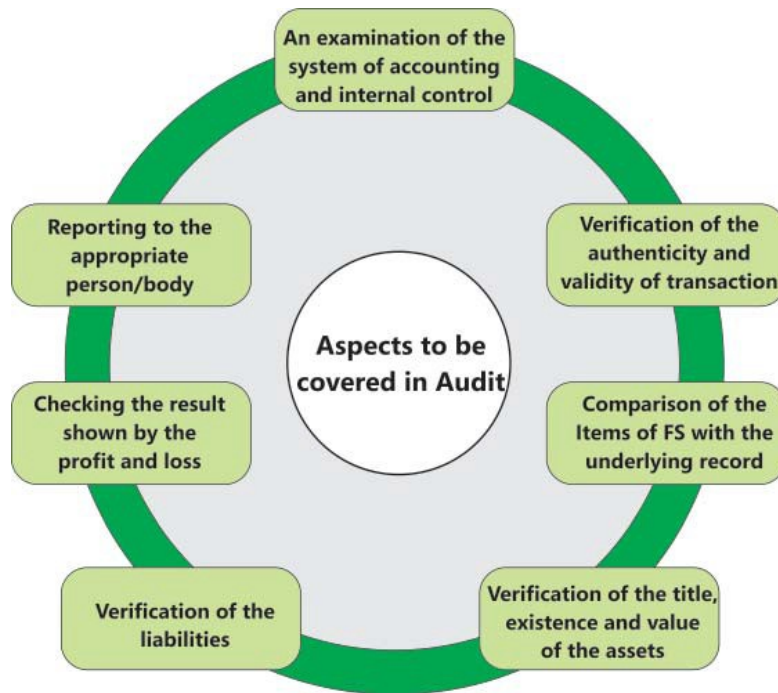


- (b) **considering the judgments that management has made in preparing the financial statements** accordingly, the auditor assess the selection and consistent application of accounting policies, the manner in which the information has been classified, and the adequacy of disclosure.
6. **The auditor is not expected to perform duties which fall outside the scope of his competence.** For example, the professional skill required of an auditor does not include that of a technical expert for determining physical condition of certain assets.
7. **Constraints on the scope of the audit** of financial statements that impair the auditor's ability to express an unqualified opinion on such financial statement should be set out in his report, and a qualified opinion or disclaimer of opinion should be expressed as appropriate.

3.1 Aspects to be covered in Audit

The principal aspects to be covered in an audit concerning final statements of account are the following:

- (i) **An examination of the system of accounting and internal control** to ascertain whether it is appropriate for the business and helps in properly recording all transactions.



- (ii) **Reviewing the system and procedures** to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.
- (iii) **Checking of the arithmetical accuracy of the books of account** by the verification of postings, balances, etc.
- (iv) **Verification of the authenticity and validity of transaction** entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.
- (v) **Ascertaining that a proper distinction has been made between items of capital and of revenue nature** and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.
- (vi) **Comparison of the balance sheet and profit and loss account or other statements with the underlying record** in order to see that they are in accordance therewith.
- (vii) **Verification of the title, existence and value of the assets** appearing in the balance sheet.

Assertions about account balances at the period end:

- (a) **Existence**—assets, liabilities, and equity interests exist.
- (b) **Rights and obligations**—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- (c) **Completeness**—all assets, liabilities and equity interests that should have been recorded have been recorded.
- (d) **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.

- (viii) **Verification of the liabilities stated** in the balance sheet.
- (ix) **Checking the result shown by the profit and loss** and to see whether the results shown are true and fair.
- (x) **Where audit is of a corporate body, confirming that the statutory requirements** have been complied with.
- (xi) **Reporting to the appropriate person/body** whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

Definition of Assertions: It refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

(Note: For detailed discussion on assertions, students may refer Chapter 3- Audit Documentation and Audit Evidence)



4. TYPES OF AUDIT

Audit is not legally obligatory for all types of business organisations or institutions. On this basis audits may be of two broad categories i.e., audit required under law and voluntary audits.

- (i) **Audit required under law:** The organisations which require audit under law are the following: e.g companies governed by the Companies Act; banking companies; other statutory bodies required by their regulators or by specific Act.
- (ii) **In the voluntary category** are the audits of the accounts of proprietary entities, partnership firms, Hindu undivided families, etc. In respect of such accounts, there is no basic legal requirement of audit. Many of such enterprises as a matter of internal rules require audit. Some may be required

to get their accounts audited on the directives of Government for various purposes like sanction of grants, loans, etc. But the important motive for getting accounts audited lies in the advantages that follow from an independent professional audit. This is perhaps the reason why large numbers of proprietary and partnership business get their accounts audited. Government companies have some special features which will be seen later.

As already stated, the auditor should get the scope of his duties and responsibilities defined by obtaining instructions in writing. Also it is always a wise precaution to state in the report, accompanying the balance sheets of proprietary or partnership firms or other similar organisations, the nature of the work carried out and explain the important features of the financial statements on which a report has been made. Furthermore, to ensure that the report will be brought to the notice of all concerned, the accounts should bear reference to the report.

A special reference is necessary for non-profit making institutions like schools, clubs, hospitals. Most of these have some internal rules to govern their affairs and generally a provision about the requirement of audit is inserted. Activity in the nature of business is not altogether ruled out as a club may sell drinks and eatables to the members and their guests or a school may have endowed agricultural property to yield income. What makes them distinct, is the absence of the question of division of profit: any surplus which may arise can only be used for achieving the objects of the institution. Educational institutions, hospitals, associations, etc., irrespective of any internal rules, get their accounts audited because most of them enjoy government or municipal grants and, generally, for this purpose audited accounts are insisted upon.

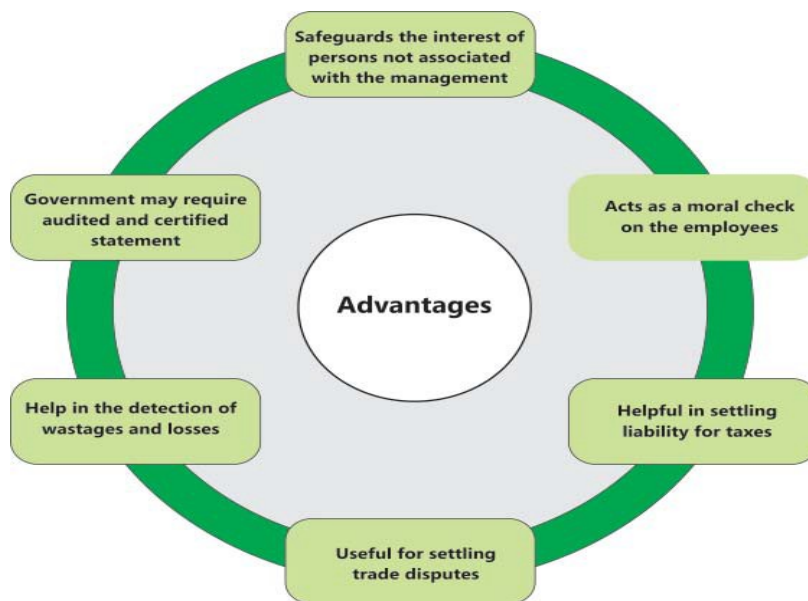
Trust, however, stands on a slightly different footing; these may be public trusts or private trusts. Trusts can carry on business as well. In the majority of cases trustees are private persons. Trusts generally have two classes of beneficiaries; tenants for life and remainders; persons to whom the accounts are of the supreme importance are often widows and minors, who cannot criticize the accounts in any effective manner. Though audit of trusts, except for public trusts, is not compulsory most of the trust deeds contain a clause for audit of accounts. Private trustees also recognise the advantages of audit in their own interest, since any erroneous treatment in the accounts for which they might be personally liable will be pointed out by the auditor.



5. ADVANTAGES OF AUDIT OF FINANCIAL STATEMENTS

The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organisations where audit is not compulsory, these advantages are given below:

- (a) **It safeguards the financial interest of persons who are not associated** with the management of the entity, whether they are partners or shareholders, bankers, FI's, public at large etc.
- (b) **It acts as a moral check on the employees** from committing defalcations or embezzlement.



- (c) Audited statements of account are **helpful in settling liability for taxes**, negotiating loans and for determining the purchase consideration for a business.
- (d) These are **also useful for settling trade disputes** for higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.
- (e) An audit can also **help in the detection of wastages and losses** to show the different ways by which these might be checked, especially those that occur

due to the absence or inadequacy of internal checks or internal control measures.

- (f) **Audit ascertains whether the necessary books of account and allied records have been properly kept** and helps the client in making good deficiencies or inadequacies in this respect.
- (g) As an appraisal function, **audit reviews the existence and operations of various controls in the organisations** and reports weaknesses, inadequacies, etc., in them.
- (h) Audited accounts are of great help in **the settlement of accounts at the time of admission or death of partner.**
- (i) **Government may require audited and certified statement** before it gives assistance or issues a license for a particular trade.



6. 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 auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit. The inherent 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.
- (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. ***Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not.*** 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 matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.

Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, 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.

(iv) **Other Matters that Affect the Limitations of an Audit:** In the case of certain subject matters, 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.

ILLUSTRATION

MNO Ltd requested the auditor CA P to provide for absolute assurance in respect of its ten branches scattered in Delhi and confirm that the financial statements are free from material misstatement due to fraud or error. Advise.

SOLUTION

The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from

material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

In view of the above, CA P cannot provide audit absolute assurance to MNO Ltd in respect of its branches.

Inherent Limitations of Audit (SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing"): The auditor is not expected to, and cannot, reduce audit risk to zero because there are inherent limitations of an audit. The inherent limitations of an audit arise from:

The Nature of Financial Reporting: The preparation of financial statements involves judgment by management.

The Nature of Audit Procedures: There are practical and legal limitations on the auditor's ability to obtain audit evidence such as:

Possibility that management or others may not provide, intentionally or unintentionally, the complete information relevant for preparation and presentation of FS.	Fraud may involve sophisticated and carefully organised schemes.	An audit is not an official investigation into alleged wrongdoing.

Timeliness of Financial Reporting and the Balance between Benefit and Cost: 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.

Other Matters that Affect the Limitations of an Audit: Certain assertions or subject matters are particularly significant, such assertions or subject matters include:

• Fraud, particularly 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.

ILLUSTRATION

DEF & Co. Chartered Accountants successfully carried out the audit of Shree Garments for the f.y. 2015-2016. After the completion of the audit, there were found material misstatements due to fraud in the financial statements which were not noticed and reported by the auditor. Management alleges that it is failure on the part of auditor. Comment.

SOLUTION

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. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.



7. RELATIONSHIP OF AUDITING WITH OTHER DISCIPLINES

The field of auditing as a discipline in simple words involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also possesses a good knowledge about the fields in respect of which he is conducting such a review.



Auditing and Accounting: Auditing reviews the financial statements which are nothing but a result of the overall accounting process.

Auditing and Law: An auditor should have a good knowledge of business laws affecting the entity.

Auditing and Economics: Auditor is expected to be familiar with the overall economic environment of the client.

Auditing and Behavioural Science: knowledge of human behaviour is essential for an auditor to effectively discharge his duties

Auditing and Statistics & Mathematics: auditor is also expected to have the knowledge of statistical sampling for meaningful conclusions and mathematics for verification of inventories.

Auditing and Data Processing: EDP auditing in itself is developing as a discipline in itself.

Auditing and Financial Management : the auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc.

Auditing and Production: good auditor is one who understands the client and his business functions such as production, cost system, marketing etc.

7.1 Auditing and Accounting

It has been pointed out earlier that both accounting and auditing are closely related with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process. It naturally calls on the part of the auditor to have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements. In fact, auditing as a discipline is also closely related with various other disciplines as there is lot of linkages in the work which is done by an auditor in his day-to-day activities. To begin with, it may be noted that the discipline of auditing itself is a logical construct and everything done in auditing must be bound by the rules of logic. Ethical precepts are the foundations on which the foundation of the entire accounting profession rests. The knowledge of language is also considered essential in the field of auditing as the auditor shall be required to communicate, both in writing as well as orally, in day-to-day work.

7.2 Auditing and Law

The relationship between auditing and law is very close one. Auditing involves examination of various transactions from the view point of whether or not these have been properly entered into. It necessitates that an auditor should have a good knowledge of business laws affecting the entity. He should be familiar with the law of contracts, negotiable instruments, etc. The knowledge of taxation laws is also inevitable as entity is required to prepare their financial statements taking into account various provisions affected by various tax laws. In analysing the impact of various transactions particularly from the accounting aspect, an auditor ought to have a good knowledge about the direct as well as indirect tax laws.

7.3 Auditing and Economics

As, it is well known, accounting is concerned with the accumulation and presentation of data relating to economic activity. Though the concept of income as put forward by economists is different as compared to the accountants concept of income, still, there are lot of similar grounds on which the accounting has flourished. From the auditing view point, the auditors are more concerned with Micro economics rather than with the Macro economics. The knowledge of Macro economics should include the nature of economic force that affect the firm, relationship of price, productivity and the role of Government and Government regulations. Auditor is expected to be familiar with the overall economic environment in which his client is operating.

7.4 Auditing and Behavioural Science

The field of auditing as a discipline involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also possesses a good knowledge about the fields in respect of which he is conducting such a review.

The discipline of behavioural science is closely linked with the subject of auditing. While it may be said that an auditor, particularly the financial auditor, deals basically with the figures contained in the financial statements but he shall be required to interact with a lot of people in the organisation. As against the financial auditor, the internal auditor or a management auditor is expected to deal with human beings rather than financial figures. One of the basic elements in designing the internal control system is personnel. However, if a sound internal control structure is designed, it cannot work until and unless the people who are working in the

organisation are competent and honest. The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties.

7.5 Auditing and Statistics & Mathematics

With the passage of time, test check procedures in auditing have become part of generally accepted auditing procedures. With the emergence of test check procedure, discipline of statistics has come quite close to auditing as the auditor is also expected to have the knowledge of statistical sampling so as to arrive at meaningful conclusions. The knowledge of mathematics is also required on the part of auditor particularly at the time of verification of inventories. The use of data analytics is advancing rapidly in auditing where many organizations are using continuous auditing and continuous monitoring of data to identify risks as part of their system of internal control.

7.6 Auditing and Data Processing

Today, organisations are witnessing revolution in the field of data processing of accounts. Many organisations are carrying out their financial accounting activities with the help of computers which can document, record, collate, allocate and value accounting data and information in very large quantity at very high speed. The dependence on the accuracy of the programmed instructions given today, the computer is able to carry out each of these activities with complete accuracy. With such a phenomenal growth in the field of computer sciences, the auditor should have good knowledge of the components, general capability of the system and the related terms. In fact, Computerised Information System auditing in itself is developing as a discipline in itself.

7.7 Auditing and Financial Management

Auditing is also closely related with other functional fields of business such as finance, production, marketing, personnel and other general areas of business management. With the overgrowing field of auditing, the financial services sector occupies a dominant place in our system. While in general terms, the auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc. The auditor is also expected to have a fair knowledge of the institutions that comprise the market place. The knowledge of various institutions and Government activities that influence the operations of the financial market are also required to be understood by an auditor.

7.8 Auditing and Production

Regarding production function, it may be stated that a good auditor is one who understands the client and his business. While carrying out the audit activity, the auditor is required to evaluate transactions from the accounting aspect in relation to the process through which it has passed through as accounting for by-products; joint-products may also require to be done. The knowledge of production process shall become more essential in case of an internal auditor. The auditor shall also require understanding the cost system in operation in the factory and assessing whether the same is adequate for the particular company. The understanding of the terminology of the production shall enable an auditor to communicate with production employees in connection with his work.

On the similar pattern the auditor is also expected to have good understanding about the marketing, personnel and other general business management areas.



8. STANDARD SETTING PROCESS

8.1 Role of International Auditing and Assurance Standards Board

In 1977, the International Federation of Accountants (IFAC) was set up with a view to bringing harmony in the profession of accountancy on an international scale. In pursuing this mission, the IFAC Board has established the International Auditing and Assurance Standards Board (IAASB) to develop and issue, in the public interest and under its own authority, high quality auditing standards for use around the world. The IFAC Board has determined that designation of the IAASB as the responsible body, under its own authority and within its stated terms of reference, best serves the public interest in achieving this aspect of its mission.

The IAASB functions as an independent standard-setting body under the auspices of IFAC. The objective of the IAASB is to serve the public interest by setting high quality auditing standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The IAASB achieves this objective by:

- ♦ Establishing high quality auditing standards and guidance for financial statement audits that are generally accepted and recognized by investors, auditors, governments, banking regulators, securities regulators and other key stakeholders across the world;

- ◆ Establishing high quality standards and guidance for other types of assurance services on both financial and non-financial matters;
- ◆ Establishing high quality standards and guidance for other related services;
- ◆ Establishing high quality standards for quality control covering the scope of services addressed by the IAASB; and
- ◆ Publishing other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of professional auditors and assurance service providers.

International Auditing and Assurance Standards Board (IAASB): The IFAC Board has established the IAASB to develop and issue, in the public interest and under its own authority, high quality auditing standards for use around the world. The IAASB functions as an independent standard-setting body under the auspices of IFAC.

Auditing and Assurance Standards Board: ICAI is a member of the IFAC and is committed to work towards the implementation of the guidelines issued by the IFAC. ICAI constituted the AASB (erstwhile Auditing Practices Committee) to review the existing auditing practices in India and to develop Engagement and Quality Control Standards (erstwhile Statements on Standard Auditing Practices) so that these may be issued by the Council of the Institute.

8.2 Role of Auditing and Assurance Standards Board

The Institute of Chartered Accountants of India is a member of the IFAC and is committed to work towards the implementation of the guidelines issued by the IFAC. The Institute of Chartered Accountants of India constituted the Auditing Practices Committee (APC) in 1982. The main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute. While formulating the SAPs in India, the APC gives due consideration to the international auditing guidelines issued by the IAPC and then tries to integrate them to the extent possible in the light of the conditions and practices prevailing in India. While formulating the SAPs, the APC takes into consideration the applicable laws, customs, usages and business environment in India. In July, 2002, the Auditing Practices Committee has been converted into an Auditing and Assurance Standards Board (AASB) by the Council of the Institute, to be in line with the international trend. A significant step has been taken aimed at bringing in the desired transparency in the working of the Auditing and Assurance Standards Board, through participation of representatives of various segments of the society and interest groups, such as, regulators, industry and academics. The nomenclature of

SAPs had also been changed to Auditing and Assurance Standards (AASs).

A major development in the field of auditing has been the issuance of revised and /or redrafted International Standards on Auditing pursuant to the Clarity Project of IAASB. The objective of this project is to improve the clarity of International Standards on Auditing (ISAs). The IAASB aims to set high quality international auditing and assurance standards that are understandable, clear and capable of consistent application, thereby serving to enhance the quality and uniformity of practice worldwide. The Auditing and Assurance Standards Board has also laid out a strategy to match step with the IAASB Clarity Project. In the year 2007, the Board issued several revised/new Standards pursuant to the IAASB Clarity Project.

Renaming, Re-numbering and Categorisation of Auditing and Assurance Standards: In terms of the Revised Preface, the Auditing and Assurance Standards are now renamed based on the type of assurance provided by the engagement undertaken by a member, viz.,

SAs

apply in the audit of historical financial information.

SREs

apply in the review of historical financial information.

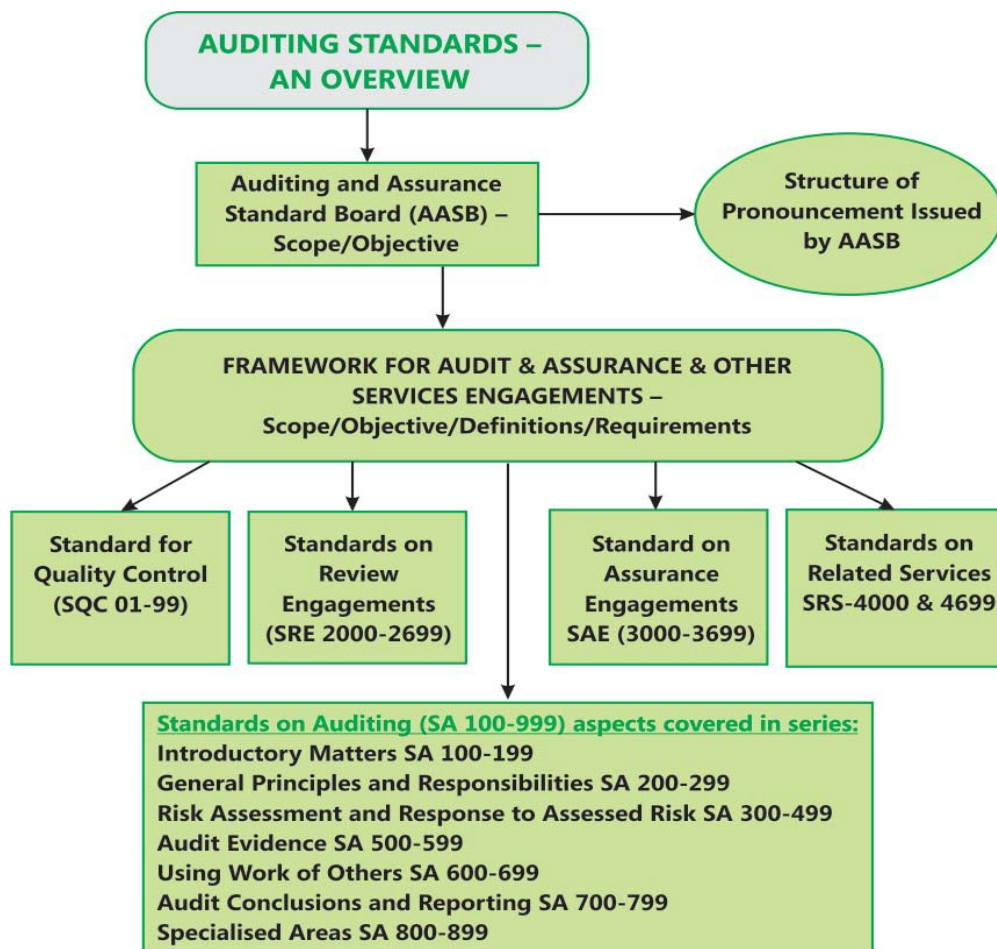
SAEs

apply in assurance engagements, dealing with subject matters other than historical financial information.

SRSs

apply to engagements to apply agreed upon procedures to information and other related services engagements such as compilation engagements.

Diagrammatic Representation of the Structure of Standards Under the New Preface



These Standards will apply whenever an independent audit is carried out; that is, in the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion thereon.

While discharging their attest function, it will be the duty of members of the Institute to ensure that the Standards are followed in the audit of financial information covered by their audit reports. If for any reason a member has not been able to perform an audit in accordance with the Standards, his report should draw attention to the material departures therefrom, auditors will be expected to follow Standards in the audits commencing on or after the date specified in the statement. Remember all Standards

are mandatory from the date mentioned herein and it is obligatory upon members of Institute to adhere to these whenever an audit is carried out.

All relevant Standards which are important from students' view point have been covered as an integral part of the text.

Compliance with Documents Issued by the Institute: The Institute has, from time to time, issued 'Guidance Notes' and 'Statements' on a number of matters. The 'Statements' have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. 'Statements' therefore are mandatory.

Accordingly, while discharging their attest function, it will be the duty of the members of the Institute:

- (a) to examine whether 'Statements' relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the 'Statements', it will be their duty to make **adequate disclosures in their audit reports** so that the users of financial statements may be aware of such deviations; and
- (b) to ensure that the 'Statements' relating to auditing matters are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with such 'Statements', his report should draw attention to the **material departures**, therefrom.

'Guidance Notes' : are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may rely in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

There are however a few guidance notes in case of which the Council has specifically stated (discussed in Announcements part reproduced in Handbook on Auditing Pronouncements) that they should be considered as mandatory on members while discharging their attest function.



9. QUALITIES OF AN AUDITOR

It is not enough to realise what an auditor should be. He is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent. The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor. In addition, he 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, Code of ethics mentions integrity, objectivity and independence as one of the fundamental principles of professional ethics.

He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact. **The Companies Act** need special mention but mercantile law, specially the law relating to contracts, is no less important. Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable.

He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment.

The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education.

He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the *sine qua non* of the practice of auditing. He must know thoroughly all accounting principles and techniques.

Lord Justice Lindley in the course of the judgment in the famous *London & General Bank case* had succinctly summed up the overall view of what an auditor should be

as regards the personal qualities. He said, "an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true".



10. ELEMENTS OF A SYSTEM OF QUALITY CONTROL

The firm's system of quality control should include policies and procedures addressing each of the following elements:

- (a) Leadership responsibilities for quality within the firm.
- (b) Ethical requirements.
- (c) Acceptance and continuance of client relationships and specific engagements.
- (d) Human resources.
- (e) Engagement performance.
- (f) Monitoring.

10.1 Leadership Responsibilities for Quality on Audits

As per SA 220 "Quality Control for an Audit of Financial Statements", the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

- (a) The importance to audit quality of:
 - (i) Performing work that complies with professional standards and regulatory and legal requirements;
 - (ii) Complying with the firm's quality control policies and procedures as applicable;
 - (iii) Issuing auditor's reports that are appropriate in the circumstances; and
 - (iv) The engagement team's ability to raise concerns without fear of reprisals; and
- (b) The fact that quality is essential in performing audit engagements.

Engagement partner refers to the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

10.2. Ethical Requirements Relating to an Audit of Financial Statements

The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements.

The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements:

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality; and
- (e) Professional behavior.

The auditor should be independent of the entity subject to the audit. The Code describes independence as comprising both-

Independence of Mind
and
Independence in Appearance.

The auditor's independence safeguards the auditor's ability to form an audit opinion without being affected by any influences. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

Standard on Quality Control (SQC) 1 sets out the responsibilities of the firm for establishing policies and procedures regarding compliance with relevant ethical requirements.

SA 220 sets out the engagement partner's responsibilities with respect to relevant ethical requirements. These include evaluating whether members of the engagement team have complied with relevant ethical requirements. SA 220

recognises that the engagement team is entitled to rely on a firm's systems in meeting its responsibilities with respect to quality control procedures.

10.2.1 Independence of Auditors

Professional integrity and independence are considered essential characteristics of all the professions but are more so in the case of accountancy profession. Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.

It is not possible to define "independence" precisely. Rules of professional conduct dealing with independence are framed primarily with a certain objective. The rules themselves cannot create or ensure the existence of independence. Independence is a condition of mind as well as personal character. It should not be confused with the superficial and visible standards of independence which are sometimes imposed by law.

There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance. The Code of Ethics for Professional Accountants issued by International Federation of Accountants (IFAC) defines the term 'Independence' as follows:

"Independence is: (a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

(b) Independence in appearance – the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised."

Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

The objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements. The auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded as being incompatible with

integrity and objectivity.

Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist requiring the application of different safeguards.

10.2.2 Threats to Independence

The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. These are:

- 1. Self-interest threats**, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (i) direct financial interest or materially significant indirect financial interest in a client, (ii) loan or guarantee to or from the concerned client, (iii) undue dependence on a client's fees and, hence, concerns about losing the engagement, (iv) close business relationship with an audit client, (v) potential employment with the client, and (vi) contingent fees for the audit engagement.
- 2. Self-review threats**, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement (Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service, design and implementation of information technology systems etc.), or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.
- 3. Advocacy threats**, which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes.
- 4. Familiarity threats** are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. This can occur in many ways: (i) close relative of the audit team working in a senior position in the client company, (ii) former partner of

the audit firm being a director or senior employee of the client, (iii) long association between specific auditors and their specific client counterparts, and (iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.

5. **Intimidation threats**, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

10.2.3 Safeguards to Independence

The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

The following are the guiding principles in this regard: -

1. For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.
2. In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.
3. Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
4. When such threats exist, the auditor should either desist from the task or put in place safeguards that eliminate them.
5. If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

10.2.4 Professional Skepticism

Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.

Professional skepticism includes being alert to, for example:

- ◆ Audit evidence that contradicts other audit evidence obtained.
- ◆ Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- ◆ Conditions that may indicate possible fraud.
- ◆ Circumstances that suggest the need for audit procedures in addition to those required by the SAs.
- ◆ Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:
- ◆ Overlooking unusual circumstances.
- ◆ Over generalising when drawing conclusions from audit observations.
- ◆ Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Professional skepticism is necessary to the critical assessment of audit evidence. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud, the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism.

10.3. Acceptance and Continuance of Client Relationships and Audit Engagements

The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed:

SQC 1 requires the firm to obtain information before accepting an engagement. Information such as the following assists the engagement partner in determining whether the decisions regarding the acceptance and continuance of audit engagements are appropriate:

- ◆ The integrity of the principal owners, key management and those charged with governance of the entity;
- ◆ Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- ◆ Whether the firm and the engagement team can comply with relevant ethical requirements; and
- ◆ Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action.

10.4 Human Resources

The firm should establish **policies and procedures** designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

Such policies and procedures address the following personnel issues:

- (a) Recruitment;
- (b) Performance evaluation;
- (c) Capabilities;
- (d) Competence;
- (e) Career development;
- (f) Promotion;
- (g) Compensation; and
- (h) Estimation of personnel needs.

Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm's engagements. The firm's recruitment processes include procedures that help the firm select individuals of integrity as well as the capacity to develop the capabilities and competence necessary to perform the firm's work.

10.5 Engagement Performance

The firm should establish **policies and procedures** designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished **through written or electronic manuals**, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Matters addressed include the following:

- ◆ How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- ◆ Processes for complying with applicable engagement standards.
- ◆ Processes of engagement supervision, staff training and coaching.
- ◆ Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- ◆ Appropriate documentation of the work performed and of the timing and extent of the review.
- ◆ Processes to keep all policies and procedures current.

10.6 Monitoring

The firm should **establish policies and procedures** designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.

The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

- (a) Adherence to professional standards and regulatory and legal requirements;

- (b) Whether the quality control system has been appropriately designed and effectively implemented; and
- (c) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.



11. PRECONDITIONS FOR AN AUDIT

As per SA 210 "Agreeing the Terms of Audit Engagements", preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.



In order to establish whether the preconditions for an audit are present, the auditor shall:

- (a) Determine whether the financial reporting framework is acceptable; and
- (b) Obtain the agreement of management that it acknowledges and understands its responsibility:
 - (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework;
 - (ii) For the internal control as management considers necessary; and
 - (iii) To provide the auditor with:
 - Access to all information such as records, documentation and other matters;
 - Additional information that the auditor may request from management for the purpose of the audit; and

- Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.



12. AGREEMENT ON AUDIT ENGAGEMENT TERMS

Legal requirement to get the accounts audited so far extends only to companies, registered societies etc. In these cases the respective law governs the appointment of auditors and their duties. In all other cases, it is a matter of contract. **It is, therefore important, both for the auditor and client, that each party should be clear about the nature of the engagement. It must be reduced to writing and should exactly specify the scope of the work.** The audit engagement letter is sent by the auditor to his client. The ICAI has issued SA 210 "Agreeing the Terms of Audit Engagements" on the subject. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent.

In the case of partnerships, a few more precautions are needed. The appointment of the auditor is normally governed by the partnership deed. The accountant, when he is approached for undertaking a professional assignment by a firm or a partner of a firm, should first get a clear idea of the nature of the service required and then ensure, with reference to the terms of partnership agreement that his appointment is valid.

According to SA 210 "Agreeing the Terms of Audit Engagements", the auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate.

The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

- (a) The objective and scope of the audit of the financial statements;
- (b) The responsibilities of the auditor;
- (c) The responsibilities of management;
- (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
- (e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

If law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities.

13. RECURRING AUDITS

On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- ◆ Any indication that the entity misunderstands the objective and scope of the audit.
- ◆ Any revised or special terms of the audit engagement.
- ◆ A recent change of senior management.
- ◆ A significant change in ownership.
- ◆ A significant change in nature or size of the entity's business.
- ◆ A change in legal or regulatory requirements.
- ◆ A change in the financial reporting framework adopted in the preparation of the financial statements.
- ◆ A change in other reporting requirements.

ILLUSTRATION

R & Co, a firm of Chartered Accountants have not revised the terms of engagements and obtained confirmation from the clients for last 5 years despite changes in business and professional environment.

Required

Elucidate the circumstances that may warrant the revision in terms of engagement.

SOLUTION

As per SA 210 on “Agreeing the Terms of Audit Engagements”, the auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the factors that may make it appropriate to revise the terms of

the audit engagement or to remind the entity of existing terms are discussed in para 14 above.



14. LIMITATION ON SCOPE PRIOR TO AUDIT ENGAGEMENT ACCEPTANCE

If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

Analysis

- If management or TCWG
- impose limitation on the scope
- such that auditor believes
- limitation would result in
- auditor disclaiming an opinion
- the auditor shall not accept such a limited engagement

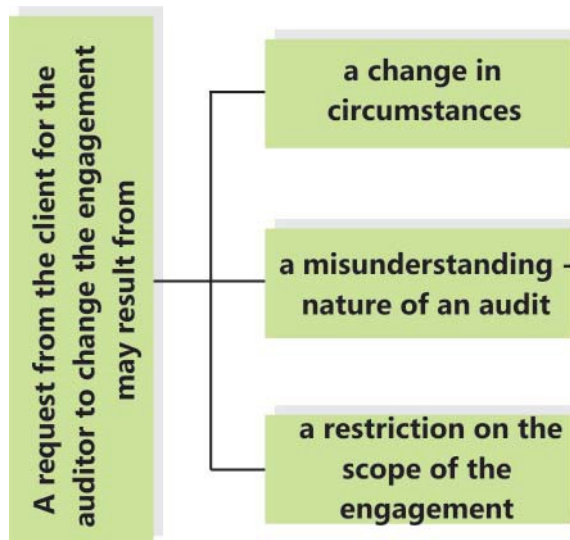


15. ACCEPTANCE OF A CHANGE IN ENGAGEMENT

An auditor who, before the completion of the engagement, is requested to **change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.**

A request from the client for the auditor to change the engagement may result from-

1. a **change in circumstances** affecting the need for the service,
2. a **misunderstanding** as to the nature of an audit or related service originally requested.
3. a **restriction on the scope of the engagement**, whether imposed by management or caused by circumstances.



The **auditor would consider carefully the reason given for the request**, particularly the implications of a restriction on the scope of the engagement, especially any legal or contractual implications.

If the auditor concludes that there **is reasonable justification to change the engagement** and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to:

- (a) the original engagement; or
- (b) any procedures that may have been performed in the original engagement.

The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.

If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

- (a) Withdraw from the audit engagement where possible under applicable law or regulation; and

- (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

ILLUSTRATION

M/s Sureshchandra & Co. has been appointed as an auditor of SC Ltd. for the financial year 2014-15. CA. Suresh, one of the partners of M/s Sureshchandra & Co., completed entire routine audit work by 29th May, 2015. Unfortunately, on the very next morning, while roving towards office of SC Ltd. to sign final audit report, he met with a road accident and died. CA. Chandra, another partner of M/s Sureshchandra & Co., therefore, signed the accounts of SC Ltd., without reviewing the work performed by CA. Suresh.

Required

State with reasons whether CA. Chandra is right in expressing an opinion on financial statements the audit of which is performed by another auditor.

SOLUTION

Relying on Work Performed by Another Auditor: As per SA 220 "Quality Control for an Audit of Financial Statements", an engagement partner taking over an audit during the engagement may apply the review procedures such as the work has been performed in accordance with professional standards and regulatory and legal requirements; significant matters have been raised for further consideration; appropriate consultations have taken place and the resulting conclusions have been documented and implemented; there is a need to revise the nature, timing and extent of work performed; the work performed supports the conclusions reached and is appropriately documented; the evidence obtained is sufficient and appropriate to support the auditor's report; and the objectives of the engagement procedures have been achieved.

Further, one of the basic principles, which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried, is that when the auditor delegates work to assistants or uses work performed by other auditor and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. This is the fundamental principle which is ethically required as per Code of Ethics.

However, the auditor should carefully direct, supervise and review work delegated. He should obtain reasonable assurance that work performed by other

auditors/experts and assistants is adequate for his purpose.

In the given case, all the auditing procedures before the moment of signing of final report have been performed by CA. Suresh. However, the report could not be signed by him due to his unfortunate death. Later on, CA. Chandra signed the report relying on the work performed by CA. Suresh. Here, CA. Chandra is allowed to sign the audit report, though, will be responsible for expressing the opinion. He may rely on the work performed by CA. Suresh provided he further exercises adequate skill and due care and review the work performed by him.

CASE STUDY

Mr. Veeru of Delhi has started a new business of selling of Handloom items. He purchases these items from a factory situated in Ludhiana and sells to local customers at a price which gives him reasonable amount of profit. All gets well in the first year and he earns some income from the business.

However, he feels that he could expand this business if he was able to bring more items to the place where he sells them and also he is aware of the fact that there are several other locations as well where he could sell these items. He could achieve this by buying a van and by employing other people who will assist him in his business on the other locations.

He needs more money to achieve this expansion of his business. He decides to ask his friend Raju to invest in the business.

Having seen the potential of Veeru's business, Raju wants to invest, but neither he wants to manage nor wants to have ultimate liability for the debts of the business in case business fails. He therefore suggested that they should set up a proprietary firm. He will be the owner of the firm and will be entitled to profits. On the other hand, Veeru would be the Manager and be paid a salary.

At the end of the first year of trading when Raju receives copy of the financial statements, he finds that Profits are much lower than what was expected. Raju knows that Veeru is paid salary so he may not care for low profits. Raju is concerned by the level of profits and feels that he wants further assurance on the accounts. He does not know whether the accounts give a true and fair view of the last year's trading because the profits do not seem as high as those Veeru had predicted when he agreed to invest.

Raju seeks solution for his problem.

The solution is that the assurance Raju is seeking may be given by an Independent Audit of accounts.

SUMMARY

An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon. The person conducting this task should take care to ensure that financial statements would not mislead anybody. As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement and to report on the financial statements. The auditor should get the scope of his duties and responsibilities defined by obtaining instructions in writing. The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit.

A significant step has been taken aimed at bringing in the desired transparency in the working of the Auditing and Assurance Standards Board, through participation of representatives of various segments of the society and interest groups, such as, regulators, industry and academics.

The auditor shall comply with relevant ethical requirements including those pertaining to independence. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements. The Code establishes the five fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements. (a) Integrity; (b) Objectivity; (c) Professional competence and due care; (d) Confidentiality; and (e) Professional behavior.

TEST YOUR KNOWLEDGE

MCQs

1. ----- along with other disciplines such as accounting and law, equips you with all the knowledge that is required to enter into auditing as a profession.
 - (a) Auditing
 - (b) Taxation
 - (c) Finance
 - (d) Taxation and Finance both
2. No business or institution can effectively carry on its activities without the help of proper ----- :
 - (a) Audit
 - (b) Record and accounts
 - (c) neither (a) nor (b)
 - (d) both (a) and (b)
3. As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:
 - (a) To obtain reasonable assurance
 - (b) To report on the financial statements
 - (c) Both (a) and (b) above
 - (d) none of the above
4. (IESBA Code) related to an audit of financial statements establishes which of the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements :
 - (a) Integrity;
 - (b) Objectivity;
 - (c) Professional competence and due care;
 - (d) All of the above
5. The auditor's _____ safeguards the auditor's ability to form an audit opinion without being affected by any influences.

- (a) Objectivity
- (b) independence
- (c) Confidentiality
- (d) Integrity

Correct /Incorrect

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

- (i) The basic objective of audit does not change with reference to nature, size or form of an entity
- (ii) The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements
- (iii) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error.
- (iv) The audit engagement letter is sent by the client to auditor.
- (v) Specific disclosure is required of the fundamental accounting assumptions followed in the financial statements.

Theoretical Questions

1. Explain clearly meaning of Auditing. How would you as an auditor perform the audit.
2. "The independent audit of an entity's financial statements is a vital service to investors, trade payables, and other participants in economic exchange". Explain
3. State the objectives of Audit according to SA 200
4. "The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats". Explain

ANSWERS/SOLUTIONS

Answers to MCQs

1. (a) 2. (b) 3. (c) 4. (d) 5. (b)

Answers to Correct/Incorrect

- (i) **Correct:** An audit is an independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon. It is clear that the basic objective of auditing, i.e., expression of opinion on financial statements does not change with reference to nature, size or form of an entity.
- (ii) **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.
- (iii) **Correct:** As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.
- (iv) **Incorrect:** As per SA 210 "Agreeing the Terms of Audit Engagements", the Audit engagement letter is sent by the auditor to his client.
- (v) **Incorrect,** as per AS 1, "Disclosure of Accounting Policies", specific disclosure of the fundamental accounting assumption is required if they are not followed in the financial statements.

Answers to Theoretical Questions

1. Refer 1: Meaning and Definition of Auditing.
2. Auditing along with other disciplines such as accounting and law, equips you with all the knowledge that is required to enter into auditing as a profession. No business or institution can effectively carry on its activities without the help of proper records and accounts, since transactions take place at different of time with numerous persons and entities. The effect of all transactions has to be recorded and suitably analysed to see the results as regards the business as a whole. Periodical statements of account are drawn up to

measure the success of whole. Periodical statements of account are drawn up to measure the success or failure of the activities in achieving the objective of the organization. This would be impossible without a systematic record of transactions. Financial statements are often the basis for decision making by the management and for corrective action so as to even closing down the organization or a part of it. All this would be possible only if the statements are reliable; decisions based on wrong accounting statements may prove very harmful or even fatal to the business. For example, if the business has really earned a profit but because of wrong accounting, the annual accounts show a loss, the proprietor may take the decision to sell the business at a loss. Thus from the point of view of the management itself, authenticity of financial statements is essential. It is more essential for those who have invested their money in the business but cannot take part in its management, for example, shareholders in a company, such persons certainly need an assurance that the annual statements of accounts sent to them are fully reliable. It is auditing which ensures that the accounting statements are authentic. In today's economic environment, information and accountability have assumed a larger role than ever before. As a result, the independent audit of an entity's financial statements is a vital service to investors, trade payable, and other participants in economic exchange.

3. Refer para 2: Overall Objectives of Audit.
4. Refer para 11.2.2: Threats to Independence.

AUDIT STRATEGY, AUDIT PLANNING AND AUDIT PROGRAMME



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ☐ Understand the Audit Planning and Overall Audit Strategy for an audit.
- ☐ Draft audit programme.
- ☐ Understand Audit Planning and Materiality.
- ☐ Learn to develop the Audit Plan and Program.
- ☐ Gain the knowledge of control of quality of audit work w.r.t delegation and supervision of audit work.

CHAPTER OVERVIEW





1. AUDIT PLANNING

1.1 Audit Plan to Conduct an Effective Audit

"The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business".

Plans should be made to cover, among other things:

- (a) acquiring knowledge of the client's accounting systems, policies and internal control procedures;
- (b) establishing the expected degree of reliance to be placed on internal control;
- (c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and
- (d) coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit.

SA-300, "Planning an Audit of Financial Statements" further expounds this principle. According to it, **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. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

1.2 Benefits of Planning in the Audit of Financial Statements

Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

- (a) Helping the auditor to devote appropriate attention to important areas of the audit.
- (b) Helping the auditor identify and resolve potential problems on a timely basis.
- (c) Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.

- (d) Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- (e) Facilitating the direction and supervision of engagement team members and the review of their work.
- (f) Assisting, where applicable, in coordination of work done by auditors of components and experts.



2. AUDIT STRATEGY

2.1 Overall Audit Strategy – Assistance to auditor



FIG. : Audit Strategy*

Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

1. The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;
2. The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material

* www.Audit-is-cool.blogspot.com

locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;

3. When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and
4. How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (**for example, on-site or off-site**), and whether to complete engagement quality control reviews.

ILLUSTRATION

The auditor T of Hand Fab Ltd is worried as to management of key resources to be employed to conduct audit.

Required

How the audit strategy would be helpful to the auditor?

SOLUTION

Refer Para 1.2 for solution

2.2 Establishment of Overall Audit Strategy

In establishing the overall audit strategy, the auditor shall

- (a) Identify the characteristics of the engagement that define its scope;

Example

- ◆ The expected audit coverage, including the number and locations of components to be included.
- ◆ The nature of the business segments to be audited, including the need for specialized knowledge.
- ◆ The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.

- (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;

Example

- ◆ The entity's timetable for reporting, such as at interim and final stages.

- ◆ The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.
 - ◆ The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.
 - ◆ The discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- (c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
- (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
- (e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

3. RELATIONSHIP BETWEEN OVERALL AUDIT STRATEGY AND AUDIT PLAN

Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

4. DEVELOPMENT OF AUDIT PLAN

4.1 Description of Audit Plan

The auditor shall develop an audit plan that shall include a description of

- (a) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".

- (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 "The Auditor's Responses to Assessed Risks".
- (c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.

Example

Planning of the auditor's risk assessment procedures occurs early in the audit process.

However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

4.2 Knowledge of the Client's Business

It is one of the important principles in developing an overall audit plan. In fact without adequate knowledge of client's business, a proper audit is not possible. 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.

Example

- ◆ The competitive environment, including demand, capacity, product and price competition as well as cyclical or seasonal activity.
- ◆ Supplier and customer relationships, such as types of suppliers and customers (e.g., related parties, unified buying groups) and the related contracts with those entities.
- ◆ Technological developments, such as those related to the entity's products, energy supply and cost.

◆ The effect of regulation on entity operations.

(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.

Example

- ◆ Understanding the sources of an entity's earnings can help us identify risks of material misstatement related to valuation of certain products or lines of businesses or areas that may be more susceptible to management fraud.
- ◆ Understanding key supplier and customer relationships can help us identify potential related parties or risks related to revenue recognition.
- ◆ An entity with components in multiple tax jurisdictions, resulting in additional risk of misstatement in the tax accounts.
- ◆ An acquisition may result in a complex structure of holding companies to achieve benefits to the shareholders giving rise to significant intercompany transactions which may give rise to material misstatements due to fraud or error.
- ◆ Transactions outside the entity's normal course of business may include: complex equity transactions, transactions regarding the leasing of premises, or the rendering of management services by the entity to another party, when no consideration is exchanged, transactions under contracts with terms that change before expiration should be studied in depth.

(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.

Example

1. We use our understanding of the entity's accounting principles, financial reporting policies or disclosures to help us determine:
 - The need to involve a specialist to help perform audit procedures related to particular disclosures, such as pension disclosures.
 - The effect on our audit of significant new or revised disclosures that may be required as a result of changes in the entity's environment, financial condition or activities, such as a change in the segments for the reporting of segment information arising from a significant business combination.
2. Management determines that most of the entity's competitors have adopted an accounting policy that is different from that adopted by the entity. After evaluation, management determines that the alternative accounting policy is generally accepted and further determines that the alternative accounting policy preferable as it will result in greater comparability and result in reliable and more relevant information. Management therefore decides to change the entity's accounting policy.

- (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

Example

1. If one of management's objectives is to grow the business, management may develop a strategy of steady but regular growth through specific marketing campaigns and development of new markets. Alternatively, management may develop a more aggressive, complex strategy of acquiring competitors. Each of these strategies gives rise to differing business risks and potentially differing risks of material misstatement.
2. Examples of potential business risks include:
 - Failure to keep up to date with new products, technologies or services.
 - Excessive reliance on a key supplier, product or individual, such as the owner.
 - Lack of personnel with expertise to react to changes in the industry.
 - Insufficient or excessive production capacity caused by inaccurate estimation of demand.

- Loss of financing due to the entity's inability to meet financial covenants.
- (e) The measurement and review of the entity's financial performance.

Example

External information such as analysts' reports and credit rating agency reports may be useful information for us to obtain an understanding of an entity's performance measures. Such reports can often be obtained from the entity.

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 judgements regarding the appropriateness of accounting policies and disclosures.

5. AUDIT PLANNING – A CONTINUOUS PROCESS

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. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

1. The analytical procedures to be applied as risk assessment procedures.
2. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
3. The determination of materiality.
4. The involvement of experts.
5. The performance of other risk assessment procedures.

6. OVERALL AUDIT STRATEGY AND THE AUDIT PLAN – THE AUDITOR'S RESPONSIBILITY

The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement.

Example

To coordinate some of the planned audit procedures with the work of the entity's personnel.

Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's responsibility. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit.

Example

Discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process.

ILLUSTRATION

W, the auditor of SKM Ltd asks its finance and audit head to prepare audit strategy for conducting audit of SKM Ltd. W also insist him to draw detailed audit procedures also. On the request of auditor W, complete audit strategy as well as audit procedures are prepared by finance head of the company. Subsequently, auditor realizes that effectiveness of the audit is compromised and it was his responsibility to prepare the overall audit strategy. Comment.

SOLUTION

Refer paragraph 5, Keeping in view the content given in paragraph 5, approach of W was wrong and he should have prepared overall audit strategy and detailed audit procedures



7. CHANGES TO PLANNING DECISIONS DURING THE COURSE OF THE AUDIT

The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. 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. This may be the

case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. **For example**, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.



8. DIRECTION, SUPERVISION AND REVIEW

The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

1. The size and complexity of the entity.
2. The area of the audit.
3. The assessed risks of material misstatement

Example

An increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work.

4. The capabilities and competence of the individual team members performing the audit work.

Example

We may have identified a problem related to the production process that raised concerns about inventory obsolescence. After obtaining an understanding of the entity's process that raised concerns about inventory obsolescence (which we had identified as a significant class of transactions), we concluded that additional tests of details were required. Therefore, the senior will likely take part, along with the team, in the discussions with management about the provision for obsolescence and examine related documentation supporting the provision, rather than just reading the memo on file. These procedures should be completed as the work is being performed rather than as an after the fact review. The extent of the senior's involvement requires judgment, taking into consideration the complexity of the area and the experience of the team.



9. DOCUMENTATION OF AUDIT PLAN

The auditor shall document:

- (a) the overall audit strategy;
- (b) the audit plan; and
- (c) any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

Example

The auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Example

The following things should form part of auditor's documentation:

- ◆ A summary of discussions with the entity's key decision makers.
- ◆ Documentation of audit committee pre-approval of services, where required.
- ◆ Audit documentation access letters.
- ◆ Other communications or agreements with management or those charged with governance regarding the scope, or changes in scope, of our services.

- ◆ Auditor's report on the entity's financial statements.
- ◆ Other reports as specified in the engagement agreement (e.g., debt covenant compliance letter).



10. AUDIT PROGRAMME

It is desirable that in respect of each audit and more particularly for bigger audits an audit programme should be drawn up. Audit programme is a list of examination and verification steps to be applied and set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statements of account produced for audit or on the basis of an appraisal of the accounting records of the client.

Definition : An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements.

In other words, an audit programme is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives.

10.1 Evolving One Audit Programme – Not Practicable For All Businesses

Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable. However, it becomes a necessity to specify in detail in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

10.2 The Assistant Engaged - Be Encouraged To Keep An Open Mind

To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme. As experience is gained by actually carrying out the work, the programme may be altered to take care of

situations which were left out originally, but are found relevant for the particular concern. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, it may be dropped. The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him. He should be instructed to note and report significant matters coming to his notice, to his seniors or to the partners or proprietor of the firm engaged for doing the audit.

10.3 Periodic Review of The Audit Programme

There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

Example

If the audit programme for the audit of a branch of a financing house, drawn up a number of years ago, fails to take into consideration that the previous policy of financing of a vehicle has been changed to financing of real estate acquisition, the whole audit conducted thereunder would be entirely misdirected and may even result into nothing more than a farce. [Pacific Acceptance Corporation Ltd. v. Forsyth and Others.]

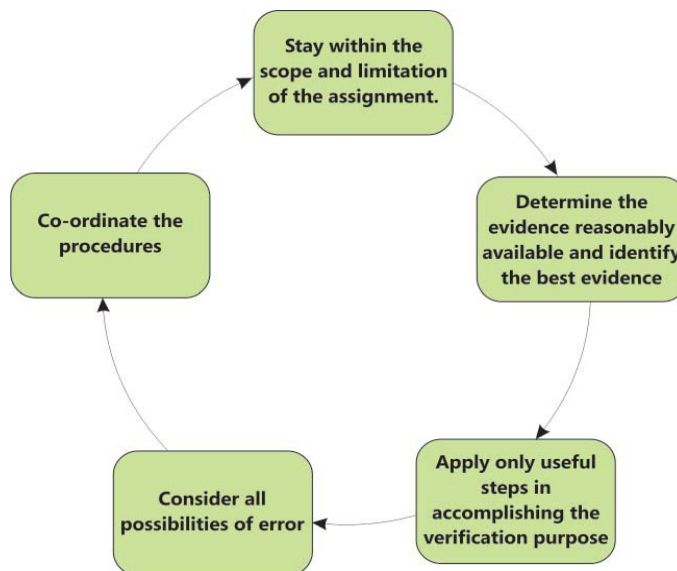
The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. However, as a basic feature, audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work. Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

10.4 Constructing an Audit Programme

For the purpose of programme construction, the following points should be

kept in mind:

- (1) Stay within the scope and limitation of the assignment.
- (2) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
- (3) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.
- (4) Consider all possibilities of error.
- (5) Co-ordinate the procedures to be applied to related items.



10.5 Audit Programme- Designed to provide Audit Evidence

Audit Evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. This is the primary task before the auditor when he draws up the audit programme. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction.

Example**Sales are evidenced by:**

- (i) invoices raised by the client;
- (ii) price list;
- (iii) forwarding notes to client;
- (iv) inventory-issue records;
- (v) sales managers' advice to the inventory section;
- (vi) acknowledgements of the receipt of goods by the customers; and
- (vii) collection of money against sales by the client.

In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion.

An auditor picks up evidence from a variety of fields and it is generally of the following broad types:

- (a) Documentary examination,
- (b) Physical examination,
- (c) Statements and explanation of management, officials and employees,
- (d) Statements and explanations of third parties,
- (e) Arithmetical calculations by the auditor,
- (f) State of internal controls and internal checks,
- (g) Inter-relationship of the various accounting data,
- (h) Subsidiary and memorandum records,
- (i) Minutes,
- (j) Subsequent action by the client and by others.

Example

1. For cash in hand, the best evidence is 'count'
2. For investment pledged with a bank, the banker's certificate.

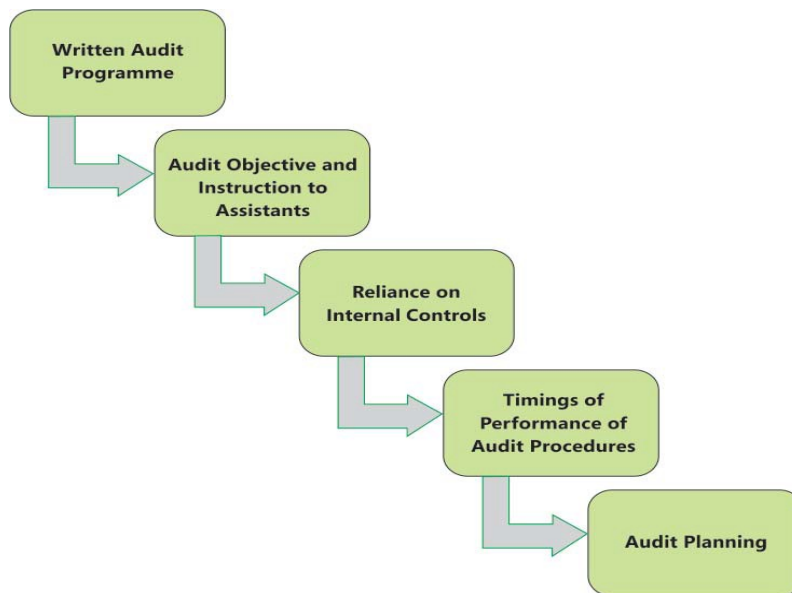
3. For verifying assertions about book debts, the client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence: some of these are corroborative, other being complementary. In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction about the reliability of the assertion.

The auditor, however, has to place appropriate weight on each piece of evidence and accordingly should prescribe the priority of verification. It is true that in all cases one procedure may not bring the highest satisfaction and it may be dangerous for the auditor to ignore any evidence that is available. By the word "available" we do not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to the circumstances and usage.

10.6 Developing the Audit Programme

1. **Written Audit Programme:** The auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.
2. **Audit Objective and Instruction to Assistants:** The programme may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.
3. **Reliance on Internal Controls:** In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. The auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit. However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence. The auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistants, and the involvement of other auditors or experts.
4. **Timings of Performance of Audit Procedures:** The auditor normally has flexibility in deciding when to perform audit procedures. However, in some cases, the auditor may have no discretion as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.

5. **Audit Planning:** The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.



10.7 Advantages and Disadvantages of an Audit Programme

The advantages of an audit programme are:

- (a) It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.
- (b) It is essential, particularly for major audits, to provide a total perspective of the work to be performed.
- (c) Selection of assistants for the jobs on the basis of capability becomes easier when the work is rationally planned, defined and segregated.
- (d) Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records. Under a properly framed programme, the danger is significantly less and the audit can proceed systematically.

- (e) The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.
- (f) The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.
- (g) It serves as a guide for audits to be carried out in the succeeding year.
- (h) A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor. It may be of considerable value in establishing that he exercised reasonable skill and care that was expected of professional auditor.

Some disadvantages are also there in the use of audit programmes but most of these can be removed by following some concrete steps.

The disadvantages are:

- (a) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.
- (b) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.
- (c) Inefficient assistants may take shelter behind the programme i.e. defend deficiencies in their work on the ground that no instruction in the matter is contained therein.
- (d) A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observe matters objectively and bring significant matters to the notice of supervisor/principal.



11. QUALITY CONTROL FOR AUDIT WORK– DELEGATION AND SUPERVISION OF AUDIT WORK

An audit is a complex task involving number of people at different levels. As we observed in the preparation and development of audit programme, the auditor would naturally have to depend upon number of technical experts as well. During the course of his work, the auditor is also likely to use the work performed by other auditors also.

A lot of work is delegated by auditor to his assistants. The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose. SA 220, "Quality Control for an Audit of Financial Statements" lays down standards on the quality control.

The objective of the auditor is to implement quality control procedures at the engagement level that provides the auditor with reasonable assurance that:

(a) The audit complies with professional standards and regulatory and legal requirements; and

(b) The auditor's report issued is appropriate in the circumstances.



12. AUDIT PLANNING AND MATERIALITY

Materiality is an important consideration for an auditor to evaluate whether the financial statements reflect a true or fair view or not. SA 320 on "Materiality in Planning and Performing an Audit" requires that an auditor should consider materiality and its relationship with audit risk while conducting an audit. When planning the audit, the auditor considers what would make the financial information materially misstated. The auditor's preliminary assessment of materiality related to specific account balances and classes of transactions helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk. It may be noted that the auditor's assessment of materiality and audit risk may be different at the time of initially planning of the audit as

against at the time of evaluating the results of audit procedures.

12.1 Determining Materiality and Performance Materiality when Planning the Audit

When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

Performance Materiality defined : Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

12.1.1 Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- ◆ The elements of the financial statements

Example

Assets, liabilities, equity, revenue, expenses;

- ◆ Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused

Example

For the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets

- ♦ The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;

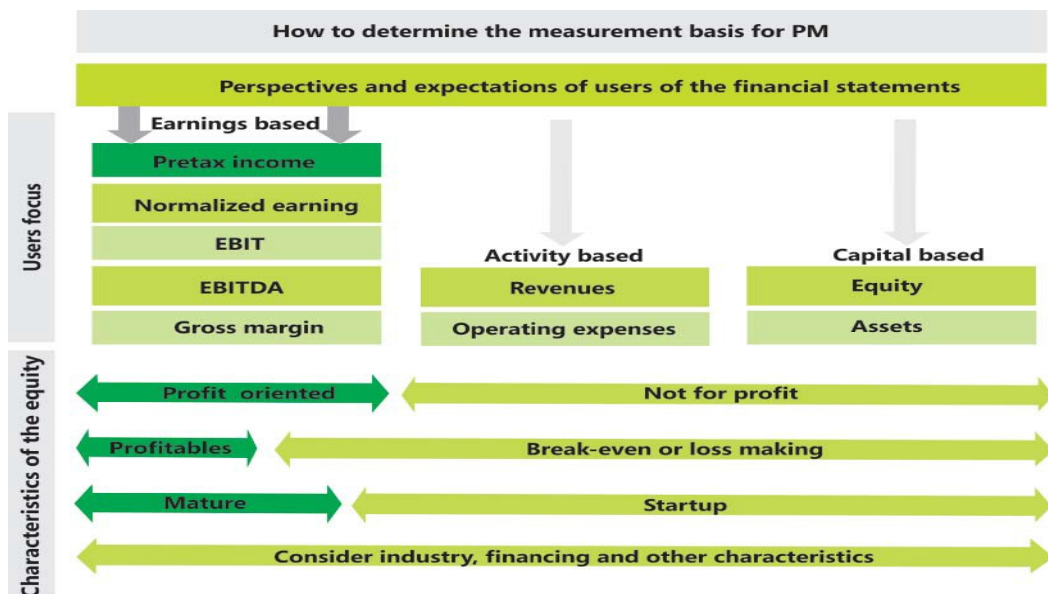
The entity's ownership structure and the way it is financed and

Example

If an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings;

The relative volatility of the benchmark.

12.1.2 Examples of appropriate benchmarks depending on entity's circumstances



Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as :

- ♦ profit before tax,
- ♦ total revenue,
- ♦ gross profit and total expenses,
- ♦ total equity or net asset value.

Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

12.1.3 Chosen Benchmark – Relevant financial data

In relation to the chosen benchmark, relevant financial data ordinarily includes –

- ◆ prior periods' financial results and financial positions,
- ◆ the period to-date financial results and financial position, and
- ◆ budgets or forecasts for the current period,
- ◆ adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates.

Example

When, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

12.1.4 Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment.

There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

Example

The auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in different circumstances.

12.2 Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures

Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

1. Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items.

Example

Related party transactions, and the remuneration of management and those charged with governance.

2. The key disclosures in relation to the industry in which the entity operates.

Example

Research and development costs for a pharmaceutical company.

3. Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements.

Example

A newly acquired business.

12.3 Revision in Materiality level as the Audit Progresses

Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.

Example

If during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

12.4 Documenting the Materiality

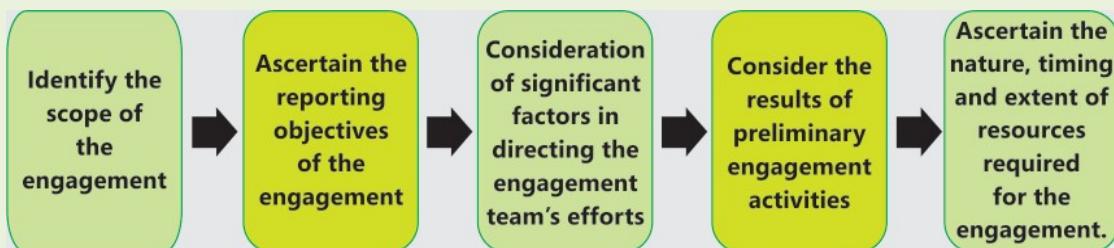
The audit documentation shall include the following amounts and the factors considered in their determination:

- (a) Materiality for the financial statements as a whole;
- (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures ;
- (c) Performance materiality ;and
- (d) Any revision of (a)-(c) as the audit progressed

SUMMARY

After establishment of the overall audit strategy, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.

In establishing the overall audit strategy, the auditor shall:



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.

Development of an Overall Plan:

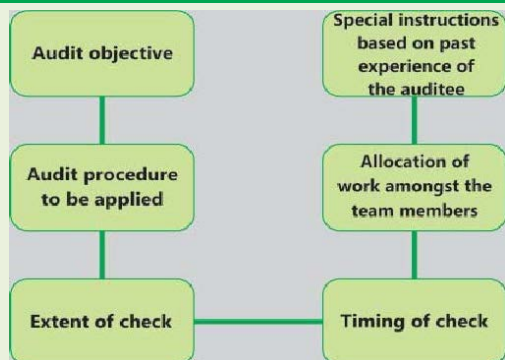
- ◆ The terms of his engagement and statutory responsibilities.
- ◆ Nature and timing of reports
- ◆ Applicable legal or statutory requirements.
- ◆ Accounting policies adopted by the client
- ◆ Effect of new accounting or auditing pronouncements on the audit.
- ◆ Identification of significant audit areas.

- ◆ Setting of materiality levels for audit purposes.
- ◆ The degree of reliance on accounting system and internal control
- ◆ Possible rotation of emphasis on specific audit areas.
- ◆ The nature and extent of audit evidence to be obtained.
- ◆ The work of internal auditors and the extent of their involvement
- ◆ The involvement of other auditors
- ◆ The involvement of experts.
- ◆ The allocation of work between joint auditors
- ◆ Establishing and coordinating staffing requirements.

The auditor shall document (a) the overall audit strategy; (b) the audit plan; and (c) any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

AN AUDIT PROGRAMME is a detailed plan and consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements. For framing an audit programme the following points should be kept in view:

SA 320 on "Materiality in Planning and Performing an Audit" requires that an auditor should consider materiality and its relationship with audit risk while conducting an audit. The auditor's preliminary assessment of materiality related to specific account balances and classes of transactions helps the auditor decide such questions as what items to examine and whether



TEST YOUR KNOWLEDGE

MCQs

1. The audit plan is _____ detailed than the overall audit strategy
 - (a) Less
 - (b) More
 - (c) Equal
2. Planning is _____ process of an audit 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:
 - (a) continuous
 - (b) discreet
 - (c) neither continuous nor discreet
3. the auditor shall develop an audit plan that shall include a description of:
 - (a) the nature, timing and extent of planned risk assessment procedure
 - (b) The nature, timing and extent of planned further audit procedures at the assertion level.
 - (c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.
4. With reference to SA 300, the auditor shall document:
 - (a) The overall audit strategy
 - (b) The audit plan
 - (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.
 - (d) All of the above
5. The overall audit strategy and the audit plan remain the _____ responsibility
 - (a) auditor's
 - (b) management's
 - (c) those charged with governance

- (d) All of the above
6. Determining a percentage to be applied to a chosen benchmark (in relation to materiality) involves the exercise of _____
- (a) Independence
- (b) Professional judgement
- (c) Professional skepticism
- (d) All of the above

Correct/Incorrect

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

1. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.
2. Establishing an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan is prerogative of the management.
3. Planning is a discrete phase of an audit
4. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) does not need any revision.

Theoretical Questions

1. "Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy". Explain.
2. "Planning is not a discrete phase of an audit, but rather a continual and iterative process". Discuss.
3. "The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors." Explain.
4. "The utility of the audit programme can be retained and enhanced only by keeping the programme and also the client's operations and internal control

under periodic review so that inadequacies or redundancies of the programme may be removed'. Discuss stating clearly the advantages of an audit programme.

5. "Determining materiality involves the exercise of professional judgment". Discuss stating the factors that may affect the identification of an appropriate benchmark. Also give example.

ANSWERS/SOLUTIONS

Answers to MCQs.

1. (b) 2. (a) 3. (d) 4. (d) 5. (a) 6. (b)

Answers to Correct/Incorrect

1. **Correct:** Once the overall audit strategy has been established, an audit plan can be developed to — achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.
2. **Incorrect.** The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.
3. **Incorrect.** Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begin 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
4. **Incorrect:** Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.

Hints to Theoretical Questions

1. Refer para 3
2. Refer para 5
3. Refer para 8
4. Refer para 10
5. Refer para 12



AUDIT DOCUMENTATION AND AUDIT EVIDENCE

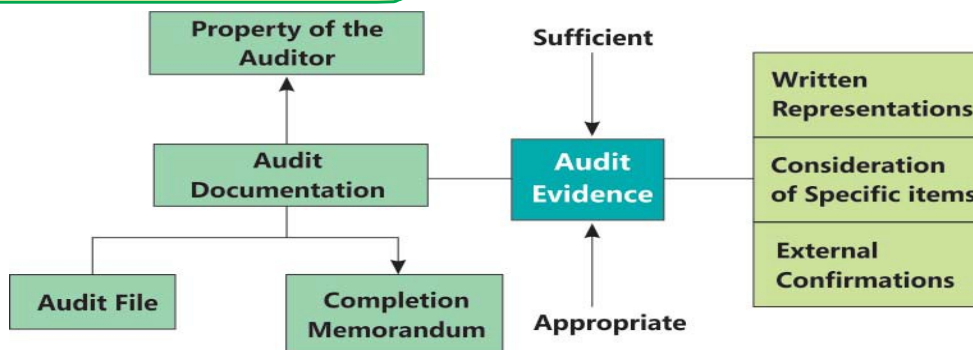


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ☐ Understand the concepts of audit documentation, nature and purpose of audit documentation, Form, content and extent of audit documentation, audit documentation summary, audit file, assembly of the final audit file, ownership of audit documentation, nature of related party relationships and transactions.
- ☐ Gain the knowledge of written representations and the objectives of the auditor regarding written representation.
- ☐ Identify Audit Evidence—Specific Considerations For Selected Items, External confirmation.
- ☐ Learn objective of Auditor with respect to Opening balances – in conducting an initial audit engagement.
- ☐ Explain audit evidence, sufficiency and appropriateness of audit evidence, types of audit evidence, relevance and reliability of audit evidence, and also methods to obtain audit evidence.
- ☐ Understand materiality, its definition and judge the materiality of the item in different circumstances.
- ☐ Explain concepts of true and fair and disclosure of accounting policies.
- ☐ Understand the Fundamental Accounting Assumptions.

CHAPTER OVERVIEW



1. AUDIT DOCUMENTATION

Audit documentation: SA 230 on “Audit Documentation”, audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as “working papers” or “work papers” are also sometimes used.)

1.1 Nature of Audit Documentation

Audit documentation provides:

- evidence of the auditor’s basis for a conclusion about the achievement of the overall objectives of the auditor; and
- evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

1.2 Purpose of Audit Documentation

The following are the purpose of Audit documentation:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
- 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.
- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

1.3 Form, Content and Extent of Audit Documentation

The form, content and extent of audit documentation depend on factors such as:

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed.
3. The identified risks of material misstatement.
4. The significance of the audit evidence obtained.
5. The nature and extent of exceptions identified.
6. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
7. The audit methodology and tools used.

1.4 Examples of Audit Documentation

Audit documentation may be recorded on paper or on electronic or other media.

Example

Audit Documentation include:

- ◆ Audit programmes.
- ◆ Analyses.
- ◆ Issues memoranda.
- ◆ Summaries of significant matters.
- ◆ Letters of confirmation and representation.
- ◆ Checklists.
- ◆ Correspondence (including e-mail) concerning significant matters.

The auditor may include copies of the entity's records (**for example**, significant and specific contracts and agreements) as part of audit documentation. Audit documentation is not a substitute for the entity's accounting records.

1.5 Audit File

Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

1.6 Assembly of the Final Audit File

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

- ◆ Deleting or discarding superseded documentation.
- ◆ Sorting, collating and cross referencing working papers.
- ◆ Signing off on completion checklists relating to the file assembly process.
- ◆ Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

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.

1.7 Documentation of Significant Matters and Related Significant Professional Judgments

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

Examples of significant matters include:

- ◆ Matters that give rise to significant risks.
- ◆ Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- ◆ Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- ◆ Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter Paragraph in the auditor's report.

An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- ◆ The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.
- ◆ The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- ◆ The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

1.8 Completion Memorandum or Audit Documentation Summary

The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-

- ◆ the significant matters identified during the audit and
- ◆ how they were addressed.

Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist auditor's consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

1.9 Ownership of Audit Documentation

Standard on Quality Control (SQC) 1 provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation 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.

2. AUDIT EVIDENCE

2.1 Introduction

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgment.

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:-

- (1) Information contained in the accounting records:** Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
- (2) Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements:** Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

2.2 Sufficiency and Appropriateness of Audit Evidence

Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and

analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. The sufficiency and appropriateness of audit evidence are interrelated.

Sufficiency of Audit Evidence: Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality. **Auditor's judgment as to sufficiency may be affected by the factors such as:**

- (i) **Materiality**
 - (ii) **Risk of material misstatement**
 - (iii) **Size and characteristics of the population.**
- (a) **Materiality** may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.
- (2) **Risk of material misstatement** may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level (a) Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls. (b) Control risk—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control. Less evidence would be required in case assertions that have

a lower risk of material misstatement. But on the other hand if assertions have a higher risk of material misstatement, more evidence would be required.

- (c) **Size of a population** refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

Appropriateness of Audit Evidence: Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

SA 330, "The Auditor's Responses to Assessed Risks" requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgement. SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgement regarding whether sufficient appropriate audit evidence has been obtained.

In order to obtain reliable audit evidence, information produced by the entity ("IPE") that is used for performing audit procedures needs to be sufficiently complete and accurate.

2.3 Sources of Audit Evidence

Some audit evidence is obtained by performing audit procedures to test the accounting records.

Example

- ◆ through analysis and review,
- ◆ reperforming procedures followed in the financial reporting process,
- ◆ and reconciling related types and applications of the same information.

Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.

More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually.

Example

Corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.

Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts' reports, and comparable data about competitors.

2.4 Audit Procedures to Obtain Audit Evidence

Audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

- (a) Risk assessment procedures; and
- (b) Further audit procedures, which comprise:
 - (i) Test of controls, when required by the SAs or when the auditor has chosen to do so; and
 - (ii) Substantive procedures, including tests of details and substantive analytical procedures.

The audit procedures inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry described below may be used as risk assessment procedures, test of controls or substantive procedures, depending on the context in which they are applied by the auditor

Risk assessment procedures refer to the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Nature and Timing of the Audit Procedures

The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source

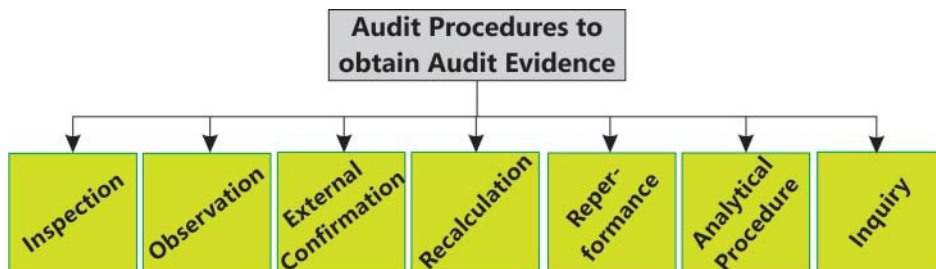
documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

Audit Procedures

Audit procedures to obtain audit evidence can include:

- (i) Inspection
- (ii) Observation
- (iii) External Confirmation
- (iv) Recalculation
- (v) Reperformance
- (vi) Analytical Procedures
- (vii) Inquiry



Inspection: Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.

Example

Example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a inventory or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

Observation: Observation consists of looking at a process or procedure being performed by others.

Example

The auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities.

Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

External Confirmation: An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only.

Example

The auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are.

External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions.

Example

The absence of a "side agreement" that may influence revenue recognition.

Recalculation: Recalculation consists of checking the mathematical accuracy of

documents or records. Recalculation may be performed manually or electronically.

Re-performance: Re-performance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

Example

Re-performing the reconciliation of bank statement, re-performing the aging of accounts receivable.

Analytical Procedures: Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non- financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

(Note : Students are advised to refer Chapter 8 Analytical Procedures for detailed understanding of the concept)

Inquiry: Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures.

Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

At this stage, it would be pertinent to discuss further audit procedures, which comprise:

- (i) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and
- (ii) Substantive procedures, including tests of details and substantive analytical procedures.

Test of controls: Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

- (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
- (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

Nature and Extent of Test of Controls

In designing and performing test of controls, the auditor shall:

- (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
 - (i) How the controls were applied at relevant times during the period under audit.
 - (ii) The consistency with which they were applied.
 - (iii) By whom or by what means they were applied.
- (b) Determine whether the controls to be tested depend upon other controls (indirect controls), and if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls.

Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.

The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness.

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Matters the auditor may consider in determining the extent of test of controls include the following:

- ◆ The frequency of the performance of the control by the entity during the period.
- ◆ The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- ◆ The expected rate of deviation from a control.
- ◆ The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- ◆ The extent to which audit evidence is obtained from tests of other controls related to the assertion.

Timing of Test of Controls

The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls in order to provide an appropriate basis for the auditor's intended reliance.

Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of the entity's monitoring of controls.

Using Audit Evidence Obtained in Previous Audits

In determining whether it is appropriate to use audit evidence about the operating

effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

- (a) The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;
- (b) The risks arising from the characteristics of the control, including whether it is manual or automated;
- (c) The effectiveness of general IT-controls;
- (d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;
- (e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and
- (f) The risks of material misstatement and the extent of reliance on the control.

If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit.

Evaluating the Operating Effectiveness of Controls

When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.

A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

Specific inquiries by auditor when deviations from controls are detected.

When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

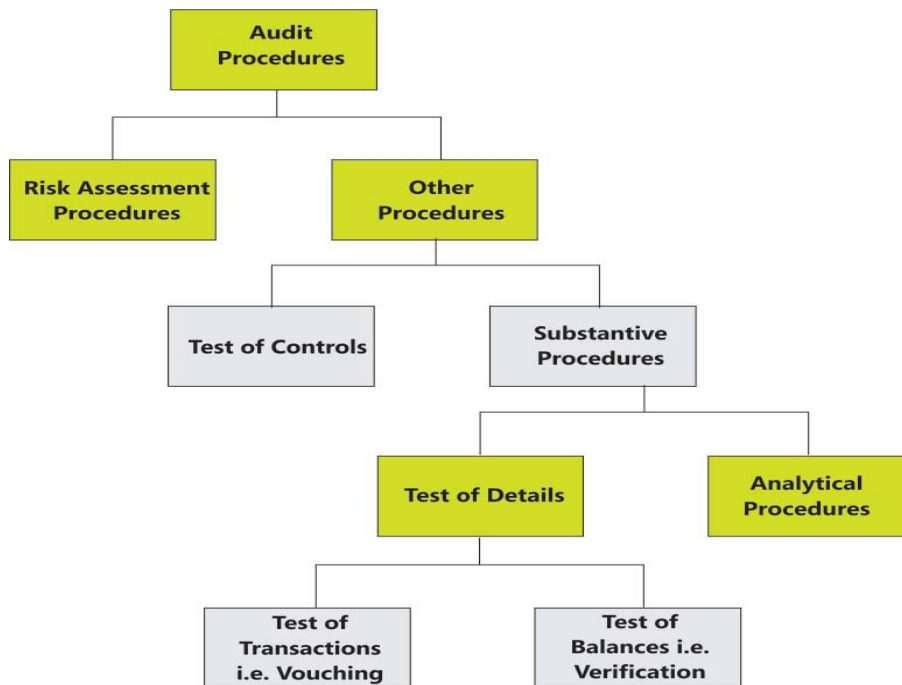
- (a) The test of controls that have been performed provide an appropriate basis for reliance on the controls;
- (b) Additional test of controls are necessary; or
- (c) The potential risks of misstatement need to be addressed using substantive procedures.

Substantive Procedures

Substantive procedure may be defined as an audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

- (i) Tests of details (of classes of transactions, account balances, and disclosures), and
- (ii) Substantive analytical procedures.

The following chart illustrates different audit procedures:



Designing and Performing Substantive Procedures

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

1. This requirement reflects the facts that:

- (i) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and
 - (ii) there are inherent limitations to internal control, including management override.
2. Depending on the circumstances, the auditor may determine that:
- (i) Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from test of controls.
 - (ii) Only tests of details are appropriate.
 - (iii) A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.
3. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520, "Analytical Procedures" establishes requirements and provides guidance on the application of analytical procedures during an audit.
4. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.
5. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from test of controls are unsatisfactory.
6. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing.

External Confirmation as Substantive Procedures

The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures.

1. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not

be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no "side agreement" exists that may be relevant to an entity's revenue cut-off assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- (i) Bank balances and other information relevant to banking relationships.
 - (ii) Accounts receivable balances and terms.
 - (iii) Inventories held by third parties at bonded warehouses for processing or on consignment.
 - (iv) Property title deeds held by lawyers or financiers for safe custody or as security.
 - (v) Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
 - (vi) Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
 - (vii) Accounts payable balances and terms.
2. Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence.

Example

External confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence

3. The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters.

Example

For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions.

Such considerations may influence the auditor's decision about whether to perform external confirmation procedures.

4. Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:
 - (i) The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
 - (ii) The ability or willingness of the intended confirming party to respond – for example, the confirming party:
 - may not accept responsibility for responding to a confirmation request;
 - may consider responding too costly or time consuming;
 - may have concerns about the potential legal liability resulting from responding;
 - may account for transactions in different currencies; or
 - may operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

- (iii) The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

Substantive Procedures Related to the Financial Statement Closing Process

The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:

- (a) Agreeing or reconciling the financial statements with the underlying accounting records; and
- (b) Examining material journal entries and other adjustments made during the course of preparing the financial statements.

The nature, and also the extent, of the auditor's examination of journal entries and

other adjustments depends on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

Substantive Procedures Responsive to Significant Risks: When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

The above paragraph requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error.

Example

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

In obtaining audit evidence from substantive procedures, the auditor is concerned with the following assertions:

Assertions refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

The Use of Assertions

1. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

2. 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:
- (a) 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.
 - (b) 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.
 - (c) 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.
3. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.
 4. When making assertions about the financial statements of certain entities, especially, for example, where the Government is a major stakeholder, in addition to those assertions set out in paragraph 2, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

Let us elaborate this with the help of two illustrations. We must clearly understand that each item contained in financial statements asserts something to the readers of the accounts to indicate the ownership, existence, quantity of various things, etc. Auditing is concerned with the testing of the authenticity of the information thus conveyed.

Example 1: When we find in the balance sheet, an item under current assets reading as “cash in hand - ₹ 8,000” the obvious assertions that would strike the mind are the following:

- (i) The firm concerned had ₹ 8,000 in hand in valid notes and coins on the balance sheet day;
- (ii) That the cash was free and available for expenditure to the firm; and
- (iii) That the books of account show a cash balance of identical amount at the end of the day on which the balance sheet is drawn up.

Example 2:

Particulars		₹
Plant and Machinery (at cost)		2,00,000
Less: Depreciation till the end of previous year	70,00	
Depreciation for the year	13,00	83,000
		1,17,000

The assertions are as follows:

- (i) the firm owns the plant and machinery;
- (ii) the historical cost of plant and machinery is ₹ 2 lacs;
- (iii) the plant and machinery physically exists;
- (iv) the asset is being utilised in the business of the company productively;
- (v) total charge of depreciation on this asset is ₹ 83,000 to date on which ₹ 13,000 relates to the year in respect of which the accounts are drawn up; and
- (vi) the amount of depreciation has been calculated on recognised basis and the calculation is correct.

From the above two illustrations we know the sort of assertions that are implied in the financial statements. Incidentally, the assertions are generally implied and not specifically spelt out, though some explicit assertions are also found in the financial statements. Explicit assertions are made when otherwise the reader will be left with an incomplete picture; it may even be misleading.

An example of the former category may be found in the following items appearing in the liability side of the balance sheet:

Secured Loans ₹ 4,00,000

The description does not give us a complete picture. We do not know:

- (i) the name of the lender, if it is relevant;
- (ii) the nature of security provided; and
- (iii) the rate at which interest is payable.

A specific mention is required about these things for a proper appreciation of the item and the financial position. Negative assertions are also encountered in the financial statements and the same may be expressed or implied. For example, if it is stated that there is no contingent liability it would be an expressed negative assertion; on the other hand, if in the balance sheet there is no item as "building", it would be an implied negative assertion that the entity did not own any building on the balance sheet date.

Every financial statement contains an overall representation in addition to the specific assertions so far discussed. Each financial statement purports to present something as a whole in addition to its component details. For example, an income statement purports to present "the results of operations" a balance sheet purports to present "financial position". The auditor's opinion is typically directed to these

overall representations. But to formulate and offer an opinion on the overall truth of these statements he has first to inquire into the truth of many specific assertions, expressed and implied, both positive, and negative, that makes up each of these statements. Out of his individual judgments of these specific assertions he arrives at a judgement on the financial statement as a whole.

Some observations about audit evidence may be of help in deciding upon the techniques to be adopted for obtaining them. First, there is nothing mysterious about the evidence which an auditor can obtain and on which he relies; it is straight forward information, some of it is obtained only by diligent effort but all of it is of the common sense variety. Second, evidence varies in reliability. When the auditor recalculates certain figures, like depreciation or inventory valuation, he may be completely convinced about the reliability of the company's figure. However, information supplied by an employee may not be that reliable because he may have an interest in concealing rather than revealing the truth. This suggests that we must always be alert to the relative reliability of different kinds of evidence. Third, some evidence may be more difficult to obtain than other. It is relatively easy to put questions to employees who are present inside the company. It is easy to examine inventory on hand; it is more difficult to verify inventory stored elsewhere. Fourth, it must be recognised that the available evidence be persuasive and that the evidence may not be conclusive. In giving the opinion, the auditor necessarily takes a calculated risk. He gets the best evidence reasonably available and forms his judgment accordingly. In fact, in auditing it is very difficult and at times impracticable to obtain conclusive evidence both on account of time and cost constraints. This explains why an auditor gives an opinion rather than some kind of guarantee or certificate. All he can state is that he has carefully examined the various assertions in the financial statements, obtained evidence what he, in his professional judgement, thought adequate or the best available; and that he has considered that evidence judiciously in forming an opinion as to the reliability of the financial statements. Fifth, the auditor may gain increased assurance when audit evidence obtained from different sources of a different nature is consistent. In the circumstances, he may obtain a cumulative degree of assurance higher than that which he attaches to the individual items of evidence by themselves. Conversely when audit evidence obtained from one source is inconsistent with that obtained from another, further procedure may have to be performed to resolve the inconsistency. Sixth, the auditor should be thorough in his efforts to obtain evidence and be objective in its evaluation. In selecting procedures to obtain evidence, he should recognize the possibility that the financial information may be materially misstated. Seventh, there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. However, the

matter of difficulty and expenses involved in testing a particular item is not in itself a valid basis for omitting a procedure. Eight, when the auditor is in reasonable doubt as to any assertion he should attempt to obtain sufficient appropriate evidence to remove such doubt. If he is unable to obtain sufficient appropriate evidence, he should not express an unqualified opinion.

2.5 Types of Audit Evidence

Internal evidence and external evidence: Evidence which originates within the organisation being audited is internal evidence.

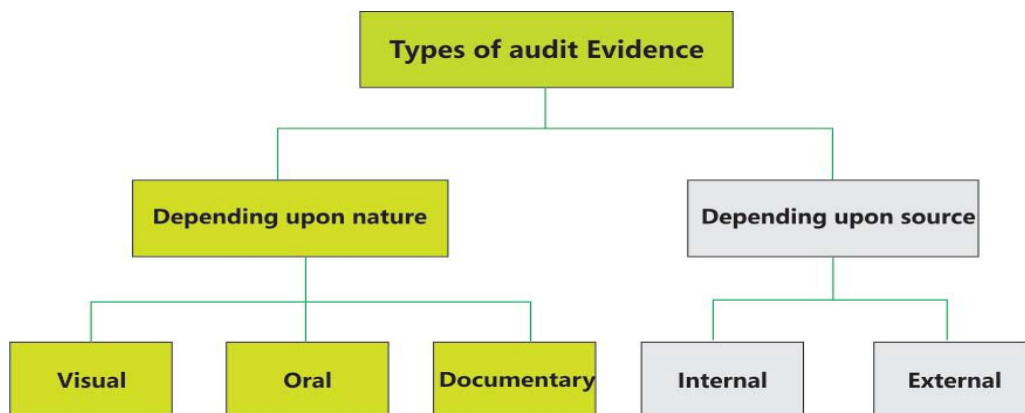
Example

Sales invoice, Copies of sales challan and forwarding notes, goods received note, inspection report, copies of cash memo, debit and credit notes, etc.

External evidence on the other hand is the evidence that originates outside the client's organization.

Example

Purchase invoice, supplier's challan and forwarding note, debit notes and credit notes coming from parties, quotations, confirmations, etc.



In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is also available to the auditor. Since in the origination of internal evidence, the client and his staff have the control, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected; but an auditor has to be alive to the possibilities of manipulation and creation of false and misleading evidence to suit the client or his staff. The external evidence is generally considered to be more reliable as they come from third parties

who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of any third party who has provided any material evidence e.g. an invoice of an associated concern, he should exercise greater vigilance in that matter. As an ordinary rule the auditor should try to match internal and external evidence as far as practicable. Where external evidence is not readily available to match, the auditor should see as to what extent the various internal evidence corroborate each other.

2.6 Relevance and Reliability

While audit evidence is primarily obtained from audit procedures performed during the course of the audit, it may also include information obtained from other sources.

Example

Previous audits, in certain circumstances, and a firm's quality control procedures for client acceptance and continuance. The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

Relevance: Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing.

Example

If the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off. Similarly, obtaining audit evidence regarding a particular assertion, for example, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to

the same assertion.

Test of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing test of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation in conditions which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

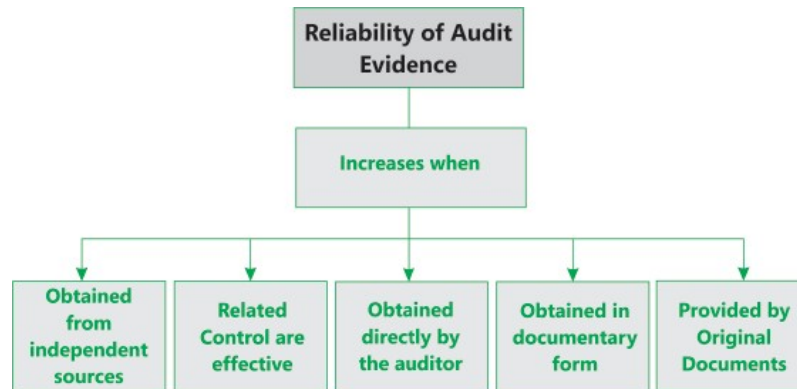
Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

Reliability: The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- ◆ The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- ◆ The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- ◆ Audit evidence obtained directly by the auditor (for **example**, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for **example**, inquiry about the application of a control).
- ◆ Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for **example**, a

contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

- ♦ Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.



3. WRITTEN REPRESENTATIONS

Written representations may be defined as a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

3.1 Written Representations as Audit Evidence

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.

Written representations are requested from those responsible for the preparation and presentation of the financial statements.

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or

about specific assertions.

ILLUSTRATION

The auditor P of PAR and Co., a firm of Chartered Accountants is conducting audit of Kapur Industries Ltd. The auditor requests management to provide Banker's certificate in support of Fixed deposits whereas management provides only written representation on the matter.

Required

Discuss how would you deal as an auditor.

SOLUTION

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

Applying the above to the given problem, the auditor would further request the management to provide him with the Banker's certificate in support of fixed deposits held by the company.

3.2 The objectives of the auditor regarding written representation

The objectives of the auditor are:

(a) To obtain written representations

To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

(b) To support other evidence

To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and

(c) To respond appropriately

To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

3.3 Management from Whom Written Representations Requested

The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

Written representations are requested from those responsible for the preparation and presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation. However, management (rather than those charged with governance) is often the responsible party.

Written representations may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation and presentation of the financial statements.

Due to its responsibility for the preparation and presentation of the financial statements, and its responsibilities for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.

In some cases, however, management may decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein, including individuals who have specialized knowledge relating to the matters about which written representations are requested. Such individuals may include:

- ◆ An actuary responsible for actuarially determined accounting measurements.
- ◆ Staff engineers who may have responsibility for and specialized knowledge about environmental liability measurements.
- ◆ Internal counsel who may provide information essential to provisions for legal claims.

In some cases, management may include in the written representations qualifying language to the effect that representations are made to the best of its knowledge and belief. It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.

3.4 Written Representations about Management's Responsibilities

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements.

Audit evidence obtained during the audit that management has fulfilled the responsibilities is not sufficient without obtaining confirmation from management about the same. This is because the auditor is not able to judge solely on other audit evidence.

For example, the auditor could not conclude that management has provided the auditor with all relevant information agreed in the terms of the audit engagement without asking it whether, and receiving confirmation that, such information has been provided.

The written representations draw on the agreed acknowledgement and understanding of management of its responsibilities by requesting confirmation that it has fulfilled them. The auditor may also ask management to reconfirm its acknowledgement and understanding of those responsibilities in written representations. This is particularly appropriate when:

- ◆ Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
- ◆ The terms of the audit engagement were prepared in a previous year;
- ◆ There is any indication that management misunderstands those responsibilities; or
- ◆ Changes in circumstances make it appropriate to do so.



4. AUDIT EVIDENCE — SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS

The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:

- (a) Existence and condition of inventory;
- (b) Completeness of litigation and claims involving the entity; and
- (c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

4.1 Inventory

When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

- (a) Attendance at physical inventory counting, unless impracticable, to:
 - (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
 - (ii) Observe the performance of management's count procedures;
 - (iii) Inspect the inventory; and
 - (iv) Perform test counts.
- (b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

4.2 Attendance at Physical Inventory Counting

Attendance at Physical Inventory Counting Involves:

- (a) Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
- (b) Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
- (c) Obtaining audit evidence as to the reliability of management's count procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

4.3 Matters Relevant in Planning Attendance at Physical Inventory Counting

Matters relevant in planning attendance at physical inventory counting include, for example:

- (a) Nature of inventory.
- (b) Stages of completion of work in progress.
- (c) The risks of material misstatement related to inventory.

- (d) The nature of the internal control related to inventory.
- (e) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- (f) The timing of physical inventory counting.
- (g) Whether the entity maintains a perpetual inventory system.
- (h) The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate
- (i) Whether the assistance of an auditor's expert is needed.

4.4 Physical Inventory Counting Conducted Other than at the Date of the Financial Statements

If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

4.5 If the Auditor is unable to Attend Physical Inventory Counting due to Unforeseen Circumstances

If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

4.6 Attendance at Physical Inventory Counting Is Impracticable

If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, **for example**, where inventory is held in a location that may pose threats to the safety of the auditor.

The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as

explained in SA 200, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

In some cases where attendance is impracticable, alternative audit procedures, for **example** inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

- (a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.
- (b) Perform inspection or other audit procedures appropriate in the circumstances.

ILLUSTRATION

Paramount Exports Ltd is a manufacturer exporter having its own production capacity and also gets the job work done through various job workers. The auditor of Paramount Exports Ltd. Considers that inventory held with job workers is material to the financial statements.

Required

Suggest the audit procedures in the given case.

SOLUTION

When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

- (a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

- (b) Perform inspection or other audit procedures appropriate in the circumstances.

4.7 Litigation and Claims

The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

- (a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
- (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- (c) Reviewing legal expense accounts.

4.8 If the Auditor Assesses a Risk of Material Misstatement regarding Litigation or Claims - Communication with the Entity's External Legal Counsel

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

The auditor shall do so through a letter of inquiry requesting the entity's external legal counsel to communicate directly with the auditor.

If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.

In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims.

This may be the case, for example, where:

- ◆ The auditor determines that the matter is a significant risk.
- ◆ The matter is complex.
- ◆ There is disagreement between management and the entity's external legal counsel. Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

ILLUSTRATION

Pride India Ltd is a manufacturer of various FMCG (fast moving consumable goods) range of products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims resulting to risk of material misstatements.

Required

Suggest the auditor with reference to SAs.

SOLUTION

The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

- (a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
- (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- (c) Reviewing legal expense accounts.

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

**5. EXTERNAL CONFIRMATION**

External confirmation may be defined as an audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

5.1 Definition of other Important Terms

Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

The exception need to be assessed to the entire population after analyzing the reason for difference.

5.2 External Confirmation Procedures

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

- (a) Determining the information to be confirmed or requested;
- (b) Selecting the appropriate confirming party;
- (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
- (d) Sending the requests, including follow-up requests when applicable, to the confirming party.

5.3 Determining the Information to be Confirmed or Requested

External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a "side agreement".

5.4 Designing Confirmation Requests

The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

Factors to consider when designing confirmation requests include:

- ◆ Specific identified risks of material misstatement, including fraud risks.
- ◆ The layout and presentation of the confirmation request.
- ◆ Prior experience on the audit or similar engagements.
- ◆ The assertions being addressed.

- ◆ The method of communication [for **example**, in paper form, or by electronic mode (like e-mail) or other medium].
- ◆ Management's authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
- ◆ The ability of the intended confirming party to confirm or provide the requested information (for **example**, individual invoice amount versus total balance).

5.5 Management's Refusal to Allow the Auditor to Send a Confirmation Request

If management refuses to allow the auditor to send a confirmation request, the auditor shall:

- (a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
- (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
- (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260.

The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.

ILLUSTRATION

While conducting the audit of Jay Kay Ltd, the auditor K of KLM and Associates, Chartered Accountants observes that there are large number of Trade payables and receivables standing in the books of accounts as on 31st March. The auditor wanted to send confirmation request to few trade receivables but the management refused the auditor to send confirmation request.

Required

How would the auditor proceed?

SOLUTION

If management refuses to allow the auditor to send a confirmation request, the auditor shall:

- (a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
- (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
- (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260.

The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.

**6. INITIAL AUDIT ENGAGEMENT**

An engagement in which either:

- (i) The financial statements for the prior period were not audited; or
- (ii) The financial statements for the prior period were audited by a predecessor auditor.

6.1 Objective of Auditor with respect to Opening Balances – in conducting an Initial Audit Engagement

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:

- (a) Opening balances contain misstatements that materially affect the current period's financial statements; and
- (b) 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.

6.2 Audit Procedures regarding Opening Balances

The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

- (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;
- (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
- (c) Performing one or more of the following:
 - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
 - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
 - (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance in accordance with SA 450.

6.3 Consistency of Accounting Policies relating to opening balances

The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the

accounting policies have been properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

6.4 Audit Conclusions and Reporting in relation to Opening Balances

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.

If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with SA 705.

7. MEANING OF RELATED PARTY

A party that is either:

- (i) A related party as defined in the applicable financial reporting framework ; or
- (ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - (a) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
 - (b) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
 - (c) Another entity that is under common control with the reporting entity through having:
 - Common controlling ownership;
 - Owners who are close family members; or
 - Common key management.

However, entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

7.1 Nature of Related Party Relationships and Transactions

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

Example

- ◆ Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- ◆ Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
- ◆ Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

7.2 Responsibilities of the Auditor

There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements.

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances.

The auditor needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:

- (a) Achieve a true and fair presentation ; or
- (b) Are not misleading (for compliance frameworks).

In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether fraud risk factors are present as required by SA 240. This is because fraud may be more easily committed through related parties.

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- ◆ Management may be unaware of the existence of all related party relationships.
- ◆ Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

Planning and performing the audit with professional skepticism as required by SA 200 is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.



8. 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 verify that all assets, liabilities, income and expenses are stated as amounts which are in accordance with accounting principles and policies which are relevant and no material amount, item or transaction has been omitted.

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, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with Accounting Standards.

What constitutes a 'true and fair' view is a matter of an auditor's judgment in the

particular circumstances of a case. In more specific terms, to ensure true and fair view, an auditor has to see:

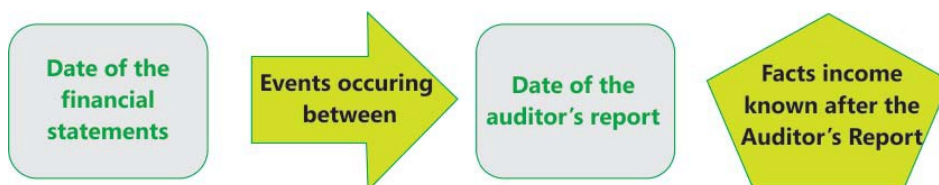
- (i) that the assets are neither undervalued or overvalued, according to the applicable accounting principles,
- (ii) no material asset is omitted;
- (iii) the charge, if any, on assets are disclosed;
- (iv) material liabilities should not be omitted;
- (v) the profit and loss account and balance sheet discloses all the matters required to be disclosed;
- (vi) accounting policies have been followed consistently; and
- (vii) all unusual, exceptional or non-recurring items have been disclosed separately.



9. AUDITOR AND THE SUBSEQUENT EVENTS

Meaning of Subsequent Events

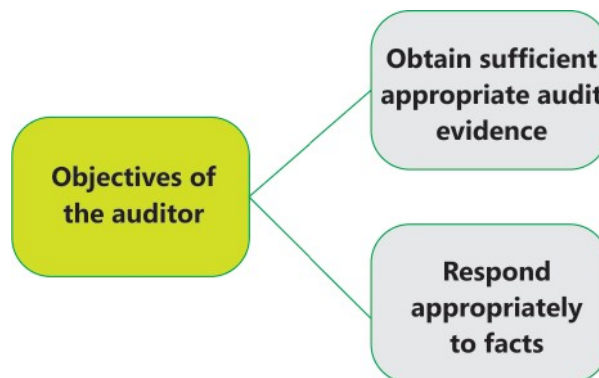
Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.



Objectives

The objectives of the auditor are to:

- (a) Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements; and
- (b) Respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

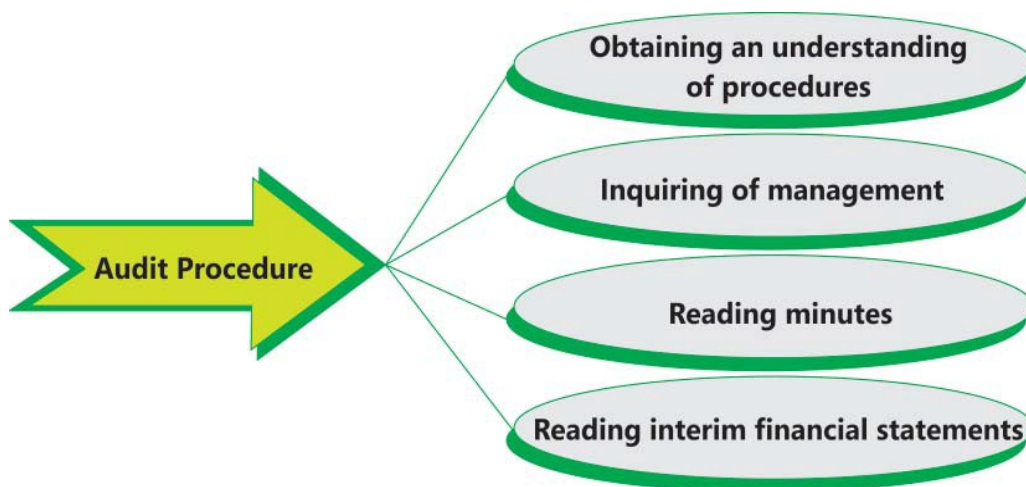


Audit Procedure Regarding Events Occurring between the Date of the Financial Statements and the Date of the Auditor's Report

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.

The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment which shall include the following:



- (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- (b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- (c) Reading 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.
- (d) Reading the entity's latest subsequent interim financial statements, if any.

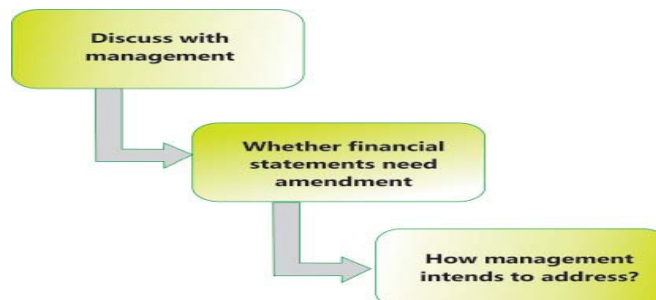
When, as a result of the procedures performed as required above, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

Auditor's Obligations Regarding Subsequent Events

(I) Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- (a) Discuss the matter with management and, where appropriate, those charged with governance.
- (b) Determine whether the financial statements need amendment and, if so,
- (c) Inquire how management intends to address the matter in the financial statements.



(II) Facts Which Become Known to the Auditor After the Financial Statements have been Issued

After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, when, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- (a) Discuss the matter with management and, where appropriate, those charged with governance.
- (b) Determine whether the financial statements need amendment and, if so,
- (c) Inquire how management intends to address the matter in the financial statements.

**10. AUDITOR AND THE GOING CONCERN ASSUMPTION****Going Concern Basis of Accounting**

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. 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.

Objectives of the auditor regarding going concern

The objectives of the auditor are:

- (a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
- (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and
- (c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

Responsibilities of the Auditor

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.

However, as described in SA 200, 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.

Events or Conditions That May Cast Significant Doubt on the Entity's Ability to Continue as a Going Concern

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.

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.

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.

Additional Audit Procedures When Events or Conditions Are Identified

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:

- (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 assessment, whether the outcome of these plans is likely to improve the situation and whether management’s plans are feasible in the circumstances.
- (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:
 - (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 regarding their future action plans and the feasibility of these plans.

Audit procedures that are relevant to the requirement as stated above 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.

SUMMARY

Audit documentation (SA 230) refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Audit documentation provides evidence of the auditor's basis for a conclusion and evidence that the audit was planned and performed in accordance with SAs. Audit file refers to one or more folders or other storage media containing the records that comprise the audit documentation for a specific engagement.

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Sufficiency is the measure of the quantity of audit evidence. Appropriateness is the measure of the quality of audit evidence. The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant.

Risk assessment procedures refer to the audit procedures performed to obtain an

understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Assertions refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

Written representations may be defined as a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence.

When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory.

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

External confirmation may be defined as an audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances.

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.

Events occurring between the date of the 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.

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.

TEST YOUR KNOWLEDGE

MCQs

1. _____ refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.
 - (a) Audit Techniques
 - (b) Audit evidence
 - (c) Audit Documentation
 - (d) None of the above
2. _____ may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
 - (a) Audit File
 - (b) Audit evidence
 - (c) Completion Memorandum
 - (d) both (a) and (b) above
3. As per SQC-1 "An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than _____ days after the date of the auditor's report".
 - (a) 30
 - (b) 60
 - (c) 90
 - (d) 45
4. A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
 - (a) ... Positive confirmation request

- ... (b) Non Response
 - (c) Negative Confirmation request
 - (d) Exception
5. Auditor's judgment as to sufficiency may be affected by which factor:
- (a) Materiality
 - (b) Risk of material misstatement
 - (c) Size and characteristics of the population.
 - (d) All of the above
6. Which of the following is not an Audit procedures to obtain audit evidence :
- (a) Inspection
 - (b) Observation
 - (c) External Confirmation
 - (d) None of the above
7. Which of the following is not an assertion about presentation and disclosure:
- (a) Occurrence and rights and obligations
 - (b) Completeness
 - (c) Classification and understandability
 - (d) Existence

Correct/Incorrect

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

- (i) As per SA 230 on "Audit Documentation", the working papers are not the property of the auditor.
- (ii) Purchase invoice is an example of internal evidence.
- (iii) Sufficiency is the measure of the quality of audit evidence.

Theoretical Questions

- 1. Define audit documentation. Also give some examples.
- 2. "Audit documentation summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits". Explain.

3. "Although written representations provide necessary audit evidence yet they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal". Discuss.
4. Discuss the objective of Auditor with respect to Opening balances in conducting an initial audit engagement.
5. Define Risk of material misstatement. Explain its components also.
6. "When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences" Explain.

ANSWERS/SOLUTIONS

Answers to MCQs

1.	(c)	2.	(a)	3.	(b)	4.	(c)	5.	(d)	6.	(d)
7.	(d)										

Answers to Correct/Incorrect

- (i) **Incorrect:** As per SA 230 on "Audit Documentation" the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.
- (ii) **Incorrect:** Internal evidence is the evidence that originates within the client's organisation. Since purchase invoice originates outside the client's organisation, therefore, it is an example of external evidence.
- (iii) **Incorrect:** Sufficiency is the measure of the quantity of audit evidence. On the other hand, appropriateness is the measure of the quality of audit evidence.

Answers to Theoretical Questions

1. Refer Para 1.4
2. Refer Para 1.8
3. Refer Para 3.1
4. Refer Para 6.1
5. Refer Para 2.2
6. Refer Para 2.4

RISK ASSESSMENT AND INTERNAL CONTROL

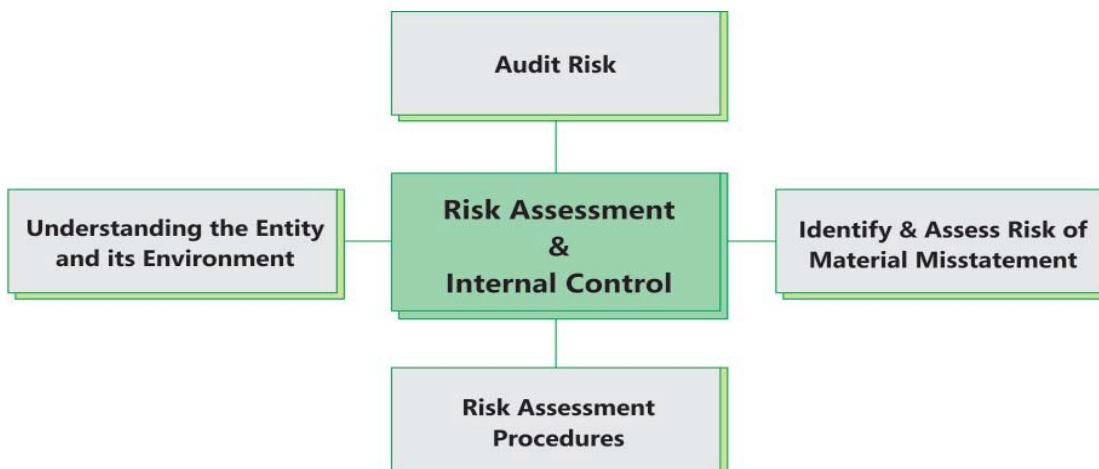


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ☐ Audit Risk, Risk of Material Misstatement and its Components.
- ☐ Risk Assessment Procedures.
- ☐ The Entity and Its Environment, Including the Entity's Internal Control.
- ☐ Concept of Internal Control, Components of Internal Control and Controls relevant to Audit.
- ☐ Identify Significant Risks.

CHAPTER OVERVIEW





1. AUDIT RISK

Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statement are materially misstated. Thus, it is the risk that the auditor may fail to express an appropriate opinion in an audit assignment.

Audit risk is a function of the risks of material misstatement and detection risk.

From the above, it is clear that –

Audit Risk = Risk of Material Misstatement x Detection Risk-----(1)

Note 1: Risk of material misstatement may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

- (a) **Inherent risk**—The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
- (b) **Control risk**—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Note 2: Misstatement refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

1.1 Assessment of Risks - Matter of Professional Judgement

The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

1.2 What is not included in Audit Risk?

- (i) Audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.

- (ii) Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

1.3 Risks of Material Misstatement at Two levels

The risks of material misstatement may exist at two levels:

- | |
|--|
| (i) The overall financial statement level- Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. |
| (ii) The assertion level for classes of transactions, account balances, and disclosures- Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. |

1.4 Components of Risk of Material Misstatement

The risks of material misstatement at the assertion level consist of two components:

- (i) Inherent risk and
- (ii) control risk.

Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete. Factors in the entity and its environment may also influence the inherent risk related to a specific assertion.

Inherent risk factors are considered while designing tests of controls and substantive procedures. Category of auditor's assessment lower or higher, each category covers a range of degrees of inherent risk. Auditor may assess the inherent risk of two different assertions as lower while recognizing that one assertion has less inherent risk than the other, although both have been assessed as lower. It is important to consider the reason for each identified inherent risk even if the risk is

lower, when auditor designs tests of controls and substantive procedures.

Example

A lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management. However, internal control can only reduce but not eliminate risks of material misstatement in the financial statements. This is because of the inherent limitations of internal control.

Example

The possibility of human errors or mistakes, or of controls being circumvented by collusion. Accordingly, some control risk will always exist.

The SAs provide the conditions under which the auditor is required to test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.

Auditor assesses control risk as Rely or Not rely on Controls. When making control risk assessments, consider:

- ◆ The control environment's influence over internal control. A control environment that supports the prevention, and detection and correction, of material misstatements allows greater confidence in the reliability of internal control and audit evidence generated within the entity. However it does not guarantee the effectiveness of specific controls. We therefore, test the operating effectiveness of controls over significant class of transactions (SCOTs) when we plan to take a controls reliance strategy. Conversely, the control environment may undermine the effectiveness of specific controls and is a key factor in our control risk assessments.
- ◆ Evaluations of the related IT processes that support application and IT-dependent manual controls.
- ◆ Our testing approach over SCOTs and disclosure processes (i.e., controls reliance or substantive only strategy).
- ◆ The expectation of the operating effectiveness of controls based on the understanding of entity's processes.

Example

Identify a control that a shipping report is prepared only for goods that have been shipped. To determine that only sales that have occurred are recorded, identify a further control that sales cannot be recorded unless a shipping report is produced. In this example, several controls operate collectively in order to address the occurrence assertion for sales.

In another example, a regular reconciliation of quantities shipped to quantities billed is a specific control that may be effective enough by itself to address the WCGW (**What Could Go Wrong**) regarding the completeness assertion in a sales process.

Whether several controls are required to operate collectively (i.e., a suite of controls) to achieve a financial reporting objective. If so, the auditor should assess whether all controls operate effectively in order to rely on controls.

Control risk assessment when control deficiencies are identified : When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements.

When control deficiencies are identified and auditor identifies and tests more than one control for each relevant assertion, he evaluates control risk considering all of the controls he has tested. If auditor determines that they support a 'rely on controls' risk assessment, or if compensating controls are identified, tested and evaluated to be effective, he may conclude that the 'rely on controls' is still appropriate. Otherwise we change our control risk assessment to 'not rely on controls.'

When a deficiency relates to an ineffective control that is the only control identified for an assertion, he revises risk assessment to 'not rely on controls' for associated assertions, as no other controls have been identified that mitigate the risk related to the assertion. If the deficiency relates to one WCGW (what can go wrong) out of several WCGW's, he can 'rely on controls' but performs additional substantive procedures to adequately address the risks related to the deficiency.

1.5 Combined Assessment of the Risk of Material Misstatement

The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be

expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

It can be concluded from the above that-

Risk of Material Misstatement = Inherent Risk x Control Risk----- (2)

From (1) and (2), we arrive at-

Audit Risk = Inherent Risk x Control Risk x Detection Risk

SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

1.6 Detection Risk

Detection risk: The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

ILLUSTRATION

XYZ Ltd is engaged in the business and running several stores dealing in variety of items such as ready made garments for all seasons, shoes, gift items, watches etc. There are security tags on each and every item. Moreover, inventory records are physically verified on monthly basis.

Discuss the types of inherent, control and detection risks as perceived by the auditor.

SOLUTION

Inherent Risk: Because items may have been misappropriated by employees, therefore, risk to the auditor is that inventory records would be inaccurate.

Control Risk: There is a security tag on each item displayed. Moreover, inventory records are physically verified on monthly basis. Despite various controls being implemented at the stores, still collusion among employees may be there and risk to auditor would again be that inventory records would be inaccurate.

Detection Risk: Auditor checks the efficiency and effectiveness of various control systems in place. He would do that by making observation, inspection, enquiry, etc. In addition to these, the auditor would also employ sampling techniques to check few sales transactions from beginning to end. However, despite all these procedures, the auditor may not detect the items which have been stolen or misappropriated.



2. IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

Objective of Auditor as per SA 315: As per SA 315 - "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

Let us understand the objective of the auditor as stated in SA 315 in detail.

2.1 Identify and assess the risks of material misstatement

- (i) The auditor shall **identify and assess** the risks of material misstatement at:
 - (a) **the financial statement level**
 - (b) **the assertion level for classes of transactions, account balances, and disclosures**to provide a basis for designing and performing further audit procedures
- (ii) For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall:
 - (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
 - (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
 - (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
 - (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

2.1.1 Risk Assessment Procedures

Definition: The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Risk assessment procedure - a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels

The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

Information obtained by performing risk assessment procedures - Used as audit evidence

Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

The risks to be assessed include both those due to error and those due to fraud

The risks to be assessed include both those due to error and those due to fraud, and both are covered by this SA. However, the significance of fraud is such that further requirements and guidance are included in SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud. (Fraud risk is discussed in detail in Chapter 5 Fraud and Responsibilities of an Auditor in this regard).

What is included in Risk Assessment Procedures ?

The risk assessment procedures shall include the following:	
(a)	Inquiries of management 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.
(b)	Analytical procedures.
(c)	Observation and inspection.

- (a) **Inquiries of Management and Others Within the Entity:** Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, 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.

Example

◆	Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
◆	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 employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
◆	Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
◆	Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

◆	Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
◆	Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system- related risks.

- (b) Analytical Procedures:** Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

- (c) Observation and Inspection:** Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment.

Example

Examples of such audit procedures include observation or inspection of the following:

The entity's operations.

Documents (such as business plans and strategies), records, and internal control manuals.

Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of director's meetings)

The entity's premises and plant facilities.

2.2 UNDERSTANDING OF THE ENTITY- A CONTINUOUS PROCESS

Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- ◆ Assessing risks of material misstatement of the financial statements;
- ◆ Determining materiality in accordance with SA 320;
- ◆ Considering the appropriateness of the selection and application of accounting policies;
- ◆ Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
- ◆ Developing expectations for use when performing analytical procedures;
- ◆ Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

ILLUSTRATION

The auditor of ABC Textiles Ltd chalks out an audit plan without understanding the entity's business. Since he has carried out many audits of textile companies, there is no need to understand the nature of business of ABC Ltd. Advise the auditor how he should proceed.

SOLUTION

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

throughout the audit. The auditor should proceed accordingly.

2.3 The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

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.

ILLUSTRATION

Prince Blankets is engaged in business of blankets. Its major portion of sales is taking place through internet. Advise the auditor how he would proceed in this regard as to understanding the entity and its environment.

SOLUTION

While understanding entity and its environment, internet sales is being perceived as risky area by the auditor and thereby would be spending substantial time and extensive audit procedures on this particular area.



3. INTERNAL CONTROL

Meaning of Internal Control

As per SA-315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", the internal control may be defined as "the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control."

Objectives of Internal Control

- (i) transactions are executed in accordance with managements general or specific authorization;
- (ii) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;
- (iii) assets are safeguarded from unauthorised access, use or disposition; and
- (iv) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

The Entity's Internal Control

The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

Benefits of Understanding of Internal Control

An understanding of internal control assists the auditor in :

- (i) identifying types of potential misstatements ;
- (ii) identifying factors that affect the risks of material misstatement, and
- (iii) designing the nature, timing, and extent of further audit procedures.

ILLUSTRATION

Auditor GR and Associates, appointed for audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditor does not think that it would be necessary to understand internal controls. Advise the auditor in this regard.

SOLUTION

The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

Study of various aspects of internal control is divided into four sections, as follows:

**(I) General Nature and Characteristics of Internal Control**

Purpose of Internal Control: Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

- ◆ The reliability of the entity's financial reporting;
- ◆ The effectiveness and efficiency of its operations;
- ◆ Its compliance with applicable laws and regulations; and
- ◆ Safeguarding of assets.

The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

Limitations of Internal Control**(i) Internal control can provide only reasonable assurance:**

Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting

objectives. The likelihood of their achievement is affected by inherent limitations of internal control.

(ii) Human judgment in decision-making:

Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.

Example

There may be an error in the design of, or in the change to, a control.

(iii) Lack of understanding the purpose:

Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

(iv) Collusion among People:

Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. **For example**, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

(v) Judgements by Management:

Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

(vi) Limitations in case of Small Entities:

Smaller entities often have fewer employees due to which segregation of duties is not practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken

into account by the auditor when identifying the risks of material misstatement due to fraud.

(II) Controls Relevant to the Audit

There is a direct relationship between an entity's objectives and the control system implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.

Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- ◆ Materiality.
- ◆ The significance of the related risk.
- ◆ The size of the entity.
- ◆ The nature of the entity's business, including its organisation and ownership characteristics.
- ◆ The diversity and complexity of the entity's operations.
- ◆ Applicable legal and regulatory requirements.
- ◆ The circumstances and the applicable component of internal control.
- ◆ The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.
- ◆ Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

Controls over the completeness and accuracy of information

Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.

Internal control over safeguarding of assets

Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

Controls relating to objectives that are not relevant to an audit

An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

The statute may require the auditor to report on compliance with certain internal controls

In certain circumstances, the statute or the regulation governing the entity may require the auditor to report on compliance with certain specific aspects of internal controls as a result, the auditor's review of internal control may be broader and more detailed.

(III) *Nature and Extent of the Understanding of Relevant Controls.*

- (i) Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements.

Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first

An improperly designed control may represent a significant deficiency in internal control.

- (ii) Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include-
- Inquiring of entity personnel.
 - Observing the application of specific controls.
 - Inspecting documents and reports.
 - Tracing transactions through the information system relevant to financial reporting.
- Inquiry alone, however, is not sufficient for such purposes.
- (iii) Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls.

Example

Obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing, performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes.

(IV) **Components of Internal Control**

The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

- (A) The control environment;
- (B) The entity's risk assessment process
- (C) The information system, including the related business processes, relevant to financial reporting, and communication
- (D) Control activities
- (E) Monitoring of controls.

- (A) Control Environment– Component of Internal Control–** The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

- (i) Management has created and maintained a culture of honesty and ethical behavior; and
- (ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

What is included in Control Environment ?

The control environment includes:

- (i) the governance and management functions and
- (ii) the attitudes, awareness, and actions of those charged with governance and management .
- (iii) the control environment sets the tone of an organization, influencing the control consciousness of its people.

Elements of the Control Environment– Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- (a) Communication and enforcement of integrity and ethical values**– These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
- (b) Commitment to competence**– Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
- (c) Participation by those charged with governance**– Attributes of those charged with governance such as:
 - Their independence from management.
 - Their experience and stature.
 - The extent of their involvement and the information they receive, and the scrutiny of activities.
 - The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
- (d) Management's philosophy and operating style**– Characteristics such as management's:

- Approach to taking and managing business risks.
 - Attitudes and actions toward financial reporting.
 - Attitudes toward information processing and accounting functions and personnel.
- (e) **Organisational structure**– The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
- (f) **Assignment of authority and responsibility**– Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.
- (g) **Human resource policies and practices**– Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

(B) The Entity's Risk Assessment Process– Component of Control Environment

The auditor shall obtain an understanding of whether the entity has a process for:

- (a) Identifying business risks relevant to financial reporting objectives;
- (b) Estimating the significance of the risks;
- (c) Assessing the likelihood of their occurrence; and
- (d) Deciding about actions to address those risks.

The entity's risk assessment process forms the basis for the risks to be managed. If that process is appropriate, it would assist the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

(C) The information system, including the related business processes, relevant to financial reporting and communication– Component of Control Environment

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following are as:

- (a) The classes of transactions in the entity's operations that are significant to the financial statements;

- (b) The procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions;
- (d) How the information system captures events and conditions that are significant to the financial statements;
- (e) The financial reporting process used to prepare the entity's financial statements;
- (f) Controls surrounding journal entries.

Communicating Financial Roles and Responsibilities– Obtaining an Understanding by the Auditor: The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities including:

(a) Communications between management and those charged with governance; and	(b) External communications, such as those with regulatory authorities.

The following points need consideration in this regard:

- (i) **Understanding of Roles and Responsibilities:** Communication by the entity of the financial reporting roles and responsibilities would involve providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.
- (ii) **Understanding regarding Relation of Activities:** It includes understanding by employees as to how their activities relate to the work of others and the means of reporting exceptions to higher level within the entity.
- (iii) **Policy Manuals and Financial Reporting Manuals:** Communication may take such forms as policy manuals and financial reporting manuals.
- (iv) **Open Communication Channels:** Open communication channels help ensure that exceptions are reported and acted on.
- (v) **Less structured and easier for Small Entities:** Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and

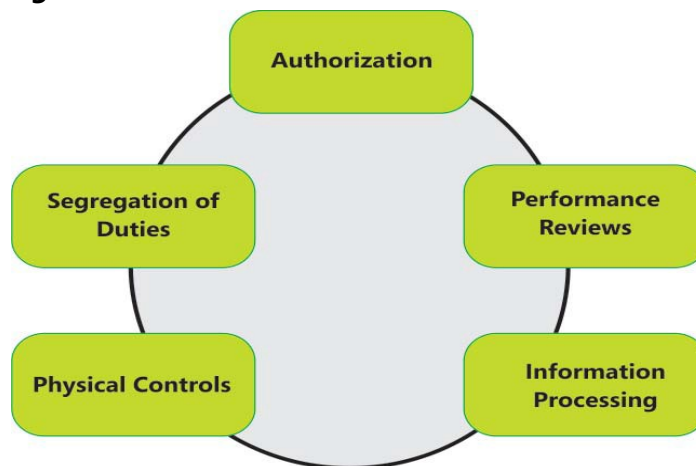
(D) Control Activities– Component of Internal Control

The auditor shall obtain an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement. An audit requires an understanding of **only those control activities** related to **significant class of transactions, account balance, and disclosure** in the financial statements and the assertions which the auditor finds relevant in his risk assessment process.

Control activities are the policies and procedures that help ensure that management directives are carried out.

Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels.

Examples of specific control activities include those relating to the following:



Control activities that are relevant to the audit are:

- Control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; or
- Those that are considered to be relevant in the judgment of the auditor;
- As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk.

In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

- (a) Whether the risk is a risk of fraud;

- (b) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;
- (c) The complexity of transactions;
- (d) Whether the risk involves significant transactions with related parties;
- (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

(Note : Student may refer Chapter 5 on for detailed understanding of Fraud Risk)

Identifying Significant Risks: Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.

Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement. The auditor assess assertions affected by a significant risk as higher inherent risk. The following are always significant risks:

- ◆ Risks of material misstatement due to fraud
- ◆ Significant transactions with related parties that are outside the normal course of business for the entity

Risks of Material Misstatement– Greater for Significant Non-Routine Transactions

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- ◆ Greater management intervention to specify the accounting treatment.
- ◆ Greater manual intervention for data collection and processing.
- ◆ Complex calculations or accounting principles.
- ◆ The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

Risks of material misstatement– Greater for Significant Judgmental Matters

Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

- ♦ Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- ♦ Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

(E) Monitoring of Controls – Component of Internal Control

The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting.

- (i) Monitoring of controls Defined:** Monitoring of controls is a process to assess the effectiveness of internal control performance over time.
- (ii) Helps in assessing the effectiveness of controls on a timely basis:** It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.
- (iii) Management accomplishes through ongoing activities, separate evaluations etc.:** Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.
- (iv) Management's monitoring activities include:** Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.
- (v) In case of Small Entities:** Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

Monitoring of Controls– If the entity has an internal audit function

If the entity has an internal audit function, the auditor shall obtain an understanding of

the following :

- (a) The internal audit function's responsibilities and how the internal audit function fits in the entity's organisational structure; and
- (b) The activities performed, or to be performed, by the internal audit function.

The following points merit consideration in this regard:

- (i) **Internal Audit Function relevant to the Audit:** The entity's internal audit function is likely to be relevant to the audit if its activities are related to the entity's financial reporting. Also if the auditor expects to use the work of the internal auditors to modify the 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.
- (ii) **Size and Structure of the Entity:** The objectives of an internal audit function vary widely depending on the size and structure of the entity and the requirements of management.
- (iii) **Internal audit function may include:** 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.
- (iv) **External auditor's activities- on the basis of Internal Audit activities:** If the internal audit function's responsibilities are related to the entity's financial reporting, the external auditor's consideration of the activities performed may include review of the internal audit function's audit plan for the period.

Satisfactory Control Environment – not an absolute deterrent to fraud:

The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, the control environment also influences the

nature, timing, and extent of the auditor's further procedures.

The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.



4. EVALUATION OF INTERNAL CONTROL BY THE AUDITOR

So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operations of these internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

Benefits of Evaluation of Internal Control to the Auditor

The review of internal controls will enable the auditor to know:

- (i) whether errors and frauds are likely to be located in the ordinary course of operations of the business;
- (ii) whether an adequate internal control system is in use and operating as planned by the management;
- (iii) whether an effective internal auditing department is operating;
- (iv) whether any administrative control has a bearing on his work (for example, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor);
- (v) whether the controls adequately safeguard the assets;
- (vi) how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned;
- (vii) how reliable the reports, records and the certificates to the management can be;

- (viii) the extent and the depth of the examination that he needs to carry out in the different areas of accounting;
- (ix) what would be appropriate audit technique and the audit procedure in the given circumstances;
- (x) what are the areas where control is weak and where it is excessive; and
- (xi) whether some worthwhile suggestions can be given to improve the control system.

Formulate Audit Program after understanding Internal Control

The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers. It is also important for him to know whether the system is actually in operation. Often, after installation of a system, no proper follow up is there by the management to ensure compliance. The auditor, in such circumstances, may be led to believe that a system is in operation which in reality may not be altogether in operation or may at best operate only partially. This state of affairs is probably the worst that an auditor may come across and he would be in the midst of confusion, if he does not take care.

It would be better if the auditor can undertake the review of the internal control system of client. This will give him enough time to assimilate the controls and implications and will enable him to be more objective in the framing of the audit programme. He will also be in a position to bring to the notice of the management the weaknesses of the system and to suggest measures for improvement. At a further interim date or in the course of the audit, he may ascertain how far the weaknesses have been removed.

From the foregoing, it can be concluded that the extent and the nature of the audit programme is substantially influenced by the internal control system in operation. In deciding upon a plan of test checking, the existence and operation of internal control system is of great significance.

A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programme.

In a situation where the internal controls are considered weak in some areas, the auditor might choose an auditing procedure or test that otherwise might not be required; he might extend certain tests to cover a large number of transactions or

other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary satisfaction.

Example

Normally the distribution of wages is not observed by the auditor. But if the internal control over wages is so weak that there exists a possibility of dummy workers being paid, the auditor might include observation of wages distribution in his programme in order to find out the workers who do not turn up for receipt of wages.

On the other hand, if he is satisfied with the internal control on sales and trade receivables, the auditor can get trade receivables' balances confirmed at almost any time reasonably close to the balance sheet date. But if the control is weak, he may feel that he should get the confirmation exactly on the date of the year closing so that he may eliminate the risk of errors and frauds occurring between the intervening period. Also, he may in that situation, decide to have a large coverage of trade receivables by the confirmation procedure.

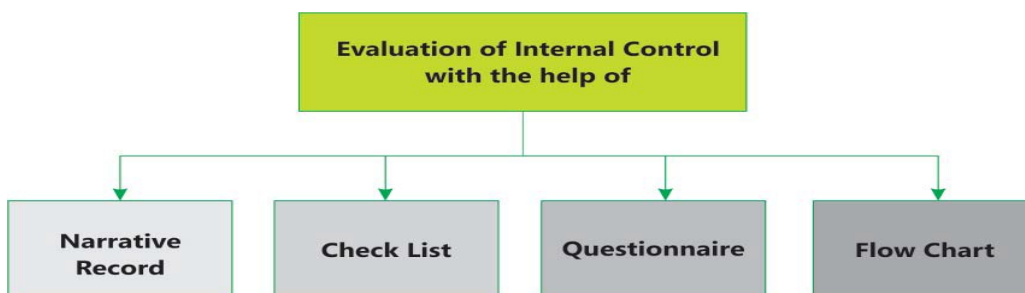
Evaluation of Internal Control– Methods

A review of the internal control can be done by a process of study, examination and evaluation of the control system installed by the management.

The first step involves determination of the control and procedures laid down by the management. By reading company manuals, studying organisation charts and flow charts and by making suitable enquiries from the officers and employees, the auditor may ascertain the character, scope and efficacy of the control system. To acquaint himself about how all the accounting information is collected and processed and to learn the nature of controls that makes the information reliable and protect the company's assets, calls for considerable skill and knowledge. In many cases, very little of this information is available in writing; the auditor must ask the right people the right questions if he is to get the information he wants. It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry.

To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following to help him to know and assimilate the system and evaluate the same:

- (i) Narrative record;
- (ii) Check List;
- (iii) Questionnaire; and
- (iv) Flow chart.



4.1 The Narrative Record

This is a complete and exhaustive description of the system as found in operation by the auditor. Actual testing and observation are necessary before such a record can be developed. It may be recommended in cases where no formal control system is in operation and would be more suited to small business.

The basic disadvantages of narrative records are:

- (i) To comprehend the system in operation is quite difficult.
- (ii) To identify weaknesses or gaps in the system.
- (iii) To incorporate changes arising on account of reshuffling of manpower, etc.

4.2 A Check List

This is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer. When he completes instruction, he initials the space against the instruction. Answers to the check list instructions are usually Yes, No or Not Applicable. This is again an on the job requirement and instructions are framed having regard to the desirable elements of control.

Example

A few examples of check list instructions are given hereunder:

1. Are tenders called before placing orders?
2. Are the purchases made on the basis of a written order?
3. Is the purchase order form standardised?
4. Are purchase order forms pre-numbered?
5. Are the inventory control accounts maintained by persons who have nothing to do with custody of work, receipt of inventory, inspection of inventory and purchase of inventory?

The complete check list is studied by the Principal/Manager/Senior to ascertain existence of internal control and evaluate its implementation and efficiency.

4.3 Internal Control Questionnaire

This is a comprehensive series of questions concerning internal control. This is the most widely used form for collecting information about the existence, operation and efficiency of internal control in an organisation.

An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review in detail. In the questionnaire, generally questions are so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. Provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not Applicable' reply is given.

The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

4.4 Flow Chart

It is a graphic presentation of each part of the company's system of internal control. A flow chart is considered to be the most concise way of recording the auditor's review of the system. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form. It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.

It is also necessary for the auditor to study the significant features of the business carried on by the concern; the nature of its activities and various channels of goods and materials as well as cash, both inward and outward; and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.



5. TESTING OF INTERNAL CONTROL

After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation. For this, he resorts to actual testing of the system in operation. This he does on a selective basis: he can plan this testing in such a manner that all the important areas are covered in a period of, say, three years. Selective testing is being done by application of procedural tests and auditing in depth.

Test of Controls:

Test of controls are performed to obtain audit evidence about the effectiveness of the:

(a) design of the accounting and internal control systems, i.e., whether they are suitably designed to prevent or detect and correct material misstatements; and

(b) operation of the internal controls throughout the period.

Test of controls include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk.

Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions and, consequently, serve as tests of control. For example, in obtaining the understanding of the accounting and internal control systems pertaining to cash, the auditor may have obtained audit evidence about the effectiveness of the bank reconciliation process through inquiry and observation.

When the auditor concludes that procedures performed to obtain the understanding of the accounting and internal control systems also provide audit evidence about the suitability of design and operating effectiveness of policies and procedures relevant to a particular financial statement assertion, the auditor may use that audit evidence, provided it is sufficient to support a control risk assessment at less than a high level.

Test of controls 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 involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, 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.

(Students may note that testing of IT System related controls are discussed in details in Chapter 6 Audit in an Automated Environment)

While obtaining audit evidence about the effective operation of internal controls, the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed. In case of deviations from the

prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications. Where, on the basis of such inquiries, the auditor concludes that the deviations are such that the preliminary assessment of control risk is not supported, he would amend the same unless the audit evidence obtained from other tests of control supports that assessment. Where the auditor concludes that the assessed level of control risk needs to be revised, he would modify the nature, timing and extent of his planned substantive procedures.

It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorisation, recording and documentation of transaction at each stage through which it flows.

Example

For example, the procedure for sales requires the following:

1. Before acceptance of any order the position of inventory of the relevant article should be known to ascertain whether the order can be executed in time.
2. An advice under the authorisation of the sales manager should be sent to the party placing the order, internal reference number, and the acceptance of the order. This advice should be prepared on a standardised form and copy thereof should be forwarded to inventory section to enable it to prepare for the execution of the order in time.
3. The credit period allowed to the party should be the normal credit period. For any special credit period a special authorisation of the sales manager would be necessary.
4. The rate at which the order has been accepted and other terms about transport, insurance, etc., should be clearly specified.
5. Before deciding upon the credit period, a reference should be made to the credit section to know the creditworthiness of the party and particularly whether the party has honoured its commitments in the past.

An auditor testing the internal controls on sales should invariably test whether any of the aforesaid procedures have been omitted. If credit has actually been granted without a reference to the credit section to know the creditworthiness of the party, it is possible that the amount may prove bad because of the financial crisis or

deadlock in the management of the party, a fact which could have been easily gathered from the credit section. Similarly, if an order is received without a reference to the inventory section, it is likely due to non-availability of the inventory on the stipulated date; execution of the order may be delayed and the company may have to compensate the buyer for the damages suffered by him.



6. INTERNAL CONTROL AND IT ENVIRONMENT

Characteristics of Manual and Automated Elements of Internal Control Relevant to the Auditor's Risk Assessment: An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements relevant to the auditor's risk assessment and further audit procedures are explained hereunder-

- (i) **Controls in Manual and IT System:** The use of manual or automated elements in internal control affects the manner in which transactions are initiated, recorded, processed, and reported:
 - (1) Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.
 - (2) Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions.
- (ii) **Use of IT:** An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT.
- (iii) **Generally, IT benefits an entity's internal control by enabling an entity to:**
 - Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
 - Enhance the timeliness, availability, and accuracy of information;
 - Facilitate the additional analysis of information;

- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- Reduce the risk that controls will be circumvented; and
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

Benefits of IT in an Entity's Internal Control

Processing of large volumes of transactions or data becomes simple;

Enhance the timeliness, availability, and accuracy of information;

Facilitate the additional analysis of information;

Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;

Reduce the risk that controls will be circumvented; and

Effective segregation of duties through security controls.

(iv) IT also poses specific risks to an entity's internal control, including, for example:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorised changes to data in master files.
- Unauthorised changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

- (v) **Suitability:** Manual elements in internal control may be more suitable where judgment and discretion are required.
- (vi) **Reliability:** Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed.
- (vii) **Nature of Entity's Information System:** The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.



7. MATERIALITY AND AUDIT RISK

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.

In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:



- (a) Identifying and assessing the risks of material misstatement;
- (b) Determining the nature, timing and extent of further audit procedures; and
- (c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.



8. DOCUMENTING THE RISK

The auditor shall document:

- (a) The discussion among the engagement team and the significant decisions reached;
- (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment and of each of the internal control components, the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
- (c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level ; and
- (d) The risks identified, and related controls about which the auditor has obtained an understanding.



9. INTERNAL AUDIT

As defined in scope of the Standards on Internal Audit, **Internal Audit** means "An independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal controlsystem".

9.1 Applicability of Provisions of Internal Audit

As per section 138 of the Companies Act, 2013 the following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely-

- (a) every listed company;
- (b) every unlisted public company having-
 - (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

- (ii) turnover of two hundred crore rupees or more during the preceding financial year; or
 - (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or
 - (iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and
- (c) every private company having-
- (i) turnover of two hundred crore rupees or more during the preceding financial year; or
 - (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year:

It is provided that an existing company covered under any of the above criteria shall comply with the requirements within six months of commencement of such section.

9.2 Who can be appointed as Internal Auditor?

As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company.

9.3 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.

9.3.1 The objectives and scope of internal audit functions

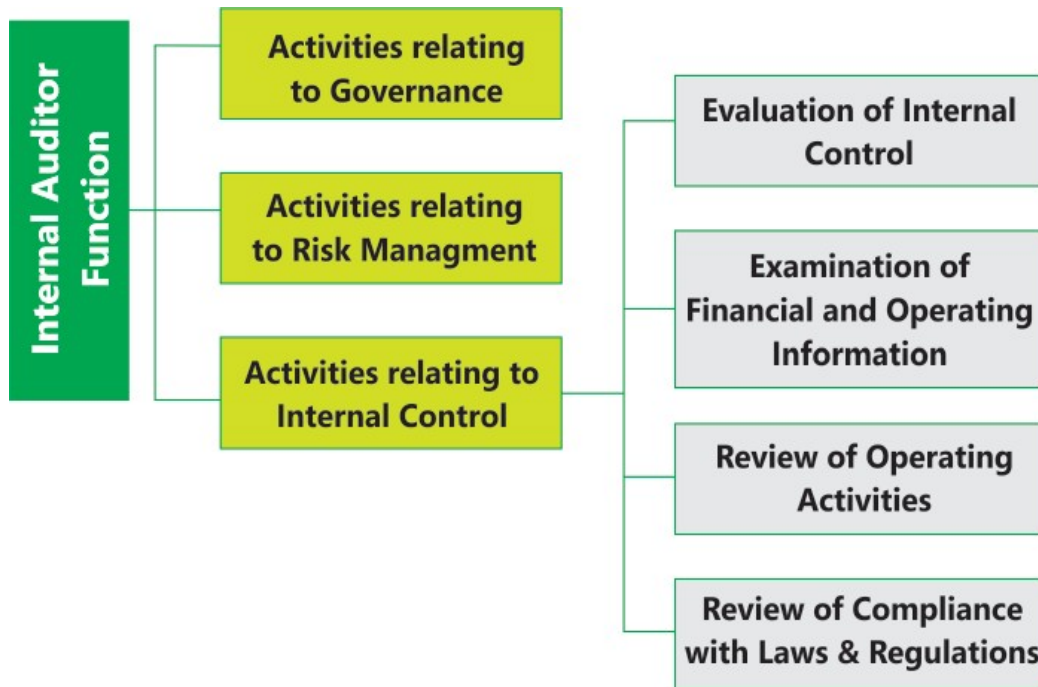
As per SA-610, "Using the Work of an Internal Auditor", the objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

The 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:

1. **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.
2. **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.
3. **Activities Relating to Internal Control:**
 - (i) **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.
 - (ii) **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.
 - (iii) **Review of operating activities:** The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including nonfinancial activities of an entity.

- (vi) **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.



10. BASICS OF STANDARDS ON INTERNAL AUDIT ISSUED BY ICAI

Considering the increasing importance of internal auditing, the Institute of Chartered Accountants of India has constituted a Committee on Internal Audit (CIA) as a non-standing committee on February 5, 2004. The CIA was constituted with the object of formulating Standards and Guidance Notes on Internal Audit now it is known as Internal Audit Standard Board.

The Board has, till date, issued eighteen Standards on Internal Audit (SIAs) and the list is given below. The SIAs aim to codify the best practices in the area of internal audit and also serve to provide a benchmark of the performance of the internal audit services. While formulating SIAs, the Board takes into consideration the applicable laws, customs, usages and business environment and generally accepted auditing practices in India.

The following SIAs are recommendatory in nature. The Standards shall become

mandatory from such date as notified by the council:

SIA 1: Planning an Internal Audit.	SIA 2: Basic Principles Governing Internal Audit
SIA 3: Documentation.	SIA 4: Reporting.
SIA 5: Sampling.	SIA 6: Analytical Procedures.
SIA 7: Quality Assurance in Internal Audit.	SIA 8: Terms of Internal Audit.
SIA 9: Communication with Management.	SIA 10: Internal Audit Evidence.
SIA 11: Consideration of Fraud in an Internal Audit.	SIA 12: Internal Control Evaluation.
SIA 13: Enterprise Risk Management.	SIA 14: Internal Audit in an Information Technology Environment.
SIA 15: Knowledge of the Entity and its Environment.	SIA 16: Using the Work of an Expert.
SIA 17: Consideration of Laws and Regulations in an Internal Audit.	SIA 18: Related Parties.



11. BASICS OF INTERNAL FINANCIAL CONTROL AND REPORTING REQUIREMENTS

Clause (e) of Sub-section 5 of Section 134 explains the meaning of internal financial controls as, "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."

From the above definition, it is clear that **internal financial controls are** the policies and procedures adopted by the company for :

1. ensuring the orderly and efficient conduct of its business, including adherence to company's policies,
2. the safeguarding of its assets,
3. the prevention and detection of frauds and errors,
4. the accuracy and completeness of the accounting records, and

5. the timely preparation of reliable financial information.”

Auditors’ Responsibility for Reporting on Internal Financial Controls over Financial Reporting in India

Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors’ report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

It may be noted that auditor’s reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143.

Accordingly, reporting on internal financial controls will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

Objectives of an auditor in an audit of internal financial controls over financial reporting: The auditor’s objective in an audit of internal financial controls over financial reporting is, “ **to express an opinion on the effectiveness of the company’s internal financial controls over financial reporting.**” It is carried out along with an audit of the financial statements.

Reporting under Section 143(3)(i) is dependent on the underlying criteria for internal financial controls over financial reporting adopted by the management. However, any system of internal controls provides only a reasonable assurance on achievement of the objectives for which it has been established. Also, the auditor shall use the concept of materiality in determining the extent of testing such controls.

Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.

The inclusion of the matters relating to internal financial controls in the directors responsibility statement is in addition to the requirement of the directors stating that they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.



12. DIFFERENCE BETWEEN INTERNAL FINANCIAL CONTROL AND INTERNAL CONTROL OVER FINANCIAL REPORTING

Internal Financial Control as per Section 134(5)(e), “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.”

On the other hand, Internal controls over financial reporting-is required where auditors are required to express an opinion on the effectiveness of an entity’s **internal controls over financial reporting**, such opinion is in addition to and distinct from the opinion expressed by the auditor on the financial statements.

SUMMARY

Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statement are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Risk of material misstatement may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components- Inherent risk and Control risk. Inherent risk is the susceptibility of an assertion to a misstatement before consideration of any related controls. Control risk is the risk that a misstatement that could occur in an assertion will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control.

Misstatement refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

The assessment of risks is a matter of professional judgment.

Detection risk refers to the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Audit Risk = Inherent Risk x Control Risk x Detection Risk

Objective of Auditor as per SA 315: As per SA 315 - "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

As per SA-315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", the internal control may be defined as "the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control."

The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud.

So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance.

The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation.

After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation. Selective testing is done by application of procedural tests and auditing in depth.

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

As defined in scope of the Standards on Internal Audit, Internal Audit means "An independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system".

Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors' report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls. The auditor's objective in an audit of internal financial controls over financial reporting is, "to express an opinion on the effectiveness of the company's internal financial controls over financial reporting." It is carried out along with an audit of the financial statements.

TEST YOUR KNOWLEDGE

MCQs

- Audit risk is a function of the risks of material misstatement and _____.
 - detection risk.
 - inherent risk
 - control risk
 - business risk
- For a given level of audit risk, the acceptable level of detection risk bears _____ relationship to the assessed risks of material misstatement at the assertion level.
 - direct.
 - Inverse
 - no
 - none of the above
- Risk of material misstatement has _____ components
 - one
 - two
 - three

- (d) four
4. Controls can be _____ related to an assertion.
- (a) directly
 - (b) indirectly
 - (c) directly or indirectly
 - (d) none of the above
5. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels. Which of the following is an example of control activities:
- (a) Authorization.
 - (b) Performance reviews.
 - (c) Information processing.
 - (d) All of the above

Correct/Incorrect

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

- (i) As per section 138 of the Companies Act, 2013 private companies are not required to appoint internal auditor.
- (ii) There is direct relationship between materiality and the degree of audit risk.
- (iii) Control risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.
- (iv) Tests of control are performed to obtain audit evidence about the effectiveness of Internal Controls Systems.
- (v) Maintenance of Internal Control System is the responsibility of the Statutory Auditor.

Theoretical Questions

1. "The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting" Explain.

2. Risk of material misstatement consists of two components" Explain clearly defining risk of material misstatement.
3. "The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement"" Explain
4. "The auditor shall obtain an understanding of the control environment" Explain stating what is included in control environment.

ANSWERS/SOLUTIONS

Answers to MCQs

1. (a) 2. (b) 3. (b) 4. (c) 5. (d)

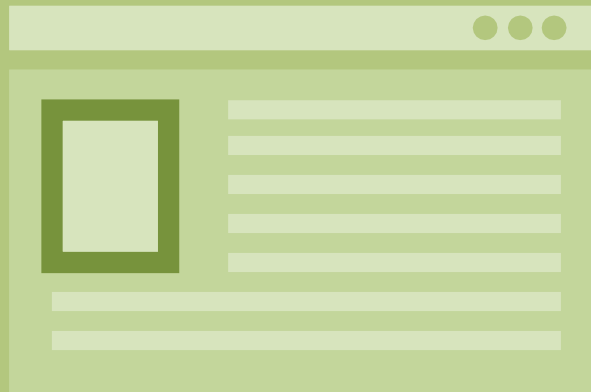
Answers to Correct/Incorrect

- (i) **Incorrect:** Section 138 of the Companies Act, 2013 requires every private company to appoint an internal auditor having turnover of ₹ 200 crore or more during the preceding financial year; or outstanding loans or borrowings from banks or public financial institutions exceeding ₹ 100 crore or more at any point of time during the preceding financial year.
- (ii) **Incorrect:** There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.
- (iii) **Incorrect:** Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.
- (iv) **Correct:** Tests of Control are performed to obtain audit evidence about the effectiveness of:
- (a) the design of the accounting and internal control systems that is whether, they are suitably designed to prevent or detect or correct material misstatements and
 - (b) the operation of the internal controls throughout the period.

- (v) **Incorrect:** The management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. Maintenance of Internal Control System is responsibility of management because the internal control is the process designed, implemented and maintained by those charged with governance/management to provide reasonable assurance about the achievement of entity's objectives.

Answers to Theoretical Questions

1. Refer Para 3.
2. Refer Para 1.
3. Refer Para 1.5
4. Refer Para 3.



FRAUD AND RESPONSIBILITIES OF THE AUDITOR IN THIS REGARD

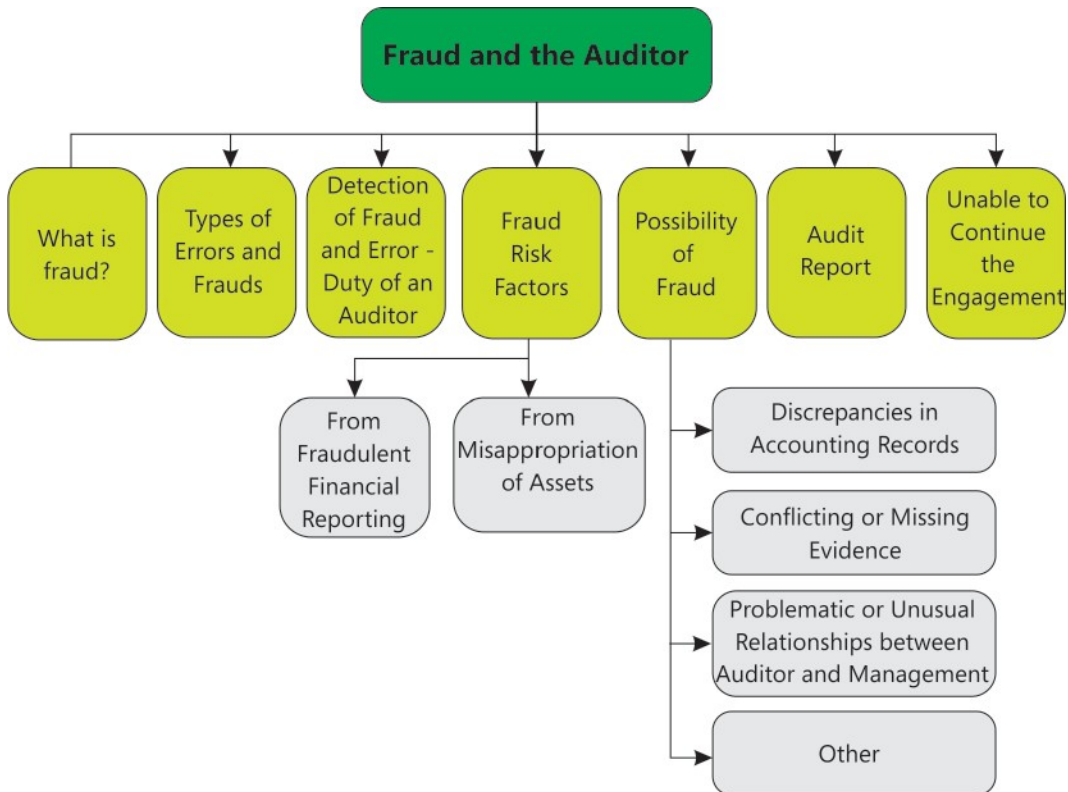


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Understand the types of errors and frauds.
- ❑ Definition of fraud as given under the Standards on Auditing and its meaning.
- ❑ Understand reasons behind management/ employees committing fraud/ error.
- ❑ Analyse the duty of an auditor regarding detection of fraud and error.
- ❑ Determine fraud risk factors and circumstances relating to possibility of fraud.
- ❑ Understand responsibility of an auditor in case of withdrawal from the engagement if encounter any circumstances that bring into question his ability to continue due to fraud

CHAPTER OVERVIEW



1. MEANING OF FRAUD

The Standard on Auditing (SA) 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" defines the term 'fraud' as-

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

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

Two types of intentional misstatements are relevant to the auditor-

- ♦ misstatements resulting from fraudulent financial reporting and
- ♦ misstatements resulting from misappropriation of assets.

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



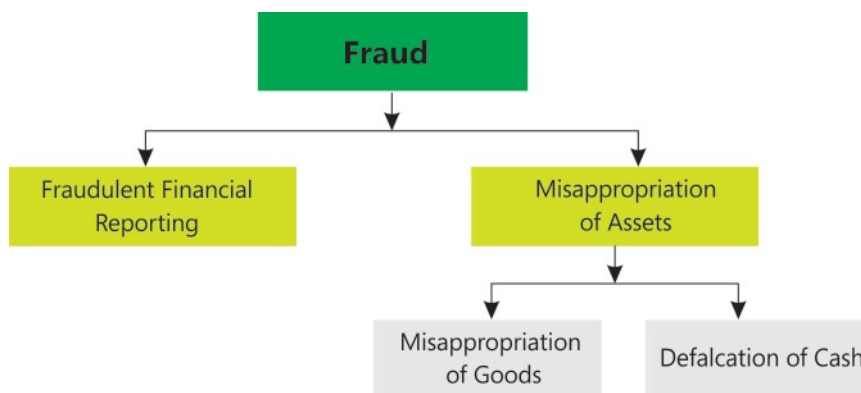
2. CHARACTERISTICS OF FRAUD

2.1 Fraud is Intentional

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

2.2 Fraud is a broad legal concept

The auditor is concerned with fraud that causes a material misstatement in the financial statements.



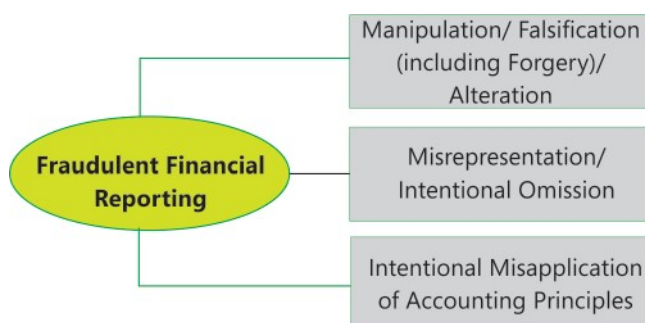
Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

- ◆ Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome.
- ◆ A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.

- ◆ Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

2.2.1 Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users.

Fraudulent financial reporting may be accomplished by the following:



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

Manipulation of Accounts: Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way. This type of fraud is generally committed:

- to avoid incidence of income-tax or other taxes;
- for declaring a dividend when there are insufficient profits;
- to withhold declaration of dividend even when there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost); and
- for receiving higher remuneration where managerial remuneration is payable by reference to profits.

There are numerous ways of committing this type of fraud. Some of the methods are given below:

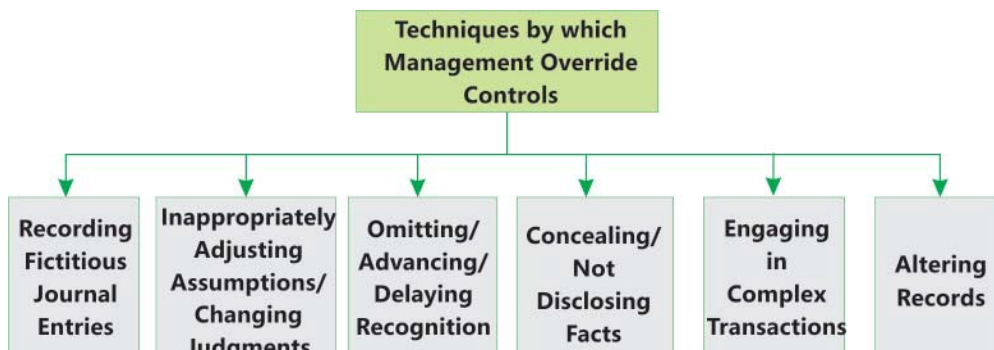
- inflating or suppressing purchases and expenses;

- (ii) inflating or suppressing sales and other items of income,
- (iii) inflating or deflating the value of closing inventory;
- (iv) failing to adjust outstanding liabilities or prepaid expenses; and
- (v) charging items of capital expenditure to revenue or by capitalising revenue expenses.

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

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

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



- ◆ Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- ◆ Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- ◆ Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- ◆ Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- ◆ Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- ◆ Altering records and terms related to significant and unusual transactions.

Why do Management/ Employees commit fraud? What induces Management/ Employees to commit fraud? Following are certain instances which will help to understand these questions:



- ◆ Financial obligations/ Pressure.
- ◆ Management's unrealistic goals.
- ◆ Dissatisfied Employees or Lack of motivation among employees.
- ◆ Name game (eg. management using power of authority by asking employees to do something illegal).
- ◆ Opportunity to commit fraud.

2.2.2 Misappropriation of Assets:

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

- ◆ Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- ◆ Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).



Fig.: Theft of Assets

- ♦ Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- ♦ Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Example

Vineet is a manager in Zed Ex Ltd. He is having authority to sign cheques up to ₹ 10,000. While performing the audit, Rajan, the auditor, noticed that there were many cheques of ₹ 9,999 which had been signed by Vineet. Further Vineet had split large payments (amounting to more than ₹ 10,000 each, into two or more cheques less than ₹ 10,000 each so that he may authorize the payments). This raised suspicion in the auditor.

The auditor found that the cheques of ₹ 9,999 were deposited in Vineet's personal account i.e. Vineet had misappropriated the amount.

Splitting the cheques into lower amounts involves manipulation of accounts. The fraud was committed by an employee.

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.¹

2.2.2.1 Misappropriation of Goods

Fraud in the form of misappropriation of goods is still more difficult to detect; for this management has to rely on various measures. Apart from the various requirements of record keeping about the physical quantities and their periodic checks, there must be rules and procedures for allowing persons inside the area where goods are kept. In addition there should be external security arrangements to see that no goods are taken out without proper authority. Goods can be anything in the premises; it may be machinery. It may even be the daily necessities of the office like stationery. The goods may be removed by subordinate employees or even by persons quite higher up in the management. Auditors can



Fig.: Theft of Goods*

* Source of image: www.clipartster.com

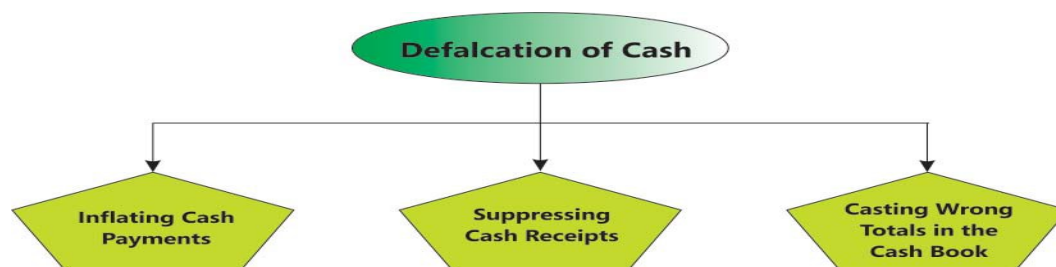
detect this by undertaking a thorough and strenuous checking of records followed by physical verification process. Also, by resorting to intelligent ratio analysis, auditors may be able to form an idea whether such fraud exists.

Therefore, it is clear from the above that the 'fraud' deals with intentional misrepresentation but, 'error', on the other hand, refers to unintentional mistakes in financial information.

Intentional errors are most difficult to detect and auditors generally devote greater attention to this type because out of long and sometimes unfortunate experience, auditors have developed a point of view that if they direct their procedures of discovering the more difficult intentional errors, they are reasonably certain to locate the more simple and far more common unintentional errors on the way.

2.2.2.2 Defalcation of Cash

Defalcation of cash has been found to perpetrate generally in the following ways:



(a) By inflating cash payments:

Examples of inflation of payments:

- (1) Making payments against fictitious vouchers.
- (2) Making payments against vouchers, the amounts whereof have been inflated.
- (3) Manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.
- (4) Casting a larger totals for petty cash expenditure and adjusting the excess in the totals of the detailed columns so that cross totals show agreement.

(b) By suppressing cash receipts:

Few techniques of how receipts are suppressed are:

- (1) **Teeming and Lading:** Amount received from a customer being misappropriated; also to prevent its detection the money received from

another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.

- (2) Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer' accounts and misappropriating amount paid by them.
- (3) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.
- (4) Not accounting for cash sales fully.
- (5) Not accounting for miscellaneous receipts, *e.g.*, sale of scrap, quarters allotted to the employees, etc.
- (6) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

(c) By casting wrong totals in the cash book.

3. DETECTION OF FRAUD AND ERROR – DUTY OF AN AUDITOR

As per SA 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a

strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance.

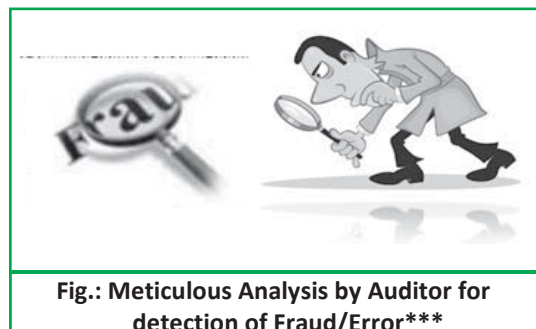


Fig.: Meticulous Analysis by Auditor for detection of Fraud/Error***

Broadly, the general principles laid down in the SA may be noted as under:

1. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. As described in SA 200, **“Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing,”** owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.
2. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor’s ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.
3. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.
4. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Case Study 1

While auditing XYZ Ltd., the auditor was told by Mr. Mahesh, the CEO of the company, that he would be responsible for the fraud & errors, if any, occurring in the books of accounts of the company.

Auditor's Responsibilities for Detection of Fraud and Error: As per SA 240 "The Auditor's Responsibilities relating to fraud in an audit of Financial Statements", an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

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

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

An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

The auditor also has the responsibility to communicate the misstatement to the appropriate level of management on a timely basis and consider the need to report to it then changed with governance. He may also obtain legal advice before reporting on the financial information or before withdrawing from the engagement. The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirm the existence of the fraud.

The auditor should also consider the implications of the frauds and errors, and frame his report appropriately. In case of a fraud, the same should be disclosed in the financial statement. If adequate disclosure is not made, there should be a suitable disclosure in his audit report.

Case Study 2

After the completion of statutory audit of ABC Ltd., a fraud was detected at the office of the auditee. The management of the company alleged that there is a failure on the part of the auditor to detect fraud and that auditor would be responsible for not detecting fraud in the company.

Detection of Fraud after Completion of Statutory Audit: As per SA 240, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. Such a system reduces but does not eliminate the possibility of fraud and error.

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

The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion.

The subsequent discovery of material misstatement of the financial information resulting from fraud or error existing during the period covered by the auditor's report does not, in itself, indicate that whether the auditor has adhered to the basic principles governing an audit. The question of whether the auditor has adhered to the basic principles governing an audit (such as performance of the audit work with requisite skills and competence, documentation of important matters, details of the audit plan and reliance placed on internal controls, nature and extent of compliance and substantive tests carried out, etc.) is determined by the adequacy of the procedures undertaken in the circumstances and the suitability of the auditor's report based on the results of these procedures.

The liability of the auditor for failure to detect fraud exists only when such failure is clearly due to not exercising reasonable care and skill. Thus, in the instant case after the completion of the statutory audit, if a fraud has been detected, the same by itself cannot mean that the auditor did not perform his duty properly. If the auditor can prove with the help of his papers (documentation) that he has followed adequate procedures necessary for the proper conduct of an audit, he cannot be held responsible for the same. If however, the same cannot be proved, he would be held responsible.



4. FRAUD RISK FACTORS AND POSSIBILITY OF FRAUD

SA 240, further, explains by way of examples certain risk factors and circumstances relating to possibility of fraud as may be considered by the auditor which are dealt in the following paragraphs.

4.1 Fraud Risk Factors

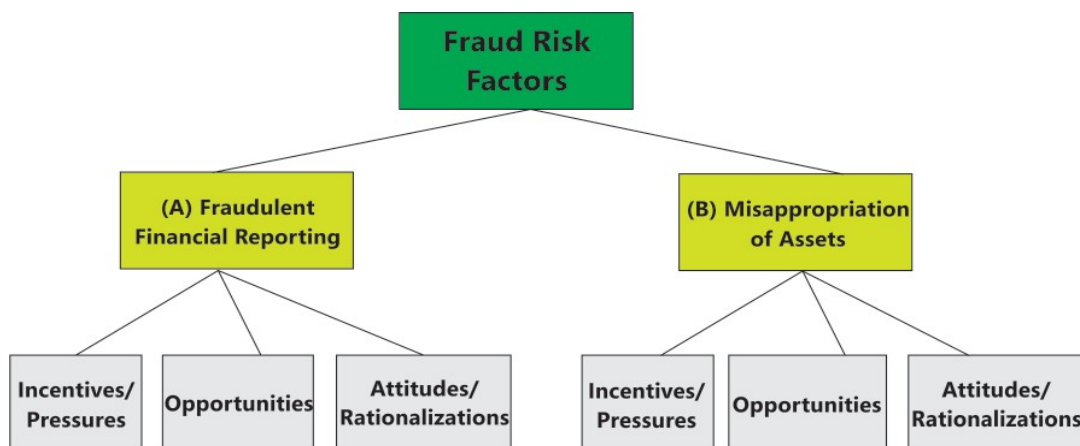
Fraud Risk Factors may be defined as events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Examples of Fraud Risk Factors: The fraud risk factors identified here are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration, i.e.,

- (A) fraudulent financial reporting, and
- (B) misappropriation of assets.

For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur:

- (a) incentives/pressures,
- (b) opportunities, and
- (c) attitudes/rationalizations.



Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all

of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

(A) Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting: The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting -

Incentives/Pressures: Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

1. High degree of competition or market saturation, accompanied by declining margins.
2. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
3. Significant declines in customer demand and increasing business failures in either the industry or overall economy.
4. Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
5. Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
6. New accounting, statutory, or regulatory requirements.

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

1. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
2. A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
3. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
4. Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.

5. Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

Attitudes/Rationalizations: Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.

1. Known history of violations of securities laws or other laws and regulations.
2. Excessive interest by management in maintaining or increasing the entity's inventory price or earnings trend.
3. Management failing to remedy known significant deficiencies in internal control on a timely basis.
4. An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
5. The owner-manager makes no distinction between personal and business transactions.
6. The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
 - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
 - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
 - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
 - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

(B) Risk Factors Arising from Misstatements Arising from Misappropriation of Assets: Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/ pressures, opportunities, and attitudes/ rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur.

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

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

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

1. Known or anticipated future employee layoffs.
2. Recent or anticipated changes to employee compensation or benefit plans.
3. Promotions, compensation, or other rewards inconsistent with expectations.

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

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

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

- ◆ Inadequate segregation of duties or independent checks.
- ◆ Inadequate oversight of senior management expenditures, such as travel and other reimbursements.
- ◆ Inadequate record keeping with respect to assets.
- ◆ Inadequate system of authorization and approval of transactions (for example, in purchasing).
- ◆ Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- ◆ Lack of complete and timely reconciliations of assets.

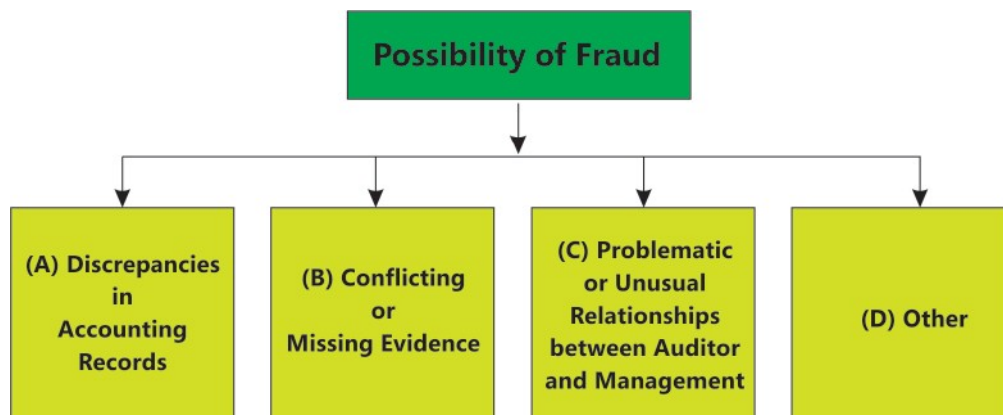
- ♦ Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- ♦ Lack of mandatory vacations for employees performing key control functions.
- ♦ Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- ♦ Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations: Disregard for the need for monitoring or reducing risks related to misappropriations of assets.

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

4.2 Circumstances Relating to Possibility of Fraud

Examples of circumstances that indicate the possibility of fraud: The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud-



(A) Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

(B) Conflicting or missing evidence, including:

- Missing documents.
- Documents that appear to have been altered.
- Significant unexplained items on reconciliations.
- Unusual discrepancies between the entity's records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.
- Missing or non-existent cancelled cheques in circumstances where cancelled cheques are ordinarily returned to the entity with the bank statement.
- Missing inventory or physical assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.

Example

Raj is the auditor of XYZ Ltd. Raj is analysing the financial statements of the company by studying significant ratios. Some of the ratios that he studied was the gross profit ratio and net profit ratio. The gross profit ratio for the current year 2016-17 is 19% and for the previous year 2015-16 was 25%. Similarly, net profit ratio for the current year 2016-17 is 7%, whereas in previous year 2015-16 it was 11%.

There is a large variation in the gross profit ratio and net profit ratio over the two years. Hence, auditor has reason to believe that there may be something unusual. He will consider the results of such analytical procedures while drawing up his audit plan and allot more time to studying purchases.

Example

Analytical procedures exhibiting unusual ratios and trend e.g. unusually large transactions reported in the last month of the reporting period.

(C) Problematic or unusual relationships between the auditor and management, including:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
- Undue time pressures imposed by management to resolve complex or contentious issues.
- Unusual delays by the entity in providing requested information.
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- An unwillingness to address identified deficiencies in internal control on a timely basis.

(D) Other

- Unwillingness by management to permit the auditor to meet privately with those charged with governance.
- Accounting policies that appear to be at variance with industry norms.
- Frequent changes in accounting estimates that do not appear to result from changed circumstances.
- Tolerance of violations of the entity's Code of Conduct.

 5. FRAUD REPORTING

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.

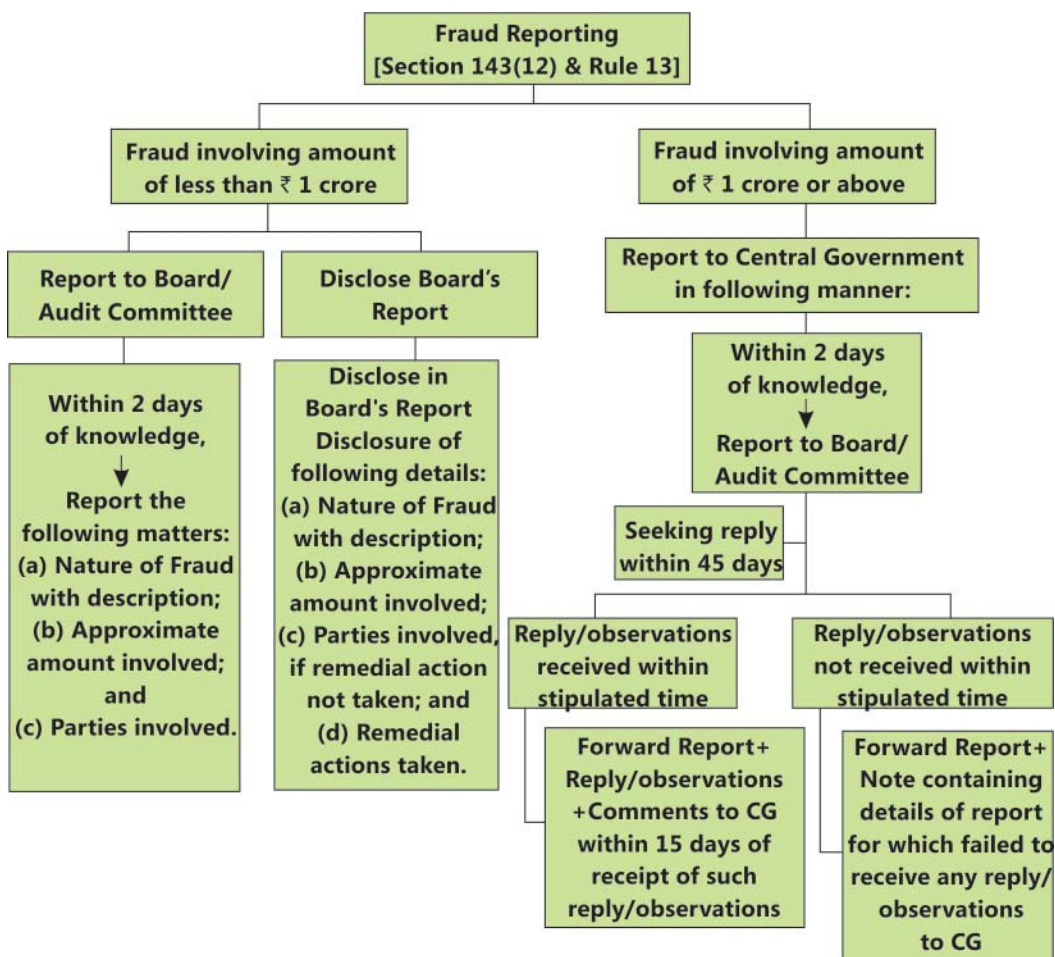
In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub- rule (1) **[i.e. less than ₹ 1 crore]**, the auditor shall report the matter to Audit Committee constituted under section 177 or 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.



Sub-section (13) of section 143 of the Companies Act, 2013 safeguards the act of fraud reporting by the auditor if it is done in good faith. It states that no duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter above if it is done in good faith.

It is very important to note that these provisions shall also apply, *mutatis mutandis*, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively. If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12) of section 143, he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

Reporting on Frauds already detected and reported: The auditor should apply professional skepticism to evaluate/verify that the fraud was indeed identified/detected in all aspects by the management or through the company's

vigil/whistle blower mechanism so that distinction can be clearly made with respect to frauds identified/detected due to matters raised by the auditor vis-à-vis those identified/detected by the company through its internal control mechanism.

Since reporting on fraud under section 143(12) is required even by the cost auditor and the secretarial auditor of the company, it is possible that a suspected offence involving fraud may have been reported by them even before the auditor became aware of the fraud. Here too, if a suspected offence of fraud has already been reported under section 143(12) by such other person, and the auditor becomes aware of such suspected offence involving fraud, he need not report the same since he has not per se identified the suspected offence of fraud.

However, in case of a fraud which involves or is expected to involve individually, an amount of ₹ 1 crore or more, the auditor should review the steps taken by the management/those charged with governance with respect to the reported instance of suspected offence of fraud stated above, and if he is not satisfied with such steps, he should state the reasons for his dissatisfaction in writing and request the management/ those charged with governance to perform additional procedures to enable the auditor to satisfy himself that the matter has been appropriately addressed. If the management/those charged with governance fail to undertake appropriate additional procedures within 45 days of his request, the auditor would need to evaluate if he should report the matter to the Central Government in accordance with Rule 13 of the Companies (Audit and Auditors) Rules, 2014.

Reporting under Companies (Auditor's Report) Order, 2016 [CARO, 2016]: The auditor is also required to report under **clause (x)** of paragraph 3 of Companies (Auditor's Report) Order, 2016, 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.

The scope of auditor's inquiry under this clause is restricted to frauds 'noticed or reported' during the year. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud by the company or on the company by its Officer or employees has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of SA 240, "The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements".

Audit Procedures and Reporting under CARO:

- (1) While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. While planning, the auditor should also make inquiries of management to determine whether management is aware of any known fraud or suspected fraud that the company is investigating.
- (2) The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon.

The auditor should enquire from the management about any frauds on the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees including officers of the company. The auditor should also examine the minute book of the board meeting of the company in this regard.

- (3) The auditor should obtain written representations from management that:
 - (i) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error;
 - (ii) it believes the effects of those uncorrected misstatements in financial statements, aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;
 - (iii) it has
 - (a) disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and
 - (b) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
4. Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written

representation from management that any uncorrected misstatements resulting from fraud are, in management's opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements. For that reason, management may want to add to their written representation words such as, "We do not agree that items constitute misstatements because [description of reasons]."

The auditor should consider if any fraud has been reported by them during the year under section 143(12) of the Act and if so whether that same would be reported under this Clause. It may be mentioned here that section 143(12) of the Act requires the auditor has reasons to believe that a fraud is being committed or has been committed by an employee or officer. In such a case the auditor needs to report to the Central Government or the Audit Committee. However, this Clause will include only the reported frauds and not suspected fraud.

5. Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following:
 - (i) This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified the fraud by the company or on the company by its officers or employees are only covered.
 - (ii) Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds.
 - (iii) While reporting under this clause with regard to the nature and the amount involved of the frauds noticed or reported, the auditor may also consider the principles of materiality outlined in Standards on Auditing.



6. AUDITOR UNABLE TO CONTINUE THE ENGAGEMENT

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

to continue performing the audit, the auditor shall:

- (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
- (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and
- (c) If the auditor withdraws:
 - (i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
 - (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

SUMMARY

SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" defines the term 'fraud' as "an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage".

Two types of intentional misstatements are relevant to the auditor—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. Misappropriation of Assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts.

As per SA 240 the primary responsibility for the prevention and detection of fraud rests with management. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.

Fraud Risk Factors may be defined as events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Fraud Reporting[Section 143(12) of Companies Act, 2013 & Rule 13 of CAAR, 2014]

A. Reporting of Fraud involving amount of less than 1 crore rupees : Auditor to Report Board/Audit Committee within 2 days of knowledge of fraud.

The auditor should Report the following matters:(a) Nature of Fraud with description;(b) Approximate amount involved; and (c) Parties involved.

Company is bound to disclose certain specified details in Board's Report as (a) Nature of Fraud with description; (b) Approximate amount involved; (c) Parties involved, if remedial action not taken; and (d) Remedial actions taken.

B. Reporting of Fraud involving amount of rupees 1 crore or above: 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;

- ◆ In case reply/observations received within stipulated time, the auditor is required
- ◆ to forward report along with reply/observations and comments to Central Government within 15 days of receipt of such reply/observations.
- ◆ In case reply/observations not received within stipulated time (within 45 days) the auditor should forward the report along with note containing details of report for which failed to receive any reply/observations to Central Government.

TEST YOUR KNOWLEDGE

MCQs

1. When credit purchases of ₹ 5,100 is recorded on credit side and credit sales of ₹ 5,100 is recorded on debit side, this kind of error is called_____.
 - (a) Error of omission
 - (b) Compensating error

- (c) Error of principle
 - (d) Error of commission
2. If as a result of a misstatement resulting from fraud, the auditor encounters exceptional circumstances that bring into question his ability to continue performing the audit, he shall-
- (a) Withdraw from the engagement immediately
 - (b) Report to Audit team regarding withdrawal
 - (c) Determine the professional and legal responsibilities applicable in the circumstances.
 - (d) Ask the management for his withdrawal
3. Which of the following is an example of inflating cash payments? ● ●
- (a) Making payments against purchase vouchers.
 - (b) Teeming and lading
 - (c) Not accounting for cash sales fully.
 - (d) Making payments against inflated vouchers.
4. The type of errors, existence of which becomes apparent in the process of compilation of accounts is known as:
- (a) Self-revealing errors.
 - (b) Intentional errors
 - (c) Concealed errors
 - (d) Unconcealed errors.
5. Misappropriation of assets may occur because there is-
- (a) Adequate record keeping with respect to assets
 - (b) Known history of violations of securities laws.
 - (c) Lack of complete and timely reconciliations of assets
 - (d) Dispute between shareholders in a closely held entity

Correct/Incorrect

State with reasons (in short) whether the following statement is correct or incorrect:

- (I) Teeming and lading is one of the techniques of inflating cash payments.
- (i) Fraud can be termed as intentional error
- (iii) Auditor needs to report to Central Government in case of fraud involving 20 lakhs rupees.
- (iv) The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.
- (v) Fraudulent financial reporting only involves manipulation, falsification or alteration of accounting records or supporting documents from which financial statements are prepared.

Theoretical Questions

1. What do you understand by the term 'fraud'? Provide its meaning as given as under the Standard on Auditing (SA) 240.
2. Briefly explain self-revealing errors with the help of some illustration.
3. There are many ways for cash defalcation, one of which is suppressing cash receipts. List out few techniques of how the receipts are suppressed.
4. Fraud Risk Factors are the events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Further, the nature of the industry or the entity's operations also provides opportunities to engage in fraudulent financial reporting. List out some of the cases from where these opportunities may arise.
5. You notice a misstatement resulting from fraud or suspected fraud during the audit and conclude that it is not possible to continue the performance of audit. As a statutory Auditor, how would you deal?

ANSWERS/SOLUTIONS

Answers to MCQs

1. (b) 2. (c) 3. (d) 4. (a) 5. (c)

Answers to Correct/Incorrect

- (i) **Incorrect:** Teeming and Lading is one of the techniques of suppressing cash receipts and not of inflating cash payments. Money received from one customer is misappropriated and the account is adjusted with the subsequent receipt from another customer and so on.
- (ii) **Correct:** Fraud is the word used to mean intentional error. This is done deliberately which implies that there is intent to deceive, to mislead or at least to conceal the truth. It follows that other things being equal they are more serious than unintentional errors because of the implication of dishonesty which accompanies them.
- (iii) **Incorrect:** As per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government (in case amount of fraud is ₹ 1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than 1 crore) within such time and in such manner as may be prescribed.
- Thus fraud involving amount of 20 lakh rupees should be reported to Audit Committee.
- (iv) **Correct:** As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements'. It is important that management, with the oversight of those charged with governance place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detention and punishment. This involves a commitment to create a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance.
- (v) **Incorrect:** As per SA 240, "The Auditor's Responsibilities Relating to fraud in an Audit of Financial Statements', fraudulent financial reporting may involve manipulation, falsification or alteration of accounting records or supporting documents from which financial statements are prepared, misrepresentation in or intentional omission from, financial statements of events, transaction or other significant information or intentional misapplication of accounting principles relating to amounts, classification, manner of presentation or disclosure.

Answer to Theoretical Questions

1. **Meaning of Fraud:** The SA 240 'The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements; defines the term fraud as an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.
2. **Self Revealing Errors:** These are such errors the existence of which becomes apparent in the process of compilation of account. A few illustrations of such errors are given hereunder, showing how they become apparent.

(i)	Omission to post a part of a journal entry to the ledger.	Trial balance is thrown out of agreement
(ii)	Wrong totaling of the Purchase Register	Control Account [e.g. the Sundry Trade payables Account] balances and the aggregate of the balance in the personal ledger will disagree.
(iii)	A failure to record in the cash book amounts paid into or withdrawn from the bank.	Bank reconciliation statement will show up error.
(iv)	A mistake in recording amount received from X in the account of Y.	Statements of account of parties will reveal mistake.

From the above, it is clear that certain apparent errors balance almost automatically by double entry accounting procedure and by following established practices that lie within the accounting system but not being generally considered to be a part of it, like bank reconciliation or sending monthly statements of account for confirmation.

3. Declaration of Cash by Supporting Cash Receipts: Refer Para 2.2.2.2
4. Fraud Risk Factors-Opportunities. Refer 4.1
5. Impossible to Continue the Performance of Audit: refer Para 6.

AUDIT IN AN AUTOMATED ENVIRONMENT



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ☐ Understand the meaning of an Automated environment.
- ☐ Understand the relevance of IT in an audit.
- ☐ Learn how to perform an understanding of an Automated environment and documenting the same.
- ☐ Identify the various risks in Automated environment and the corresponding controls.
- ☐ Gain knowledge of internal financial controls as per regulatory requirements.
- ☐ Recognize the way data analytics can be used in an audit.
- ☐ Learn to assess and report audit findings.

CHAPTER OVERVIEW

With the increasing adoption of information technology, business today rely on software systems and applications more than ever. Many of these IT systems generate and process data that is used in the preparation of financial statements of a company. The auditors also often rely on the data and reports that are generated from these systems. In this context, it is critical to understand the IT specific risks that could potentially impact the integrity and reliability of financial transactions and data flowing through a company's systems.

In this chapter, we will learn about the need, relevance and approach to be adopted when performing an audit in an Automated environment that is driven by IT systems and applications that are used in the preparation of financial statements of a company. We will see how the work performed with respect to Automated environment fits into the overall financial statement audit process. We will also understand how data analytics can become useful in an audit.

Finally, we will look at how to assess audit findings and report them to the stakeholders.

**1. WHAT IS AN AUTOMATED ENVIRONMENT?**

Let us first understand what the term "Automated Environment" means. An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems. Nowadays, it is very common to see computer systems being used in almost every type of business.

Example

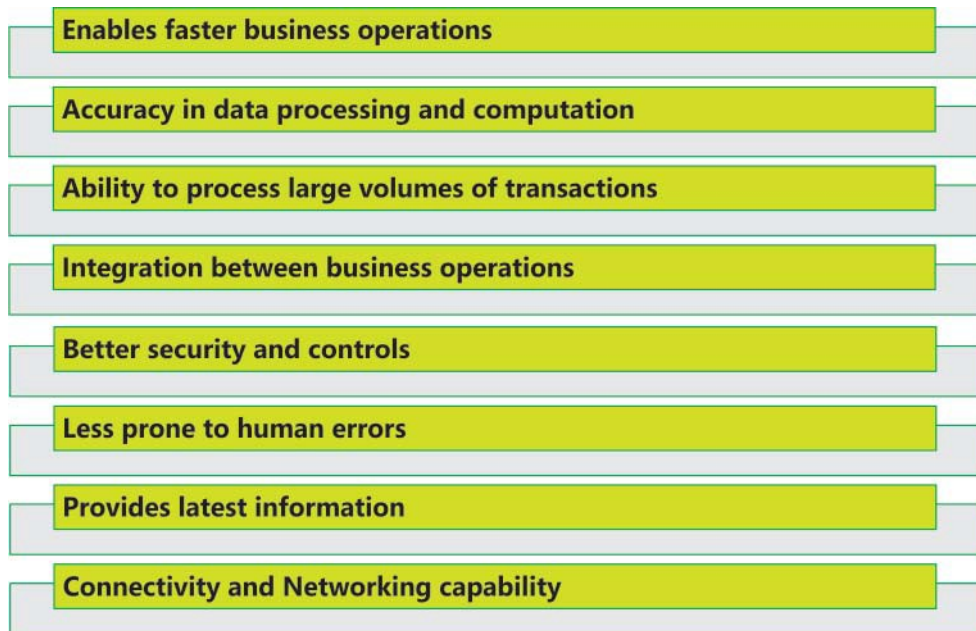
Think about how banking transactions are carried out using ATMs (Automated Teller Machines), or how tickets can be purchased using "apps" on mobile phones, etc. In these examples, you can see how these computer systems enable us to transact business at any time and any day.

Some of the key features of an automated environment are as follows:

1.1 Key features of an Automated Environment

The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business

environment is more automated, it is likely to be more complex.



If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using an off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment.

Example

Similarly, there are several other aspects that an auditor should consider to determine the level of automation and complexity of a business environment which we will look at in the following sections.



2. RELEVANCE OF 'IT' IN AN AUDIT

When a business operates in a more automated environment it is likely that we will see several business functions and activities happening within the systems. Consider the following aspects instead of:

- ♦ Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation).
- ♦ Accounting entries are posted automatically (for example, sub-ledger to GL postings are automatic).

- ◆ Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically).
- ◆ Reports used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report).
- ◆ User access and security are controlled by assigning system roles to users (**for example**, segregation of duties can be enforced effectively).

Companies derive benefit from the use of IT systems as an enabler to support various business operations and activities. Auditors need to understand the relevance of these IT systems to an audit of financial statements.

While it is true that the use of IT systems and automation benefit the business by making operations more accurate, reliable, effective and efficient, such systems also introduce certain new risks, including IT specific risks, which need to be considered, assessed and addressed by management.

To the extent that it is relevant to an audit of financial statements, even auditors are required to understand, assess and respond to such risks that arise from the use of IT systems.

[Note: Students may refer SA 315 – Identifying and assessing the risks of material misstatement through understanding the entity and its environment for detailed understanding]

In an audit of financial statements, the primary focus is around those risks that are relevant to financial reporting. However, there could be other non-audit assurance engagements that auditors maybe involved wherein the area of focus could include those IT risks relevant to company's compliance and business operations in addition to financial reporting risks.

Examples of such non-audit assurance engagements are internal audits, IT audits, pre-implementation reviews, data migration audits, third party assurance.

With the introduction of the Companies Act 2013, there is greater emphasis given to internal financial controls (IFC) from a regulatory point of view. Directors and those charged with governance (including Board of directors, Audit committee) are responsible for the implementation of internal controls framework within the company. The auditors' responsibilities now include reporting on Internal Financial Controls over Financial Reporting which include and understanding IT environment of the company and relevant risks & controls. We will learn more about IFC in

further sections of this chapter.

Given below are some situations in which IT will be relevant to an audit,

- ◆ Increased use of Systems and Application software in Business (for example, use of ERPs)
- ◆ Complexity of transactions has increased (multiple systems, network of systems)
- ◆ Hi-tech nature of business (Telecom, e-Commerce).
- ◆ Volume of transactions are high (Insurance, Banking, Railways ticketing).
- ◆ Company Policy (Compliance).
- ◆ Regulatory requirements - Companies Act 2013 IFC, IT Act 2008.
- ◆ Required by Indian and International Standards - ISO, PCI-DSS, SA 315, SOC, ISAE.
- ◆ Increases efficiency and effectiveness of audit.

In some of the above situations it is likely that carrying out audit using traditional substantive audit procedures may be difficult or even not feasible if the company prepares, records and conducts majority of business activities through IT systems only.

On the other hand, many companies may use less complex IT systems including desktop based accounting or spreadsheets. In such situations, the relevance of IT to an audit could be less. However, the auditor is still required to carry out at least an understanding the IT environment of the company and document the same.

Another area where IT can be relevant to audit is by using data analytics using computer assisted audit techniques (CAATs). By using data analytics, it is possible to improve the effectiveness and efficiency of an audit. We will learn more about data analytics in the later sections of this chapter.

From the above, we can see how IT is relevant to an audit under different situations viz., audit, non-audit and meeting regulatory compliance requirements. We will learn more about understanding risks, controls and documentation in further sections of this chapter.



3. RISKS & CONTROLS IN AN AUTOMATED ENVIRONMENT

3.1 Understanding and Documenting Automated Environment

In the previous section, we have learnt that, in an audit of financial statements, an auditor is required to understand the entity and its business, including IT as per SA 315. Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.

Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment:

- ◆ Information systems being used (one or more application systems and what they are).
- ◆ Their purpose (financial and non-financial).
- ◆ Location of IT systems - local vs global.
- ◆ Architecture (desktop based, client-server, web application, cloud based).
- ◆ Version (functions and risks could vary in different versions of same application).
- ◆ Interfaces within systems (in case multiple systems exist).
- ◆ In-house vs Packaged.
- ◆ Outsourced activities (IT maintenance and support).
- ◆ Key persons (CIO, CISO, Administrators).

The understanding of a company's IT environment that is obtained should be documented [Ref. SA 230 – *Audit Documentation*] using any standard format or template.

An example of one such template that can be used to document our understanding is illustrated below.

Information Systems being used	Version	Purpose	Location- Local vs global	Architecture	Interfaces within systems	In-House vs. Packaged	Outsourced Activities	Key Persons	In-Scope
SAP	ECC 6.0, EHPS	Accounting, Supply chain, Production	Texas, USA	Client/Server, Unix AIX 5.3, MS-SQL Server 2008	Paymaster	Packaged		CIO, Administrators	Yes

PayMaster	5.3	Payroll	Gurgaon, India	Web-based, Windows, Apache, Oracle 11g	SAP, Accent	Package d	Payroll processed at ADP		Yes
Accent	2	Appraisal	Hyderabad, India	Lotus Notes, Windows	Paymaster	In-house			No
Budget King	1	Management MIS Budgeting	Hyderabad, India	Web-based, Windows, Apache, Oracle 11 g	None	In-house			No

Having a summarized document helps the auditor in determining the areas considered in scope of audit as can be seen from the last column. In this illustration, it can be seen that two applications have been considered as in scope for audit based on the purpose and financial relevance to the audit.

Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems.

Given below are some such risks that should be considered:

- ◆ Inaccurate processing of data, processing inaccurate data, or both.
- ◆ Unauthorized access to data.
- ◆ Direct data changes (backend changes).
- ◆ Excessive access / Privileged access (super users).
- ◆ Lack of adequate segregation of duties.
- ◆ Unauthorized changes to systems or programs.
- ◆ Failure to make necessary changes to systems or programs.
- ◆ Loss of data.

3.2 Impact of IT related risks i.e. on Substantive Audit, Controls and Reporting

The above risks, if not mitigated, could have an impact on audit in different ways. Let us understand how:

Impact on Substantive Audit	Impact on Controls	Impact on Reporting
● cannot rely on the data obtained from systems ● system data and reports should be tested substantively for completeness and accuracy ● more audit evidence is needed	● cannot rely on automated controls, system calculations and accounting procedures built into applications ● cannot rely on IT dependent manual controls ● system data and reports should be tested substantively for completeness and accuracy ● more substantive audit work is needed	● communication to those charged with governance ● modified auditors report

- ◆ First, we may not be able to rely on the data obtained from systems where such risks exist. This means, all forms of data, information or reports that we obtain from systems for the purpose of audit has to be thoroughly tested and corroborated for completeness and accuracy.
- ◆ Second, we will not be able to rely on automated controls, calculations, accounting procedures that are built into the applications. Additional audit work may be required in this case.
- ◆ Third, due to the regulatory requirement of auditors to report on internal financial controls of a company, the audit report also may have to be modified in some instances.

In all the above scenarios, it is likely that the auditor will be required to obtain more audit evidence and perform additional audit work. The auditor should also be able to demonstrate how the risks were identified and what audit evidence was obtained and validated to address these IT risks.

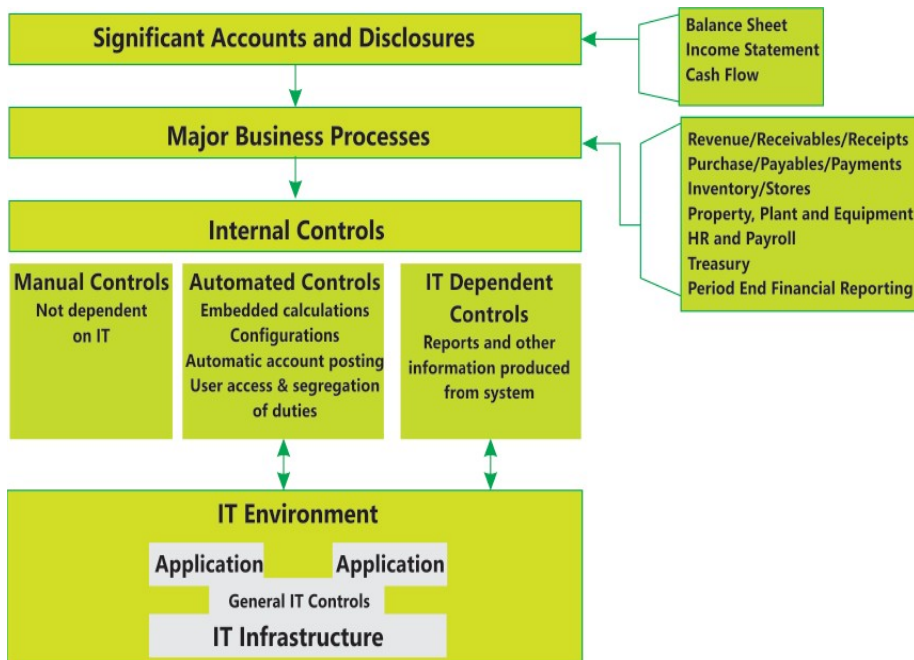
Here, we should remember that as the complexity, automation and dependence of business operations on IT systems increases, the severity and impact of IT risks too increases accordingly. The auditor should apply professional judgement in determining and assessing such risks and plan the audit response appropriately.

To mitigate the above (and more) risks and maintain the confidentiality, integrity,

availability and security of data, companies implement IT controls. Let us learn about the various types of IT controls in more detail.

3.3 Types of Controls in an Automated Environment

- ◆ General IT Controls
- ◆ Application Controls
- ◆ IT-Dependent Controls



3.3.1 General IT Controls

“General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments.

General IT-controls that maintain the **integrity** of information and **security of data** commonly include controls over the following:” (SA 315)

- ◆ Data center and network operations
- ◆ Program change
- ◆ Access security
- ◆ Application system acquisition, development, and maintenance (Business Applications)

These are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as “pervasive” controls or “indirect” controls. Let us now learn about each of the General IT controls in more detail.

Data Center and Network Operations

Objective: To ensure that production systems are processed to meet financial reporting objectives.

Activities:

- ◆ Overall Management of Computer Operations Activities
- ◆ Batch jobs – preparing, scheduling and executing
- ◆ Backups – monitoring, storage & retention
- ◆ Performance Monitoring – operating system, database and networks
- ◆ Recovery from Failures – BCP, DRP
- ◆ Help Desk Functions – recording, monitoring & tracking
- ◆ Service Level Agreements – monitoring & compliance
- ◆ Documentation – operations manuals, service reports

Program Change

Objective: To ensure that modified systems continue to meet financial reporting objectives.

Activities:

- ◆ Change Management Process – definition, roles & responsibilities
- ◆ Change Requests – record, manage, track
- ◆ Making Changes – analyze, design, develop
- ◆ Test Changes – test plan, test cases, UAT
- ◆ Apply Changes in Production
- ◆ Emergency & Minor Changes
- ◆ Documentation – user/technical manuals
- ◆ User Training

Access Security

Objective: To ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.

Activities:

- ◆ Security Organization & Management
- ◆ Security Policies & Procedures
- ◆ Application Security
- ◆ Data Security
- ◆ Operating System Security
- ◆ Network Security – internal network, perimeter network
- ◆ Physical Security – access controls, environment controls
- ◆ System Administration & Privileged Accounts – Sysadmins, DBAs, Super users

Application system acquisition, development, and maintenance

Objective: To ensure that systems are developed, configured and implemented to meet financial reporting objectives.

Activities:

- ◆ Overall Mgmt. of Development Activities
- ◆ Project Initiation
- ◆ Analysis & Design
- ◆ Construction
- ◆ Testing & Quality Assurance
- ◆ Data Conversion
- ◆ Go-Live Decision
- ◆ Documentation & Training

3.3.2 Application Controls

Application controls include both automated or manual controls that operate at a business process level. Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems.

Examples of automated applications include edit checks and validation of input data, sequence number checks, user limit checks, reasonableness checks, mandatory data fields.

3.3.3 IT dependent Controls

IT dependent controls are basically manual controls that make use of some form of data or information or report produced from IT systems and applications. In this case, even though the control is performed manually, the design and effectiveness of such controls depends on the reliability of source data.

Due to the inherent dependency on IT, the effectiveness and reliability of Automated application controls and IT dependent controls require the General IT Controls to be effective.

3.3.4 General IT Controls vs. Application Controls

- ◆ These two categories of control over IT systems are interrelated.
- ◆ The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems.

4. TESTING METHODS

Having learnt about the various IT risks and controls, let us understand the different ways testing is performed in an automated environment. There are basically four types of audit tests that should be used. They are inquiry, observation, inspection and reperformance. As shown in the illustration below, inquiry is the most efficient audit test but it is also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.

Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.

Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors including risk



assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business, assertions being addressed, etc. The auditor should document the nature of test (or combination of tests) applied along with the judgements in the audit file as required by SA 230.

When testing in an automated environment, some of the more common methods are as follows:

- ◆ Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
- ◆ Observe how a user processes transactions under different scenarios.
- ◆ Inspect the configuration defined in an application.

Example

Refer below screenshot of configuration for duplicate invoice check in SAP application.

Maintain Field Status Group: Payment transactions

Field check

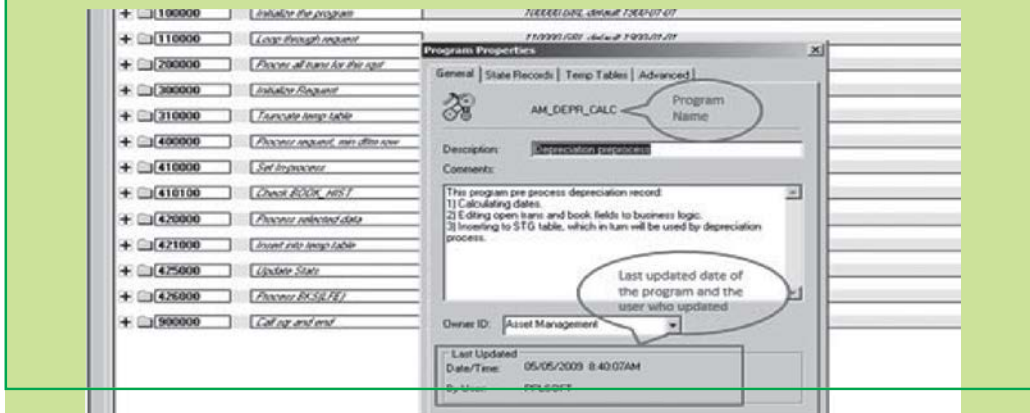
Page 1 / 1

	Suppress	Req. Entry	Opt. entry	Display
General Data				
Acct group: 0001				
Vendors				
Company code data				
Payment transactions				
Terms of payment	☐	☐	☒	☐
Double invoice validation	☐	☒	☐	☐

- ◆ Inspect the system logs to determine any changes made since last audit testing.

Example

For example, refer below screenshot for the last modified date of depreciation calculation program in PeopleSoft application



- ◆ Inspect technical manual / user manual of systems and applications.
- ◆ Carry out a test check (negative testing) and observe the error message displayed by the application.

Example

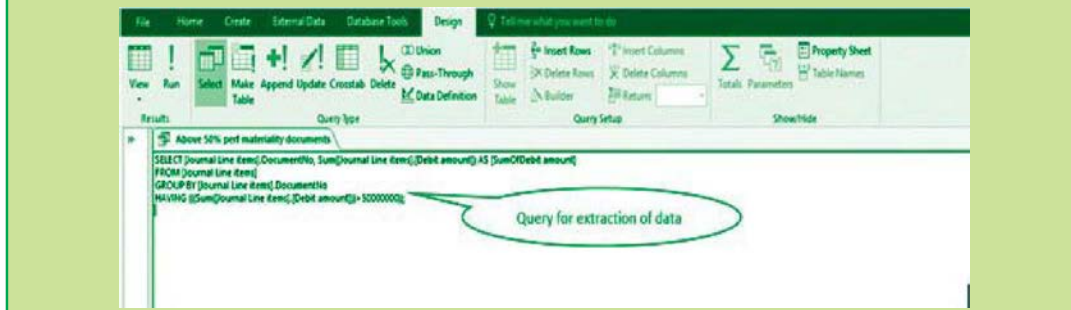
See below an error displayed by an application i.e. JD Edwards, when posting a transaction in closed period.



Conduct reperformance using raw source data and independently applying formulae, business rules or validations on the source data using CAATs.

Example

Refer below the screenshot of a query in MS Access for extraction of journal entries for above rupees 5 crores.



To rely on the system and application based information including data, reports, automated controls, configurations, calculations and IT dependent it is essential to first determine the existence and effectiveness of General IT Controls [ref para 3.3 above]. Where the general IT controls are not existing or existing but ineffective, the auditor should assess the impact of IT risks and complexity of the automated environment in which the business operations take place and plan alternative audit procedures in order to rely on the system based information [ref para 3.2 above].

5. INTERNAL FINANCIAL CONTROLS AS PER REGULATORY REQUIREMENTS

The term **Internal Financial Controls (IFC)** basically refers to the policies and procedures put in place by companies for ensuring:

- ◆ reliability of financial reporting
- ◆ effectiveness and efficiency of operations
- ◆ compliance with applicable laws and regulations
- ◆ safeguarding of assets
- ◆ prevention and detection of frauds

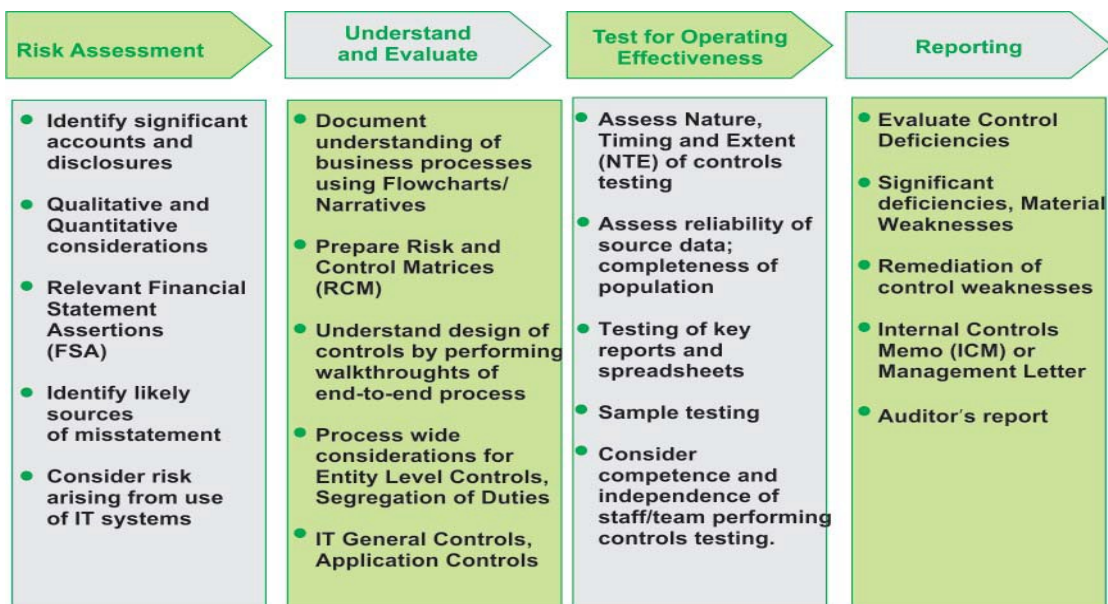
The Companies Act, 2013 has placed a greater emphasis on the effective implementation and reporting on the internal controls for a company. The table below gives a summary of the requirements of the Act.

Reference	Who is responsible	Applicability
Sec 134(5)(e)	Board of Directors	Listed Companies*
Rule 8 (5) of Companies (Accounts) Rules	Board of Directors	All Companies
Sec 149(8) and Schedule IV	Independent Directors	All companies having Independent Directors
Sec 177	Audit Committee	All companies having Audit committee
Sec 143(3) (i)	Statutory Auditors	All Companies#

* IFC is applicable from April 1, 2014 onwards, for companies.

Auditor's opinion on IFC is applicable from the financial year 2015-16 onwards wherein the Statutory Auditors, along with their opinion on financial statements, should also provide an Independent Opinion on the Design and Operating Effectiveness of Internal Financial Controls over Financial Reporting (IFC-FR) of the company as at Balance Sheet date.

The directors and management have primary responsibility of implementing and maintaining an effective internal controls framework and auditors are expected to evaluate, validate and report on the design and operating effectiveness of internal financial controls. The Guidance note on Audit of Internal Financial Controls over Financial Reporting issued by the Institute of Chartered Accountants of India provides a framework that auditors should follow to fulfil their responsibility. The below illustration is a summary of this controls based audit approach.



5.1 Audit Approach



6. DATA ANALYTICS FOR AUDIT

In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. A famous businessman recently said, "Data is the new Oil".

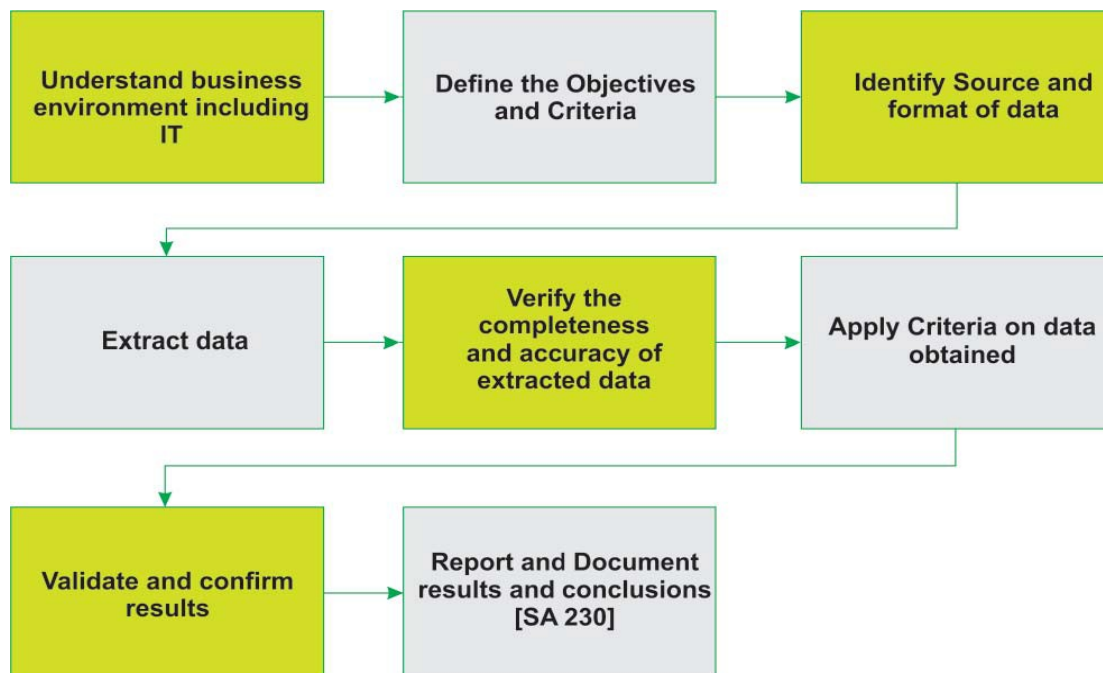
The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics. While it is true that companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even auditors can make use of similar tools and techniques in the audit process and obtain good results. The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short.

Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

- ◆ Check completeness of data and population that is used in either test of controls or substantive audit tests.
- ◆ Selection of audit samples – random sampling, systematic sampling.
- ◆ Re-computation of balances – reconstruction of trial balance from transaction data.
- ◆ Reperformance of mathematical calculations – depreciation, bank interest calculation.
- ◆ Analysis of journal entries as required by SA 240.
- ◆ Fraud investigation.
- ◆ Evaluating impact of control deficiencies.

There are several steps that should be followed to achieve success with CAATs and any of the supporting tools.

A suggested approach to benefit from the use of CAATs is given in the illustration below:



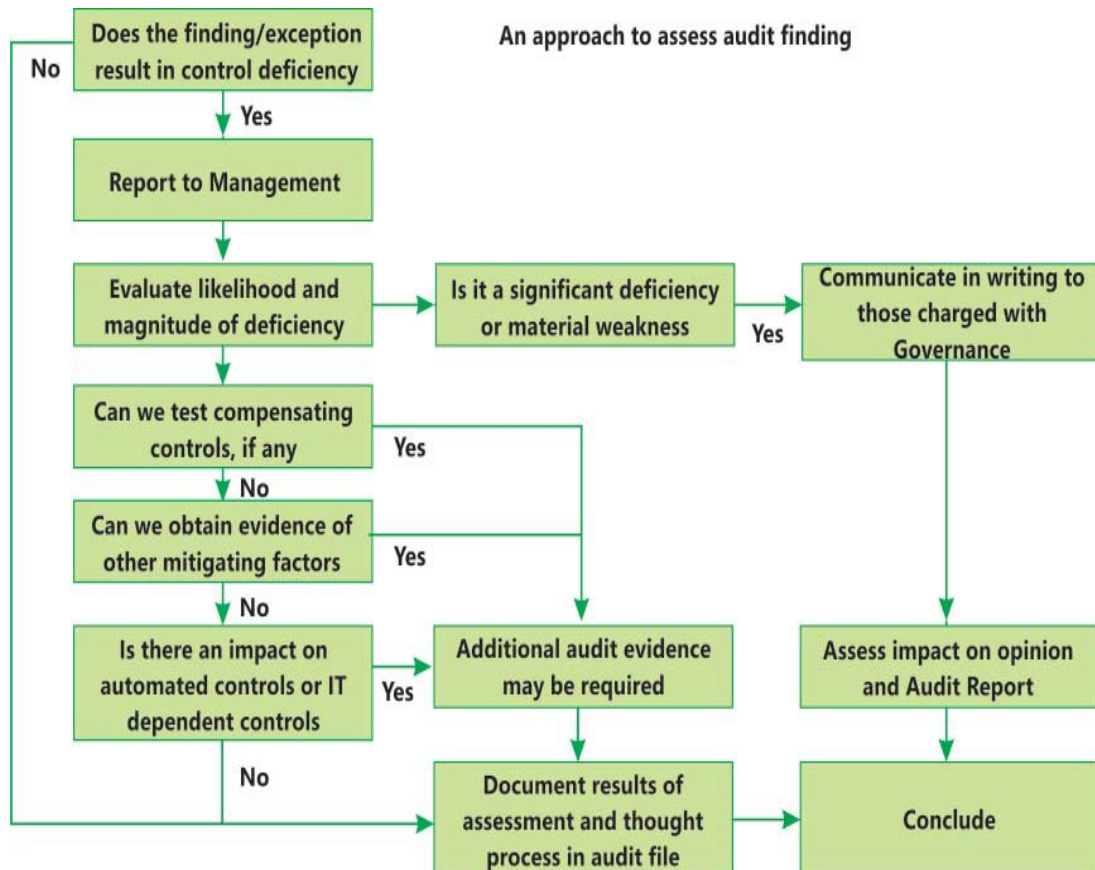
7. ASSESS AND REPORT AUDIT FINDINGS

At the conclusion of each audit, it is possible that there will be certain findings or exceptions in IT environment and IT controls of the company that need to be assessed and reported to relevant stakeholders including management and those charged with governance viz., Board of directors, Audit committee [Students may refer SA 260 (Revised) – *Communication with Those Charged with Governance for more details*].

Some points to consider are as follows:

- ◆ Are there any weaknesses in IT controls?
- ◆ What is the impact of these weaknesses on overall audit?
- ◆ Report deficiencies to management – Internal Controls Memo or Management Letter.
- ◆ Communicate in writing any significant deficiencies to Those Charged With Governance.

The auditor needs to assess each finding or exception to determine impact on the audit and evaluate if the exception results in a deficiency in internal control. Refer to the flowchart to learn how this assessment should be carried out. This approach and thought process is the same when auditing in an automated environment or when auditing in a more manual environment.



A deficiency in internal control exists if a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or the control is missing.

Evaluation and assessment of audit findings and control deficiencies involves applying professional judgement that include considerations for quantitative and qualitative measures. Each finding should be looked at individually and in the aggregate by combining with other findings/deficiencies.

The illustration below is an example of a control deficiency in General IT Controls and how this audit finding is reported to management.

7.1 Reporting Audit Findings – An Illustration

Password resets should be supported with proper request.	
Observation	As per Information Security Policy User Access changes should be initiated and approved. However, we observed that there is no formal process being followed for password reset in SAP. Password reset requests are presently communicated over phone and there is no supporting documentation being maintained for password reset requests. [Ref Information Security policy sub-section no.....]
Exposure	Passwords of User ID with critical privileges may be reset and misused. Non-compliance with Information Security Policy.
Recommendations	It is recommended that all password resets should be requested through a formal process. Adequate supporting documentation should be maintained for user changes in SAP, including password resets, and reviewed periodically.
Management Response	Comments



GLOSSARY

Applications	These are computer software programs that provide a medium for recording, storage and retrieval of business operations or transactions in electronic format.
Audit evidence	This is the data, information, reports that an auditor obtains during audit and forms the basis for an audit opinion.
Automated	A task or activity that is routinely performed by a computer system and does not require manual effort.
CAATs	Short form for Computer Assisted Audit Techniques, are a collection of computer based tools and techniques that are used in an audit for analysing data in electronic form to obtain audit evidence.

Control Deficiency	Exists when an internal control is either missing or not operating effectively to prevent or detect a misstatement in a timely manner by management.
Data	Refers to the digital content that is stored in electronic form within computer systems.
Data Analytics	A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information.
Data Processing	Refers to the systematic recording, storage, retrieval, modification and transformation of electronic data using information systems.
Database	A logical subsystem within a larger information system where electronic data is stored in a predefined form and retrieved for use.
Direct Data Change	A backend modification that is made directly to data that is stored in a database bypassing business rules built-in to a business application software.
ERP Enterprise Resource Planning	A type of business application software that provides an integrated platform to automate multiple interrelated business processes and operations.
Financial Reporting	Refers to the process of preparation, presentation and disclosure of financial statements in accordance with a specified reporting framework.
General (IT) Controls	Are a type of internal controls that help in mitigating risks that arise due to use of information technology and information systems in a business.
Information	Electronic data residing in computer systems that is organised in a logical and meaningful manner that is easy to read, understand and analyse.
Information Systems	Refers to a collection of electronic hardware, software, networks and processes that are used in a business to carry out operations and transactions.
Information Technology	The branch of science and engineering that involves designing, building, implementing and maintaining computer systems and networks that can be used in a

	variety of ways including operating businesses and setting up information systems.
Internal Controls	Are the policies and procedures that a company implements to ensure efficiency of business operations, reliability of financial reporting, compliance with laws & regulations, safeguarding of assets and prevention of frauds.
Mainframe	A term that is used to describe a very large computer with high computing power, memory and storage that are required for running large business operations. In addition to business operations, Mainframes are also used in fields of Research & Development, Space, Healthcare, Weather, etc.
Material Weakness	A control deficiency or a combination of deficiencies in internal controls that is important enough to merit the attention of those charged with governance since there is a reasonable possibility that a material misstatement will not be prevented or detected in a timely manner by management.
Operating System	Refers to a system software that is installed in a computer to convert high level user instructions or commands into low level machine understandable format and enable interaction with a computer.
Privileged access	A type of super user access to information systems that enforces less or no limits on using that system.
Risk	A possibility of something that can go wrong in a business process, transaction or operation and could result in a loss.
Segregation of duties	A type of internal control that is implemented in a company to prevent two or more conflicting functions from being assigned to or being carried out by the same person.
Significant Deficiency	A control deficiency or a combination of deficiencies in internal controls that is important enough to merit the attention of those charged with governance since there is a reasonable possibility that a misstatement will not be prevented or detected in a timely manner by management.
Software	A computer program or a collection of computer programs

	that provides an interface to a user for performing a specific activity, task, operation or transaction in electronic form through a computer or information system.
System	Refers to a collection of electronic hardware, software, networks and processes that are used in a business to carry out operations and transactions.



ABBREVIATION

IS	Information System
ATM	Automated Teller Machine
SA	Standards on Auditing
CIO	Chief Information Officer
CISO	Chief Information Security Officer
ELC	Entity Level Controls
FSLI	Financial Statement Line Item
GITC	General Information Technology Controls
IPE	Information Produced by Entity
FSA	Financial Statement Assertion
RCM	Risk & Control Matrix
NTE	Nature, Timing & Extent
ICM	Internal Controls Memorandum
SOD	Segregation of Duties
ERM	Enterprise Risk Management
COSO	Committee of Sponsoring Organisations
CAATS	Computer Assisted Auditing Techniques
ACL	Audit Command Language (CAAT Tool)
ISO	International Organization for Standardization
IFC	Internal Financial Controls

IFC-FR	Internal Financial Controls over Financial Reporting
ICFR	Internal Controls over Financial Reporting
SOX	Sarbanes Oxley Act of 2002
PCI - DSS	Payment Card Industry - Data Security Standard
ITIL	Information Technology Infrastructure Library
COBIT	Control Objectives for Information and Related Technologies
SOC	Service Organisation Controls
SSAE	Statement on Standards for Attest Engagements
ISAE	International Standards for Assurance Engagements
UAT	User Acceptance Testing
BCP	Business Continuity Plan
DRP	Disaster Recovery Plan
DBA	Data Base Administrator
Sysadmin	Systems Administrator

SUMMARY

An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems.

The fundamental principle of an automated environment is the ability carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation. As the complexity, automation and dependence of business operations on IT systems increases, the severity and impact of IT risks too increases accordingly.

The auditor should apply professional judgement in determining and assessing such risks and plan the audit response appropriately. To mitigate the above (and more) risks and maintain the confidentiality, integrity, availability and security of data, companies implement IT controls.

Three types of controls in automated environment are (i) General IT Controls (ii)

Application Controls and (iii) IT-Dependent Controls.

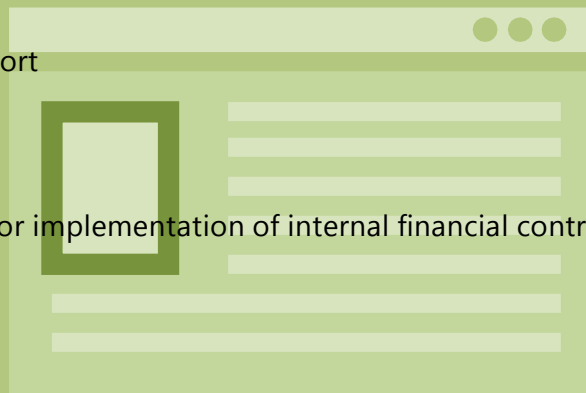
There are basically four types of audit tests that should be used. They are inquiry, observation, inspection and reperformance. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools.

A deficiency in internal control exists if a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or the control is missing. Evaluation and assessment of audit findings and control deficiencies involves applying professional judgement that include considerations for quantitative and qualitative measures.

TEST YOUR KNOWLEDGE

MCQs

1. Which of the following is a General IT control?
 - (a) IT Environment
 - (b) Application Control
 - (c) Access Security
 - (d) IT Dependent Control
2. Which of the following is an automated control?
 - (a) Program change
 - (b) System generated report
 - (c) Application control
 - (d) Configurations
3. Who is mainly responsible for implementation of internal financial controls in a company?
 - (a) Auditors
 - (b) Directors
 - (c) Employees
 - (d) Regulators



4. The Guidance Note on Audit of Internal Financial Controls over Financial Reporting has been issued by?
- (a) ICAI
 - (b) SEBI
 - (c) MCA
 - (d) RBI
5. The standard that requires auditors to analyse journal entries in an audit is?
- (a) SA 260
 - (b) SA 230
 - (c) SA 315
 - (d) SA 240

Correct/Incorrect

State with reasons (in short) whether the following statement is correct or incorrect:

- (i) All automated environments are complex.
- (ii) In an audit of financial statements, the auditor should plan response to all IT risks.
- (iii) General IT controls support the functioning of Application controls.
- (iv) Inquiry is often the most efficient audit testing method, but least effective.
- (v) Specialised audit tools like IDEA, ACL are required to perform data analytics.

Theoretical Questions

1. Briefly mention three reasons why IT should be considered relevant to an audit of financial statements.
2. Describe how risks in IT systems, if not mitigated, could have an impact on audit
3. What are the different testing methods used when auditing in an automated environment. Which is the most effective and efficient method of testing?

ANSWERS/SOLUTIONS

Answers to MCQs

1. (c) 2. (d) 3. (b) 4. (a) 5. (d)

Answers to Correct/Incorrect

- (i) **Incorrect.** The complexity of an automated environment depends on various factors including the nature of business, level of automation, volume of transactions, use of ERP and so on. There could be environment where dependence on IT and automation is relatively less or minimal and hence, considered less complex or even non-complex.
- (ii) **Incorrect.** The auditor should plan response to those IT risks that are relevant to financial reporting and not "all" IT risks.
- (iii) **Correct.** General IT controls support the functioning of automated application controls and IT dependent controls.
- (iv) **Correct.** Inquiry is the most efficient but least effective. Moreover, testing through inquiry alone is not sufficient. Inquiry should be corroborated by applying any one or a combination of observation, inspection or reperformance.
- (v) **Incorrect.** Even though specialised audit tools are very useful, such tools are not always required or necessary to carry out data analytics. More commonly available spreadsheet applications like MS-Excel can also be effectively used for carrying out data analytics.

Answers to Theoretical Questions

1. The auditor should consider relevance of IT in an audit of financial statements for the following reasons:
- (a) Since auditors rely on the reports and information generated by IT systems, there could be risk in the IT systems that could have an impact on audit.
 - (b) Standards on auditing SA 315 and SA 330 require auditors to understand, assess and respond to risks that arise from the use of IT systems.
 - (c) By relying on automated controls and using data analytics in an audit, it is possible to increase the effectiveness and efficiency of the audit process.

2. When risks in IT systems are not mitigated the audit impact could be as follows:
 - (i) The auditor may not be able rely on the reports, data obtained, automated controls, calculations and accounting procedures in the IT system.
 - (ii) The auditor has to perform additional audit work by spending more time and efforts.
 - (iii) The auditor may have to issue a modified opinion, if necessary.
3. When auditing in an automated environment, the following testing methods are used:
 - (a) Inquiry
 - (b) Observation
 - (c) Inspection
 - (d) Reperformance

A combination of inquiry and inspection is generally the most effective and efficient testing method. However, determining the most effective and efficient testing method is a matter of professional judgement and depends on the several factors including risk assessment, control environment, desired level of evidence required, history of errors /misstatements, complexity of business, assertions being addressed.

AUDIT SAMPLING

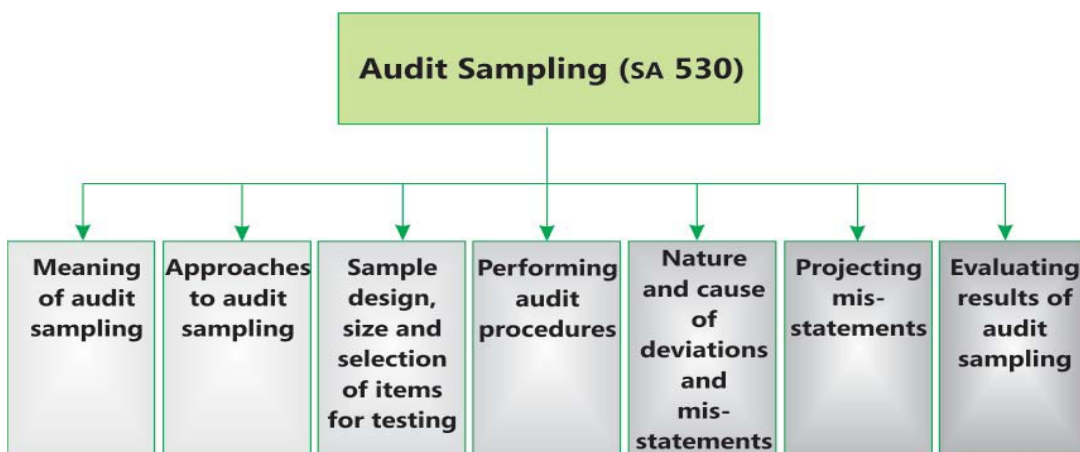


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Define Audit Sampling as per Standards on Auditing 530 and its importance.
- ❑ Identify the Approaches to Audit Sampling and Sample Selection Methods.
- ❑ Gain the knowledge of sample design, size and selection of items for testing and Sampling Risk.
- ❑ Understand the sampling techniques and how/when to apply them to audit procedures.

CHAPTER OVERVIEW





1. SAMPLING: AN AUDIT PROCEDURE

No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished and auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment of non-consequential routine checking. By routine checking we traditionally think of extensive checking and vouching of all entries.

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor, there is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do is to express his opinion and become bound by that.

To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On a consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking, he should adopt standards and techniques which are widely followed and which have a recognised basis. Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability.



2. MEANING OF AUDIT SAMPLING

According to SA 530 "Audit sampling", 'audit sampling' refers to the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on



which to draw conclusions about the entire population.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

2.1 Population

Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

The auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

2.1.1 Characteristics of Population

1. Appropriateness : The auditor will need to determine that the population from which the sample is drawn is appropriate for the specific audit objective.

Example

If the auditor's objective were to test for overstatement of accounts receivable, the population could be defined as the accounts receivable listing. On the other hand, when testing for understatement of accounts payable, the population would not be the accounts payable listing, but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports, or other populations that would provide audit evidence of understatement of accounts payable.

The individual items that make up the population are known as sampling units. The population can be divided into sampling units in a variety of ways.

Example

If the auditor's objective were to test the validity of accounts receivables, the sampling unit could be defined as customer balances or individual customer invoices. The auditor defines the sampling unit in order to obtain an efficient and effective sample to achieve the particular audit objectives.

It is important for the auditor to ensure that the population is appropriate to the objective of the audit procedure, which will include consideration of the direction of testing.

2. Completeness : The population also needs to be complete, which means that if the auditor intends to use the sample to draw conclusions about whether a control activity operated effectively during the financial reporting period, the

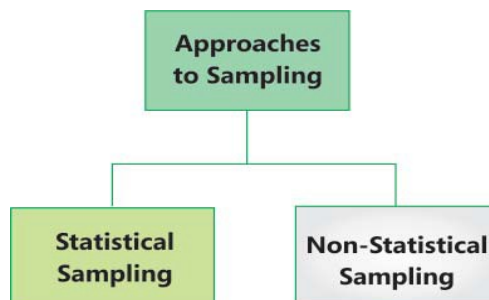
population needs to include all relevant items from throughout the entire period.

3. Reliable : When performing the audit sampling, the auditor performs audit procedures to ensure that the information upon which the audit sampling is performed is sufficiently complete and accurate.



3. APPROACHES TO 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.



Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics. A sampling approach that does not have above characteristics is considered **non-statistical sampling**.

1. An approach to sampling that has the random selection of the sample items,

2. The use of probability theory to evaluate sample results, and

3. The use of probability theory including measurement of sampling risk characteristics.

Characteristics of Statistical sampling approach

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Sample must be representative

Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

3.1 Statistical Sampling- More Scientific

Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

3.2 Non-Statistical Sampling

Under this approach, the sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor. This approach has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. For example, March, June and September may be selected in year one and different months would be selected in the next year. An attempt would be made to avoid establishing a pattern of selection year after year to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined.

The non-statistical sampling is criticized on the grounds that it is neither objective nor scientific. The expected degree of objectivity cannot be assured in non-statistical sampling because the risk of personal bias in selection of sample items cannot be eliminated. The closeness of the qualities projected by the sample results with that of the whole population cannot be measured because the sample has not been selected in accordance with the mathematically based statistical techniques. However, it may be stated that the auditor with his experience and knowledge of the client's business can evaluate accurately enough the sample findings to make audit decision and the mathematical proof of accuracy in some cases may be a luxury which the auditor cannot afford.

The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

- (i) Size of the organisation under audit.
- (ii) State of the internal control.
- (iii) Adequacy and reliability of books and records.

- (iv) Tolerable error range.
- (v) Degree of the desired confidence.

In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries. Auditors realised that they can derive good satisfaction by undertaking a much lesser checking by adoption of this technique in the auditing process. It is a mathematical truth that the sample, if picked purely on a random basis would reveal the features and characteristics of the population.

By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking provided he can put reliance on the internal controls and checks within the client's organisation because they provide the reliability of the records. What should be the extent of desirable checking in any particular matter is for auditor to judge on basis of his opinion about the state of control in a particular area. If control is satisfactory in its design and implementation, a much smaller sample can give the auditor the necessary reliability of the result he obtains. On the other hand, if in certain areas controls are slack or not properly implemented, the auditor may have to take a much larger sample for getting satisfactory result.

Another truth about the sampling technique should be noted. It can never bring complete reliability; it cannot give precisely accurate results. It is a process of estimation. It may have some error. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular case.

Example

Mr. X may consider that in his estimation of stores valuation, an error of 2% may not be material; he also decides that he needs at least 98% reliability of the result. He is to pick up the requisite number of items of the stores for reliability of the result. The requisite number he can get from the random number table. The question of reliability of the result is directly linked with the reliability of the internal control and of the books and records; when these are satisfactory, lesser degree of reliability of the sampling estimation may suffice – if these are not satisfactory, the auditor may have to decide upon a higher degree of reliability which can only be obtained from a larger sample.

Very often we come across this term when an audit is conducted on the basis of a part checking. This, it is said, owes its origin to the statistical theory of sampling.

3.3 Appropriateness of Sampling Approaches

In statistical sampling, the sample results are measurable as to the adequacy and reliability of the audit objectives whereas in non-statistical sampling the auditor's opinion determines the sample size but it cannot be measured how far the sample size would fulfill the audit objective.

The advantages of statistical sampling may be summarized as follows -

- (1) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
- (2) The sample selection is more objective and thereby more defensible.
- (3) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
- (4) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
- (5) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort, for instance when exact accuracy is required or in case of legal requirements etc.

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.



4. SAMPLE DESIGN, SIZE AND SELECTION OF ITEMS FOR TESTING

When designing an audit sample, the auditor shall consider the purpose of the audit procedures and the characteristics of the population from which the sample will be drawn. The auditor shall determine a sample size sufficient to reduce

sampling risk to an acceptably low level. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

4.1 Sample Design

When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose. Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling. In fulfilling the requirement of SA 500 Audit Evidence, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

The auditor's consideration of the purpose of the audit procedure includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements.

Example

In a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement. Also, a misposting between customer accounts does not affect the total accounts receivable balance.

Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size.

Example

If the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls.

Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate.

4.1.1 Stratification and Value-Weighted Selection

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.

Stratification: Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, **for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.**

The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population.

Example

20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

If a class of transactions or account balance has been divided into strata, the

misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

Value-Weighted Selection: When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, **for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units.** One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.

This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

4.2 Sample Size

The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. There are various factors typically have on the determination of sample size. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non- statistical approach is chosen.

4.2.1 Examples of Factors Influencing Sample Size for Tests of Controls

The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

- ◆ When there is an increase in the extent to which the auditor's risk assessment takes into account relevant controls. The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests

of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased). Thus, sample size will increase.

- ◆ If there is an increase in the tolerable rate of deviation. Then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be.
- ◆ When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase, as higher the expected rate of deviation, larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.
- ◆ An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size. Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.
- ◆ In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be negligible effect on sample size due to increase in the number of sampling units in the population.

4.2.2 Examples of Factors Influencing Sample Size for Tests of Details

The following are factors that the auditor may consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.

- ◆ The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the auditor does not perform tests of controls, the auditor's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be. Thus we can say that there will be an increase in sample size in case of an increase in the auditor's assessment of the risk of material misstatement.
- ◆ The more the auditor is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be. Hence, if there is an increase in the use of other substantive procedures directed at the same assertion, the size of sample will decrease.
- ◆ An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population will increase the sample size. Hence, greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.
- ◆ An increase in tolerable misstatement will decrease the sample size as lower the tolerable misstatement, the larger the sample size needs to be.
- ◆ The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of misstatement in the population. Factors relevant to the auditor's consideration of the expected misstatement amount include the extent, to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures. So sample size will increase in case of an increase in the amount of misstatement the auditor expects to find in the population.
- ◆ When stratification of the population is appropriate then sample size will decrease as when there is a wide range (variability) in the monetary size of

items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

- ◆ There will be negligible effect on sample size due to number of sampling units in the population. For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures.)

Data Analytics- Data analytics is defined as the process of inspecting, cleaning, transforming and modelling data with the goal of highlighting useful Information, suggesting conclusions and supporting decision making.

For example, JE Testing is a Data Analytic Tool.

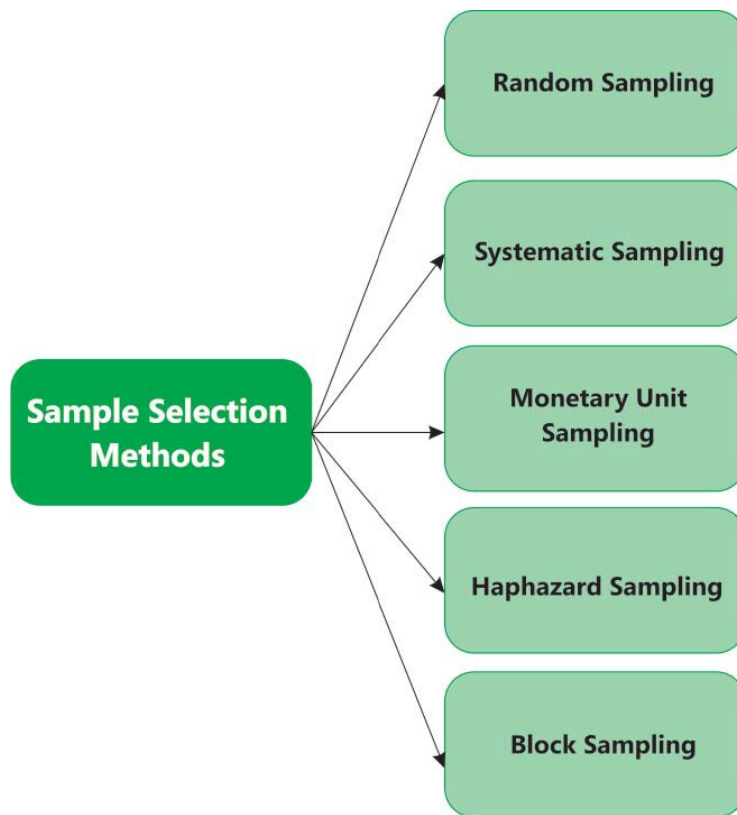
4.3 Selection of Items for Testing

With statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected. With non-statistical sampling, judgment is used to select sample items. Because the purpose of sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected, it is important that the auditor selects a representative sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population.

The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection.

4.4 Sample Selection Methods

Sample should be selected in such a manner that it is representative of the population from which the sample is being selected. It will necessitate that each item in the population has an equal chance of being included in the sample.



Some of the important methods of selecting the sample are discussed below -

(1) 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.

Example

The population can be considered homogeneous, if say, trade receivables balances fall within the range of ₹ 55,000 to ₹ 2,25,000 and not in the range between ₹ 525 to ₹ 10,50,000.

(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.

Example

In the above case, trade receivables balances may be divided into four groups as follows:-

- (a) balances in excess of ₹ 10,00,000;
- (b) balances in the range of ₹ 7,75,001 to ₹ 10,00,000;
- (c) balances in the range of ₹ 5,50,001 to ₹ 7,75,000;
- (d) balances in the range of ₹ 2,25,001 to ₹ 5,50,000; and
- (e) balances ₹ 2,25,000 and below.

From these above groups the auditor may pick up different percentage of items from each of the group. From the top group i.e. balances in excess of ₹ 10,00,000, the auditor may examine all the items; from the second group 25 per cent of the items; from the third group 10 per cent of the items; and from the lowest group 2 per cent of the items may be selected.

The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

Therefore, we can say that random selection method is applied through random number generators, for example, random number tables).

(2) Interval Sampling or Systematic Sampling: Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is

selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

Example

If in a population of branch sales, particular branch sales occur only as every 100th item and the sampling interval selected is 100. The result would be that either the auditor would have selected all or none of the sales of that particular branch.

To minimise the effect of the possible known buyers through a pattern in the population, more than one starting point may be taken. The multiple random starting point is taken because it minimises the risk of interval sampling pattern with that of the population being sampled.

(3) Monetary Unit Sampling: It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(4) Haphazard sampling: Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (**for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page**) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

(5) Block Sampling: This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

Example

Take the first 200 sales invoices from the sales day book in the month of September; alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows items to the completion.

There is a close similarity between this method and non-statistical sampling. Consequently it has similar characteristics, namely, simplicity and economy. On the other hand there is a risk of bias and of establishing a pattern of selection which may be noted by the auditees.

4.5 Sampling and Non-Sampling Risk

Sampling Risk. 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 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 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.

Non-Sampling Risk. The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

Example

Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognize a misstatement or deviation.

Sources of Non Sampling risk are :

Human Mistakes	Misinterpreting the sample results
Applying audit procedures not appropriate to the objectives of audit	
Relying on erroneous information e.g. erroneous confirmation	

Non sampling risk can never be mathematically measured.



5. PERFORMING AUDIT PROCEDURES

The auditor shall perform audit procedures, appropriate to the purpose, on each item selected. If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details.



FIG. 2: Performing Audit Procedures*

An example of when it is necessary to perform the procedure on a replacement item is when a voided check is selected while testing for evidence of payment authorization. If the auditor is satisfied that the check has been properly voided such that it does not constitute a deviation, an appropriately chosen replacement is examined.

An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost.

An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.



6. NATURE AND CAUSE OF DEVIATIONS AND MISSTATEMENTS

In analyzing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

* Source for image Jasonbloomaccounting.com

Therefore, the auditor shall investigate the nature and causes of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

7. PROJECTING MISSTATEMENTS

The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded. When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

8. EVALUATING RESULTS OF AUDIT SAMPLING

The auditor shall evaluate-

- (a) The results of the sample; and
- (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the

population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

In case the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

SUMMARY

SA 530 "Audit Sampling", defines 'audit sampling' as application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

Audit sampling can be applied using either non-statistical or statistical sampling approaches.

The factors that should be considered for deciding upon the extent of checking on a sampling plan are size of the organisation under audit, state of the internal control, adequacy and reliability of books and records, tolerable error range and degree of the desired confidence.

Sample should be selected in such a manner that it is representative of the

population from which the sample is being selected. Some of the sample selection methods are Random Sampling (Simple/Stratified), Systematic Sampling, Monetary Unit Sampling, Haphazard Sampling, Block Sampling etc.

The auditor shall perform audit procedures, appropriate to the purpose, on each item selected. The auditor is also required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

The auditor shall evaluate the results of the sample; and whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

TEST YOUR KNOWLEDGE

MCQs

1. The main advantage of using statistical sampling techniques is that such techniques:
 - (a) Mathematically measure risk
 - (b) Eliminate the need for judgmental sampling
 - (c) Defines the values of tolerable error
 - (d) All of the them.
2. Which of the following factors is (are) considered in determining the sample size for tests of control?
 - (a) Projected error
 - (b) tolerable error
 - (c) Expected error
 - (d) Both (b) and (c)
3. Tolerable error is the maximum monetary error that the auditor is prepared to accept in the population and still conclude that audit objective has been achieved, is directly related to
 - (a) Sample size
 - (b) Audit risk
 - (c) Materiality

- (d) Expected error
4. Which of the following is source of Non Sampling risk :
- (a) Human Mistakes
 - (b) Applying audit procedures not appropriate to the objectives of audit
 - (c) Misinterpreting the sample results
 - (d) All of the above
5. Which of the following is more scientific :
- (a) Statistical
 - (b) Non- statistical
 - (c) both (a) and (b)
 - (d) none of the above

Correct/Incorrect

State with reasons (in short) whether the following statement is correct or incorrect:

- (i) The method which involves dividing the population into groups of items is known as block sampling.
- (ii) Universe refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.
- (iii) Non Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.
- (iv) Sample need not be representative
- (v) The objective of stratification is to increase the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

Theoretical Questions

1. What is the meaning of Sampling? Also discuss the methods of Sampling. Explain in the light of SA 530 "Audit Sampling".
2. With reference to Standard on Auditing 530, state the requirements relating to audit sampling, sample design, sample size and selection of items for testing.

3. While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?
4. Write short notes on the following:
 - (a) Advantages of Statistical sampling in Auditing.
 - (b) Stratified sampling

ANSWERS/SOLUTIONS

Answers to MCQs

1. (a) 2. (d) 3. (c) 4. (d) 5. (a)

Answers to Correct/Incorrect

- (i) **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.
- (ii) **Incorrect:** Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.
- (iii) **Incorrect:** Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.
- (iv) **Incorrect:** Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.
- (v) **Incorrect:** The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

Answers to Theoretical Questions

1. **Meaning of Audit Sampling:** "Audit Sampling" means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

Refer Para 4.4 for methods of selecting samples.

2. **Audit Sampling:** As per SA 530 on "Audit Sampling", the meaning of the term Audit Sampling is – the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The requirements relating to sample design, sample size and selection of items for testing are explained below-

Sample design - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

Sample Size- The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

Selection of Items for Testing- The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

3. **Risk Factors while applying Sampling Techniques:** As per SA 530 "Audit Sampling", sampling risk is 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 tests 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 test of controls, the controls are less effective than they actually are, or in the case of tests 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.

4. (a) **Advantages of Statistical Sampling in Auditing:** Refer Para 3.3.
(b) **Stratified Sampling:** Refer Para 4.4.

ANALYTICAL PROCEDURES

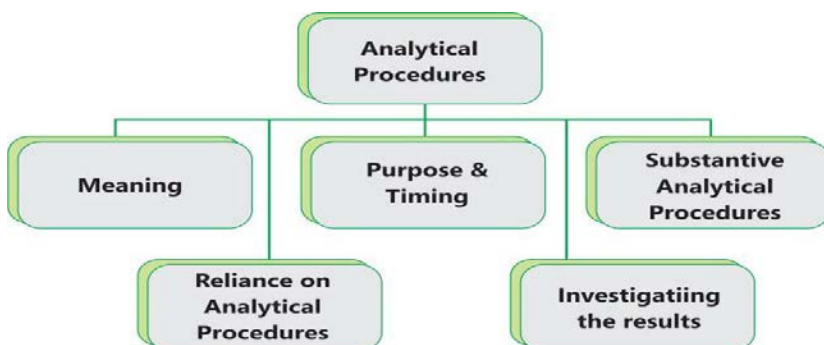


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Understand the meaning of analytical procedures as per Standards on Auditing.
- ❑ State the purposes and timing of analytical procedures.
- ❑ Deal with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures").
- ❑ Identifying risk of material misstatement through preliminary Analytical review procedures.
- ❑ Properly designing, documenting and evaluating the results of substantive analytic review procedures.

CHAPTER OVERVIEW





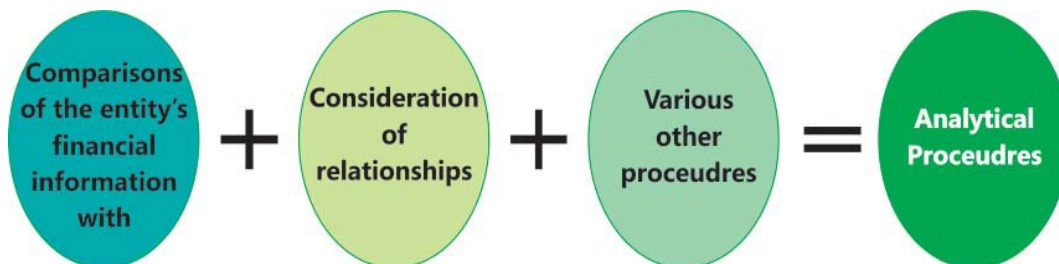
1. MEANING OF ANALYTICAL PROCEDURES

Since routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis in addition to reasonable tests. These collectively are known as overall tests. With the passage of tests, analytical procedures have acquired lot of significance as substantive audit procedure. SA-520 on Analytical Procedures discusses the application of analytical procedures during an audit.



Meaning of Analytical Procedures. 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. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Thus, analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.



Examples of Analytical Procedures having consideration of comparisons of the entity's financial information with are:

- ◆ Comparable information for prior periods.
- ◆ Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- ◆ Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Examples of Analytical Procedures having consideration of relationships are:

- ◆ Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- ◆ Between financial information and relevant non-financial information, such as payroll costs to number of employees.

ILLUSTRATION

Particulars	Client		Industry	
	2015-16	2016-17	2015-16	2016-17
Inventory Turnover	2.8	2.9	3.1	2.8
Gross Margin	22.5%	22.7%	23.6%	22.2%

Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Thus, we can say that Analytical Procedures may be segregated into these major types as comparison of client and industry data, comparison of client data with similar prior period data, comparison of client data with client-determined expected results, comparison of client data with auditor-determined expected results and comparison of client data with expected results, using non financial data.



2. PURPOSE AND TIMING OF ANALYTICAL PROCEDURES

2.1 Purpose of Analytical Procedures

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

Analytical procedures are used for the following purposes:

- (i) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
- (ii) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the

financial statements are consistent with the auditor's understanding of the entity.

For instance, establishing the relationship that exists between certain balances included in the Balance Sheet and the Statement of Profit and Loss and comparing them with those that existed between the same set of balances in the previous year, reconciling the physical balances of assets with the relevant financial record; obtaining of account from the bankers, account receivables and account payables and reconciling with relevant balances in books of account; confirming amounts of outstanding income and expenses by preparing reconciliation statements, etc. These are helpful in the detection of unusual state of affairs and mistakes in accounts.

Example

In XYZ Ltd., after applying analytical procedures as comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio. Therefore, it became necessary for the auditor to make further enquiries as it may be due to pilferage of inventories/ misappropriation of a part of the sale proceeds/ a change in the cost of sales without a corresponding increase in the sales price.

On verifying the balances of **sundry account receivables** by obtaining the confirmation of their statements of account, it will be possible for the auditor to find out whether the discrepancy in the balance of an account receivable is due to the failure to debit his account with the cost of goods supplied to him or is the result of non-adjustment of a remittance received from him.

Also whether in the case of **account payable**, the discrepancy is due to failure to afford him credit for one or more consignments of goods supplied by him or failure to debit him with an amount of remittance.

In case of **inventories of raw materials and stores** at the end of the year any excesses or shortages therein shall be detected. The investigation of their causes might disclose that the shortages were the result of a misappropriation of inventory or that the excess were due to requisitions having been entered before the inventories were issued.

By reconciling the **amounts of interest and dividends** collected with the amounts which had accrued due and that which are outstanding for payment, the mistake, if any, in the adjustment of such an income would be detected.

The overall tests can be extended for making **inter-firm and intra-firm comparison** of trading results.

Example

If balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss for the same period of another entity engaged in the same trade and working under similar circumstances, it would be possible to find out the cause of the variation in the rate of profitability that exists.

Similarly, it would also be possible **to compare the balances** on the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years. By setting up certain expenses ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales. If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.



An abnormal fall in the cost of manufacture or that in the **administrative cost**, apart from economy in expenses, there could be no provision or less provision for expenses incurred in the year. When it is suspected, the auditor should compare the entries in the outstanding book with those in the previous year. He must also check the vouchers for one month immediately before the close of the following years. To verify that none of the expenses in the accounts under audit have been charged to the accounts of the following years.

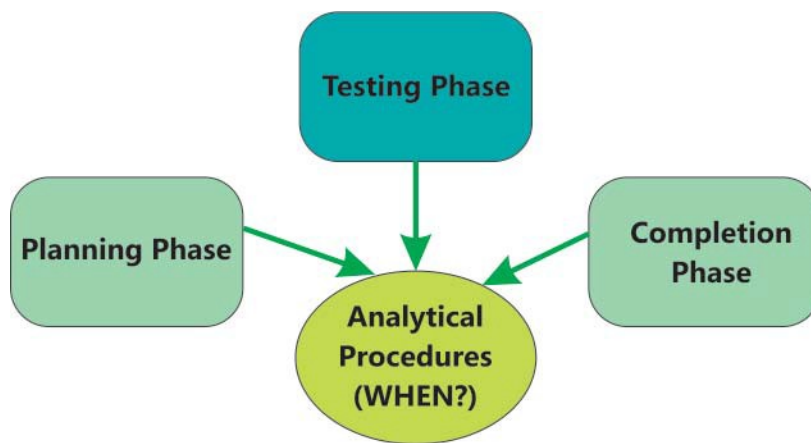
Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss. **For instance**, the cost of importing goods which are subjected to an ad-valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of excise duty paid. Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, *e.g.*, commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.

Thus, it is important to note that Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that

might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

2.2 Timing of Analytical Procedures

Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition these are also required during the completion phase.



2.3 Analytical Procedures in Planning the Audit

In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

3. SUBSTANTIVE ANALYTICAL PROCEDURES

The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of

any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

3.1 Factors to be considered for Substantive Audit Procedures

The auditor should consider the following factors for Substantive Audit Procedures:

Availability of Data – The availability of reliable and relevant data will facilitate effective procedures.

Disaggregation – The degree of disaggregation in available data can directly affect the degree of its usefulness in detecting misstatements

Account Type – Substantive analytical procedures are more useful for certain types of accounts than for others. Income statement accounts tend to be more predictable because they reflect accumulated transactions over a period, whereas balance sheet accounts represent the net effect of transactions at a point in time or are subject to greater management judgment.

Example

We can analyze data to understand the relationship to another account and through this, disaggregate the transactions flowing to and from the balance sheet account (e.g., sales and cash receipts flowing through trade receivables), or to compare ratios over time as this enhances our ability to obtain audit evidence for balance sheet accounts.

Source – Some classes of transactions tend to be more predictable because they consist of numerous, similar transactions, (e.g., through routine processes). Whereas the transactions recorded by non-routine and estimation SCOTs are often subject to management judgment and therefore more difficult to predict.

Predictability – Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable (e.g., between sales and cost of sales or between trade receivables and cash receipts). A predictable relationship is one that may reasonably be expected to exist and continue over time.

Nature of Assertion – Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). Predictive analytical procedures using data analytics can be used to address completeness, valuation/measurement and occurrence.

Inherent Risk or “What Can Go Wrong” – When we are designing audit procedures to address an inherent risk or “what can go wrong”, we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.

Example

When side agreements with respect to revenue recognition have been identified as a significant or fraud risk, it is unlikely that an analysis of sales compared to cash receipts or cost of sales would be appropriate to respond to that risk.

3.2 Techniques Available as Substantive Analytical Procedures

The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. Substantive analytical procedures generally take one of the following forms:

Trend analysis – A commonly used technique is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Ratio analysis – Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

Example

Financial ratios may include:

Trade receivables or inventory turnover

Freight expense as a percentage of sales revenue

Reasonableness tests – Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more

applicable to income statement accounts and certain accrual or prepayment accounts.

Structural modelling – A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

3.3 Analytical Procedures used as Substantive Tests

When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall:

- (i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;
- (ii) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;
- (iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and
- (iv) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.



4. SUITABILITY OF PARTICULAR ANALYTICAL PROCEDURES FOR GIVEN ASSERTIONS

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

In some cases, even an unsophisticated predictive model may be effective as an

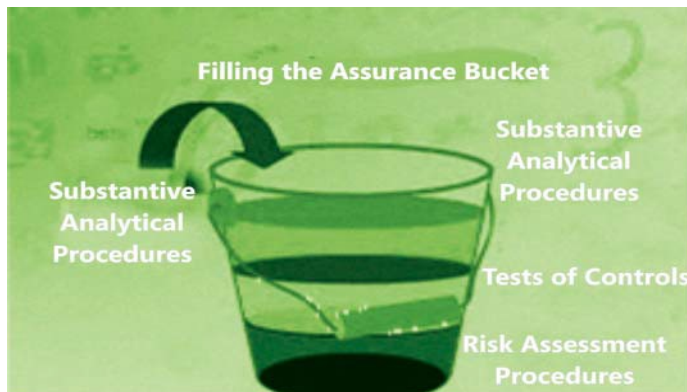
analytical procedure.

Example

If an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognized trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

The determination of the suitability of particular substantive analytical procedure is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. **For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.**



Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. **For example, when obtaining audit evidence regarding the valuation assertion for accounts**

receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

5. EXTENT OF RELIANCE ON ANALYTICAL PROCEDURES

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

- (i) Source of the information available. **For example**, information may be more reliable when it is obtained from independent sources outside the entity;
- (ii) Comparability of the information available. **For example**, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
- (iii) Nature and relevance of the information available. **For example**, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. **For example**, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.



6. RISK OF MATERIAL MISSTATEMENTS

Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

- (i) **The accuracy with which the expected results of substantive analytical procedures can be predicted.**

For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

- (ii) **The degree to which information can be disaggregated.**

For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

- (iii) **The availability of the information, both financial and non-financial.**

For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.



7. INVESTIGATING RESULTS OF ANALYTICAL PROCEDURES

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- (i) **Inquiring of management and obtaining appropriate audit evidence relevant to management's responses:** Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) **Performing other audit procedures as necessary in the circumstances:**

The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.



8. ANALYTICAL PROCEDURES THAT ASSIST WHEN FORMING AN OVERALL CONCLUSION

The conclusions drawn from the results of analytical procedures designed and performed in accordance with, are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion. **Students may note that Analytical Procedures assisting for forming an overall conclusion will be discussed in details at Final level.**



9. CONSIDERATIONS SPECIFIC TO PUBLIC SECTOR ENTITIES

The relationships between individual financial statements items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities; for example, in many public sector entities there may be little direct relationship between revenue and expenditure. In addition, because expenditure on the acquisition of assets may not be capitalized, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. Also, industry data or statistics for comparative purposes may not be available in the public sector. However, other relationships may be relevant, for example, variations in the cost per kilometer of road construction or the number of vehicles acquired compared with vehicles retired.

SUMMARY

As per "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.

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Analytical Procedures are required in the planning phase, testing phase and during the completion phase.

These Analytical procedures are used to obtain relevant and reliable audit evidence when using substantive analytical procedures; and to design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both.

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained.

Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated.

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by inquiring with management or by performing audit procedures.

The conclusions drawn from the results of analytical procedures designed and performed are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion.

TEST YOUR KNOWLEDGE

MCQs

- (i) What are analytical procedures?
 - (a) Substantive tests designed to assess control risk
 - (b) Substantive tests designed to evaluate the validity of management's representation letter
 - (c) Substantive tests designed to study relationships between financial and non-financial data
 - (d) All of the above
2. Which of the following is not an analytical procedure?
 - (a) Tracing of purchases recurred in the purchase book to purchase invoices.

- (b) ... Comparing aggregate wages paid to number of employees
 - (c) Comparing the actual costs with standard costs
 - (d) All of them are analytical procedures
3. Analytical procedures issued in the planning stage of an audit, generally:
- (a) help to determine the nature, timing and extent of other audit procedures
 - (b) direct attention to potential risk areas
 - (c) indicate important aspects of business
 - (d) All of the above
4. The basic assumption underlying the use of analytical procedures is:
- (a) It helps the auditor to study relationship among elements of financial information
 - (b) Relationship among data exist and continue in the absence of known condition to the contrary
 - (c) Analytical procedures will not be able to detect unusual relationships
 - (d) None of the above
5. What is the primary objective of analytical procedures used in the overall review stage of an audit?
- (a) To help to corroborate the conclusions drawn from individual components of financial statements
 - (b) To reduce specific detection risk
 - (c) To direct attention to potential risk areas
 - (d) To satisfy doubts when questions arise about a client's ability to continue

Correct/Incorrect

State with reasons (in short) whether the following statement is correct or incorrect:

1. 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.

2. Auditor can depend on routine checks to disclose all the mistakes or manipulation that may exist in accounts.
3. Only purpose of analytical procedures is to obtain relevant and reliable audit evidence when using substantive analytical procedures.
4. Analytical Procedures are required in the planning phase only.
5. Substantive analytical procedures are generally less applicable to large volumes of transactions that tend to be predictable over time.

Theoretical Questions

1. Define Analytical Procedures.
2. What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures".

ANSWERS/SOLUTIONS

Answers to MCQs

1. (c) 2. (a) 3. (d) 4. (b) 5. (a)

Answers to Correct/Incorrect

1. **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.
2. **Incorrect.** Routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis in addition to reasonable tests.
3. **Incorrect.** Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Analytical procedures are used for the following purposes:
 - (i) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
 - (ii) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether

... the financial statements are consistent with the auditor's understanding of the entity.

4. **Incorrect.** Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition these are also required during the completion phase.
5. **Incorrect.** Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

Answers to Theoretical Questions

1. **Meaning of Analytical Procedures:** 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. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.
Thus, analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.
2. **Extent of Reliance on Analytical Procedures (SA-520): Refer Para 5**

Intermediate Course

Study Material

(Modules 1 to 2)

PAPER 6

AUDITING AND ASSURANCE

Module - 2



BOARD OF STUDIES

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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Edition : July, 2019

Website : www.icaai.org

E-mail : bosnoida@icaai.in

Committee/Department : Board of Studies

ISBN No. :

Price : ₹

Published by : The Publication Department on behalf of
The Institute of Chartered Accountants of India,
ICAI Bhawan, Post Box No. 7100, Indraprastha
Marg, New Delhi 110 002, India.

Printed by :

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AUDIT OF ITEMS OF FINANCIAL STATEMENTS



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ☐ The general considerations in audit of financial statements.
- ☐ The specific procedures for auditing heads of balance sheet and statement of profit or loss.
- ☐ Audit procedures in respect of certain disclosures in the financial statements



INTRODUCTION

Companies prepare their financial statements in accordance with the framework of **generally accepted accounting principles (Indian GAAP)**, also commonly referred to as **accounting standards (AS)**.

A **financial statement audit** comprises the examination of an entity's **financial statements** and accompanying disclosures by an independent **auditor**. The result of this examination is a report by the **auditor**, attesting to the truth and fairness of presentation of the **financial statements** and related disclosures.

In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding:

- completeness;
- cut-off;
- existence/ occurrence;
- valuation/ measurement;
- rights and obligations; and
- presentation and disclosure

of assets, liabilities, equity, income, expenses and disclosures in accordance with the applicable accounting standards.

Example

If Company X's balance sheet shows building with carrying amount of ₹ 50 lakh, the auditor shall assume that the management has claimed/ asserted that:

- The building recognized in the balance sheet exists as at the period- end (existence assertion);
- Company X owns and controls such building (Rights and obligations assertion);
- The building has been valued accurately in accordance with the measurement principles (Valuation assertion);
- All buildings owned and controlled by Company X are included within the carrying amount of ₹ 50 lakh (Completeness assertion).

The auditor then needs to draw an audit programme to verify and obtain sufficient and appropriate audit evidence for each of the above claims/ assertions made by the management.

ASSERTIONS MAY BE BROADLY CLASSIFIED INTO THE FOLLOWING TYPES

1. INCOME STATEMENT CAPTIONS COMPRISING REVENUE AND EXPENSE BALANCES

Assertions	Explanation	Example: Employee benefit expenses
Occurrence	Transactions recognized in the financial statements have occurred and relate to the entity.	Employee benefit expense has been incurred during the period in respect of the personnel employed by the entity. Employee benefit expense does not include the cost of any unauthorized personnel.
Completeness	All transactions that were supposed to be recorded have been recognized in the financial statements.	Employee benefit expenses in respect of all personnel have been fully accounted for.
Cut-off	Whether all income and expenses are reported in the appropriate period. Cut-off is a separate assertion because the substantive procedures to verify it are typically different from those applied to the other components of completeness.	Employee benefit expenses recognized during the period relates to the current accounting period only.
Measurement	Transactions have been recorded accurately at their appropriate amounts in the financial statements.	Employee benefit expense has been measured/ calculated accurately. Any adjustments such as tax deduction at source have been correctly reconciled and accounted for.
Presentation and Disclosure	Transactions have been classified and presented	Employee benefit expense has been fairly allocated between:

	fairly in the financial statements. Presentation and disclosure assertions are considered during the course of the audit by procedures to determine that disclosures are complete and accurate. The disclosures that are most susceptible to material misstatement are those that require significant judgment and qualitative assessments. Audit teams assess the completeness and accuracy of disclosures by determining that the disclosures provide information in a manner that does not materially omit, distort or mislead the user.	— Operating expenses incurred in production activities; — General and administrative expenses; and — Cost of personnel relating to any self-constructed assets other than inventory.



2. BALANCE SHEET CAPTIONS COMPRISING ASSETS, LIABILITIES AND EQUITY BALANCES

Assertions	Explanation	Example: Inventory balance
Existence	Assets, liabilities and equity balances exist as at the period end.	Inventory recognized in the balance sheet actually existed as at the period end.
Completeness	All assets, liabilities and equity balances that were supposed to be recorded have been recognized in the financial statements.	All inventory units held by the entity and that should have been recorded, have been recognized in the financial statements. Any inventory held by a third party on behalf of the entity has been included as part of the inventory

		balance.
Cut-off	Whether all assets and liabilities are reported in the appropriate period.	Inventory balance as at the year-end does not include any element of next financial year.
Valuation	Assets, liabilities and equity balances have been valued appropriately.	Inventory has been recognized at the lower of cost and net realizable value in accordance with AS 2 - Inventories. Any costs that could not be reasonably allocated to the cost of production (e.g. general and administrative costs) and any abnormal wastage have been excluded from the cost of inventory. An acceptable valuation basis (eg. FIFO, Weighted average etc.) has been used to value inventory as at the period-end.
Rights& Obligations	Entity has the right to assets i.e. (whether the entity has ownership and title to assets) and the liabilities recognized in the financial statements represent all the entity's the obligations at a given date.	The entity owns or controls the inventory recorded in the financial statements. Any inventory held by the entity on behalf of another entity has not been recognized as part of inventory of the entity.
Presentation and Disclosure	Whether particular items in the financial statements are properly classified, described and disclosed. Presentation and disclosure assertions are considered during the course of the audit by procedures to determine that disclosures are complete and accurate. The disclosures that are most	Example 1 Employee benefit expense has been fairly allocated between: — Operating expenses incurred in production activities; — General and administrative expenses; and Cost of personnel relating to any self-constructed assets other than inventory.

	susceptible to material misstatement are those that require significant judgment and qualitative assessments. Audit teams assess the completeness and accuracy of disclosures by determining that the disclosures provide information in a manner that does not materially omit, distort or mislead the user.	Example 2 Whether related party transactions have been disclosed appropriately as per the requirements of AS 18 – Related Party Disclosures.

Following section defines the various procedures an auditor should design to perform around certain balance sheet captions:



3. BALANCE SHEET CAPTIONS

3.1 Share Capital

Every company's lifecycle starts with raising of capital. Other than a private company, every other company issues a prospectus, which may be in the abridged form, or a Statement in lieu of Prospectus, before it proceeds towards allotment of share capital. The Prospectus defines the conditions on which allotment will be made, the projects on which the amount raised shall be spent (when these have been decided upon in advance) and to specify limits on certain expenses incidental to raising of capital. The receipt of applications for shares and allotment of shares in pursuance thereto are two important aspects of every issue of capital in so far as these constitute the legal basis of the transactions in the matter of purchase of shares. These, therefore, should receive a careful attention of the auditor. He must verify that each party, has performed his part of the contract, within the allotted time.



The below table summarises the audit procedures generally required to be undertaken while auditing share capital:

Brief description	Audit procedures
To establish the existence of share capital as at the period-end Equity balances that were supposed to be Recorded have been Recognized in the financial statements. Equity balances have been valued appropriately.	Audit procedures • Tally the period-end share capital balance- authorised, issued and paid up, to the previous year audited financial statements. • In case there in no change during the year, obtain a written confirmation/ representation from the Company Secretary that there were no changes to entity's capital structure during the year • In case there is any change, verify whether the paid up capital as at the period-end is within the limits of authorised capital. • Obtain the certified copies of relevant resolutions passed at the meetings of board of directors, shareholders authorising the increase/ decrease in authorised share capital, if required, or paid up share capital. • Also, obtain and verify copies of forms filed with Ministry of Corporate Affairs (MCA) (Form SH 7 for increase in authorised share capital, Form PAS 3 for increase in paid up capital) and with Reserve Bank of India (Form FCGPR in case of Foreign Direct Investment (FDI) by a Non-resident shareholder) and verify the number of securities issued along with the issue price. • In case there was increase in share capital, verify whether the Company has accurately calculated the required fee and stamp duty payable to MCA. Shares Issued at Premium: In case a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or

otherwise, Section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account and state the means in which the amount in the account can be applied.

The provisions of this Act relating to reduction of share capital of a company shall apply as if the securities premium account were the paid-up share capital of the company.

**Application of securities premium account:
The securities premium account may be applied by the Company:**

- (a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
- (b) in writing off the preliminary expenses of the Company;
- (c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
- (d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
- (e) for the purchase of its own shares or other securities under Section 68.

The auditor needs to verify whether the premium received on shares, if any, has been transferred to a "securities premium account" and whether the application of any amount out of the said "securities premium account" is only for the purposes mentioned above.

Shares issued at a discount:

According to Section 53 of the Companies Act, 2013, a company shall not issue shares at a discount, except in the case of an issue of sweat

equity shares given under Section 54 of the Companies Act, 2013.

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.

The auditor needs to check the movement in share capital during the year and wherever there is any issue, he should verify that the Company has not issued any of its shares at a discount by reading the minutes of meeting of its directors and shareholders authorizing issue of share capital and the issue price.

Issue of Sweat Equity Shares:

According to Section 54 of the Companies Act, 2013, the employees may be compensated in the form of 'Sweat Equity Shares'.

"Sweat Equity Shares" mean equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

The auditor needs to verify that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions have been complied with (as per Section 54):

- (a) the issue is authorized by a special resolution passed by the company;
- (b) the resolution specifies the number of shares, the current market price,

consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;

- (c) not less than one year has, at the date of such issue, elapsed since the date on which the company had commenced business; and
- (d) where the equity shares of the company are listed on a recognised stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.
- (e) The rights, limitations, restrictions and provisions as applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank pari passu with other equity shareholders.

The auditor also needs to verify whether the fresh issue of shares was a rights issue or a preferential issue and whether the relevant requirements for issue of share capital as per provisions of Companies Act, 2013 have been complied with.

Reduction of Capital

For verifying reduction of capital, the auditor needs to undertake the following procedures:

- (i) Verify that the meeting of the shareholders held to pass the special resolution was properly convened and that the proposal was circularized in advance to all the shareholders;
- (ii) Verify that the Articles of Association authorises reduction of capital;
- (iii) Examine the order of the Tribunal

Required disclosures for equity have been appropriately made	confirming the reduction and verify that a copy of the order and the minutes have been registered and filed with the Registrar of Companies; (iv) Check the Registrar's Certificate as regards to reduction of capital; (v) Vouch the accounting entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also check whether the requirements of Schedule III, Part I, have been complied with in relation to presentation; (vi) Confirm whether the revaluation of assets has been properly disclosed in the Balance Sheet; (vii) Verify the adjustment made in the members' accounts in the Register of Members and confirm that either the paid up amount shown on the old share certificates has been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled; (viii) Confirm that the words "and reduced", if required by the order of the Tribunal, have been added to the name of the company in the Balance Sheet. (ix) Verify that the Memorandum of Association of the company has been suitably amended. Ensure whether the following disclosure requirements of Schedule III (Part 1) to Companies Act, 2013 have been complied with: Issued and subscribed share capital (Number of shares and value) • Balance at the beginning of the reporting period

	• Changes in equity share capital during the year • Balance at the end of the reporting period For each class of capital • Rights attached • Preferences • Restrictions, including ◦ Restrictions on the distribution of dividends ◦ Restrictions on the repayment of capital Shares held in Company by the following entities: • Holding company • Ultimate holding company • Subsidiaries of the holding company • Associates of the holding company • Subsidiaries of the ultimate holding company • Associates of the ultimate holding company Shares held in the company held by each shareholder holding more than 5% shares specifying the number of shares held Disclosure to be made for a period of five years immediately preceding the balance sheet date Aggregate number and class of shares: • Allotted as fully paid up pursuant to contract(s) without payment being received in cash • Allotted as fully paid up by way of bonus shares • Bought back.

3.2 Reserves and Surplus

Reserves are the amounts appropriated out of profits that are not intended to meet any liability, contingency, commitment or diminution in the value of assets known to exist as at the date of the Balance Sheet.

Reserves represent amounts appropriated out of profits, held for purpose of distribution of dividend or financing the expansion of the company or strengthening the company financially. The reserves can be segregated as revenue or capital reserves.

Revenue reserves represent profits that are available for distribution to shareholders or below purposes such as:

Example

To supplement divisible profits in lean years,
to finance an extension of business,
to augment the working capital of the business or
to generally strengthen the company's financial position.

Capital Reserve represents a reserve which does not include any amount regarded as free for distribution.

Example

Securities premium, capital redemption reserve.

It may be noted that if a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a capital purpose, such a reserve shall also be in the nature of a capital reserve.

A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realized.

But the amount of securities premium or capital redemption reserve account can be utilised only for the purposes specified in Sections 52 and 55 of the Companies Act, 2013, respectively.



The below table summarises the audit procedures generally required to be undertaken while auditing reserves and surplus:

Brief description	Audit procedures
To establish the existence of reserves and surplus as at the period-end	Audit procedures Trace and tally the opening balance of reserves and surplus to the previous year audited financial financial statements. For addition/utilisation in current year, in case of:

Reserves and Surplus balances that were supposed to be recorded have been recognized in the financial statements. Reserves and Surplus balances have been valued appropriately.	Profit and Loss balance - Trace the movement to surplus/ deficit as per the Statement of profit and loss for the year under audit. For adjustment related to dividend payment and the tax related thereto i.e. dividend distribution tax, verify the resolution passed by the board of directors regarding the declaration of dividend. Students should note that as per AS-4 (Revised), if dividends to holders of equity instruments are proposed or declared after the balance sheet date, an entity should not recognize those dividends as a liability as at the balance sheet date. It should, however, disclose the amount of dividends that were proposed or declared after the balance sheet date, but before the financial statements were approved for issue. Securities Premium - It needs to be confirmed that the company has issued shares in excess of the nominal value of the shares and for the same, the auditor should obtain and verify the resolution passed by the board of directors. As already discussed under the caption - 'share capital', the withdrawal from securities premium account could be done only for limited purposes; auditor needs to ensure that same.
Required disclosures for reserves and surplus have been appropriately made	Ensure whether the following disclosure requirements of Schedule III (Part 1) to Companies Act, 2013 have been complied with: Has the company sub-classified reserves and surplus into the following: • Capital reserve • Capital redemption reserve • Securities premium reserve • Debenture redemption reserves • Retained earnings • Revaluation surplus • Exchange difference on account of

	translation of financial statements of foreign operations For each component of reserves and surplus, whether the company has disclosed the following (to the extent applicable): (i) Balance at the beginning of the reporting period (ii) Changes, if any, due to changes in accounting policy or prior period error (iii) Total profit/ loss for the year (iv) Dividends (v) Transfer to retained earnings (vi) Any other change (to be specified) (vii) Balance at the end of reporting period

3.3 Borrowings

Liabilities are the financial obligations of an enterprise other than owners' funds. Liabilities include borrowings, trade payables and other current liabilities, deferred payment credits and provisions.

Verification of liabilities is as important as that of assets, for, if any liability is omitted or understated or overstated, the financial statements would not show a true and fair view of the state of affairs of the company.



The below table summarises the audit procedures generally required to be undertaken while auditing borrowings:

Brief description	Audit procedures
All borrowings on the balance sheet represent valid claims by banks or other third parties.	Review board minutes for approval of new lending agreements. During review, ensure that new loan agreements or bond issuances were authorized. Ensure that significant debt commitments were approved by the board of directors.

That all borrowings have been accounted for in the books of the company on a timely basis.

- Agree details of loans recorded (interest rate, nature and repayment terms) to the loan agreement. Verify that borrowing limits, if any, imposed by agreements are not exceeded.
- Roll out and obtain independent balance confirmations in respect of all the borrowings from the lender (banks/ financial institutions etc.).
- Agree details of leases and hire purchase creditors recorded to underlying contracts/agreements.
- Examine trust deed for terms and dates of redemption, borrowing restrictions and compliance with covenants.
- When debt is retired, ensure that a discharge is received on assets securing the debt.
- Obtain a schedule of short term and long term borrowings (including debts outstanding at the end of the previous year, as well as any new debt or renewal of debt) showing beginning and ending balances and borrowings taken and repaid during the year, and perform the following:
 - (a) Consider any evidence of additional debt obtained through examination of minutes of the board of directors, significant contracts, confirmations from banks/ lenders, support for subsequent cash disbursements (when testing payables) etc.
 - (b) Trace the closing balances as per the schedules to the general ledger.
- Review subsequent transactions after the end of the reporting period to determine if there are unrecorded liabilities at year-end and the transactions are recorded in the correct period.

	Direct confirmation procedures - Roll out and obtain independent balance confirmations in respect of all the borrowings from the lender (banks/ financial institutions etc.) and perform the following: - Ascertain that the confirmation asks for all information likely to be relevant to the tests of debt and related interest balances (e.g., applicable interest rates, due dates, collateral and security interests). - Send reminders for non-replies. - Compare the balances as per the confirmations obtained to the books of the accounts. Ask for reconciliations, if there are any differences and test the supporting documents for the reconciling items on a test check basis.
That liability is recorded at the correct amount.	- Determine that the accounting policies and methods of recording debt are appropriate and applied consistently. - Agree loan balance and loan payables to the loan agreement. - Recompute the interest and discount or premium on redemption, if any. - Check computation of the amortization of premium or discount, if any. - For foreign currency loans, check the closing exchange rate(s) used and verify the computations of the restatements of foreign currency balances outstanding at year end.
That borrowings have been presented, classified and disclosed in the financial	Determine that the following items, if any, are properly recorded, classified, and/or disclosed, as appropriate:

statements in accordance with the requirements of applicable financial reporting framework i.e. Companies Act, 2013 and applicable Indian GAAP

- (a) Bonds/ debentures
- (b) Term loans
 - from banks
 - from related parties.
- (c) Deferred payment liabilities
- (d) Deposits
- (e) Loans and advances from related parties
- (f) Other loans and advances.
- Read the provisions in loan and debt agreements and perform the following:
 - (a) Test that the entity is in compliance with loan covenants and other significant provisions of the agreements.
 - (b) If there are any provisions with which the entity is not in compliance, determine whether the debt should be classified as current. If enforcement of the provisions has been waived by the lender in case of breach of any covenant by the entity, obtain confirmation of the waiver from the lender.
- Examine the due dates on loans for proper classification between long-term and short-term.
- Where instalments of long-term loans falling due within the next twelve months have been disclosed in the financial statements (e.g. in parentheses or by way of a footnote), verify the correctness of the amount of such instalments.
- Examine the debt agreements for any restrictive covenants. Review restrictive covenant and provisions relating to default and ensure disclosure thereof in the financial statements.

- Examine the important terms in the loan agreements and the documents, if any, evidencing charge in respect of such loans and advances. Examine whether the requirements of the applicable statute regarding creation and registration of charges have been complied with including disclosure of the same to the extent mandated by statute and considered necessary for proper understanding of the user of financial statements.
- In case the value of the security falls below the amount of the loan outstanding, examine whether the loan is classified as secured only to the extent of the market value of the security.
- Examine the hire purchase agreements for the purchase of assets by the entity and ensure the correctness of the amounts shown as outstanding in the accounts, and also examine the security aspect.
- Verify whether liabilities towards bank in respect of bills discounted, bills negotiated, cheques discounted, etc. are correctly reflected and disclosed in the financial statements.
- The auditor should also verify that the amount borrowed is within the borrowing powers of the company as laid down by the Articles of Association and Memorandum of Association.
- Verify that the company has not contravened the restrictions laid down by Section 180 of the Companies Act, in respect of the borrowings of the company. Also, check compliance of Sections 185 and 186 of the Companies Act, 2013.
- Examine the purpose for which the amount is borrowed and ensure that the amount is

	not used against the interest of the company. - Where the entity has accepted deposits, examine whether the directives issued by the Reserve Bank of India or other appropriate authority have been complied with. Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 are made for each amount disclosed under the heading 'long term borrowings': - Sub-classification as secured and unsecured. - For secured borrowings, nature of security separately in each case. - Where loans are guaranteed by directors or others, whether the company has disclosed the aggregate amount of such loans under each head. - Terms of repayment for each loan unless the repayment terms of individual loans within a category are similar, in which case, they may be aggregated. - Repayment terms should include the period of maturity at the balance sheet date, number and amount of installments due, applicable interest rate and other significant relevant terms (if any). In case of a default in repayment of borrowing and/ or interest on the balance sheet date, ensure that following disclosures have been made separately for each case: - Period of default. - Amount of default.

3.4 Trade Receivables

Trade receivable are an essential part of any organisation's balance sheet, often referred to as debtors. Typically, an invoice is raised and issued to the customer

with the invoice amount being recorded as a debtor balance. Until the invoice is paid, the invoice amount is recorded on the organization's balance sheet as accounts receivable. If balances are not recoverable later on, then these amounts need to be written off as an expense in the statement of profit and loss.

It is important to carry out compliance procedures in the sales audit as part of the debtors' audit procedure. Following points need to be considered in respect of trade receivables:

- Only bona fide sales lead to trade receivables.
- All such sales are made to approved customers.
- All such sales are recorded.
- Once recorded, the debtors can be settled only by receipt of cash or on the authority of a responsible official.
- Debtors are collected on time.
- Balances are regularly reviewed. A proper system of follow up exists and if necessary, adequate provision for bad debt should be made.



The below table summarises the audit procedures generally required to be undertaken while auditing trade receivables:

Brief description	Audit procedures
To establish the existence of trade receivables as at the period-end	• Check whether there are controls in place to ensure that invoices cannot be recorded more than once and receivable balances are automatically recorded in the general ledger from the original invoice. • Ask for a period-end accounts receivable aging

report and trace the balance as per the report to the general ledger.

- Check whether realization is recorded invoice-wise or not. If not, check that money received from debtors is adjusted chronologically invoice-wise and on FIFO basis i.e. previous bill is adjusted first. If realization is made on account, verify whether the Company has obtained confirmations from debtors in respect of the same.

Direct confirmation procedures

- A significant and important audit activity is to contact customers directly and ask them to confirm the amounts of unpaid accounts receivable as of the end of the reporting period under audit. This should necessarily be done for all significant account balances as at the period-end while certain random customers having smaller outstanding invoices should also be selected.
- The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain trade receivables. In such cases, the auditor should consider whether there are valid grounds for such a request. In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.
- The trade receivables may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be decided by the auditor in consultation with the Company.
- The form of requesting confirmation from the

	trade receivables may be either (a) the form with balance outstanding amount as per the company, wherein the trade receivable is requested to respond whether or not he is in agreement with the balance shown, or (b) the form without any balance mentioned therein, wherein the trade receivable is requested to respond with the balance outstanding as per his records. The use of the form without any balance is preferable.
	• The method of selection of the trade receivables to be circularised should not be revealed to the Company until the trial balance of the trade receivables' ledger is handed over to the auditor. A list of trade receivables selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed. The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client. • Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The Company should be asked to investigate and reconcile the discrepancies, if any.
	• Where no reply is received, the auditor should perform alternate procedures regarding the balances. This could include: — Agreeing the balance to cash received subsequently; — Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred. • If there are any related party receivables, review

	them for collectability as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length. • Check that receivables for other than sales or services are not included in the list. • Review a trend line of sales and accounts receivable, or a comparison of the two over time, to check if there are any unusual trends. Also, measure the average collection period. Make inquiries about reasons for changes in trends from the management and document the same in audit work papers.
Trade receivable balances that were supposed to be recorded have been recognized in the financial statements.	• The auditor needs to satisfy himself of the cut-offs. Without a cut-off, sales could be understated or overstated, hence there is a need to perform the following cut off tests: — For the invoices issued during the last few days (last 5 days of the reporting year) i.e. cut-off date and which have been included in the debtors; check that the goods should have been dispatched and not lying with the Company; — Ensure that all goods dispatched prior to the period/ year-end have been invoiced and included in debtors on a test check basis; — Ensure that no goods dispatched after the year- end have been invoiced and included in debtors for the period under audit.
	• Test invoices listed in receivable report. Select few invoices from the accounts receivable ageing report and compare them to supporting documentation to see if they were billed with the correct amounts, to the correct customers, and on the correct dates. • Match invoices to shipping/ dispatch log. Match invoice dates to the shipment dates for those

	items in the shipping/ dispatch log, to see if sales are being recorded in the correct accounting period. This can include an examination of invoices issued subsequent to the period being audited, to see if they should have been included in the period under audit. • Assess bill and hold sales. If there is a situation where the Company is billing customers for sales despite still retaining the goods on-site (known as "bill and hold"), examine supporting documentation to determine whether a sale has actually taken place or not. • Review the receiving log to see if the Company has recorded an inordinately large amount of customer returns after the audit period, which would suggest that the Company may have shipped more goods near the end of the audit period than what the customers had authorized. • Review the process of giving discounts/ incentives and check whether the same were given as per the Company's policy/ general industry trends. • Review credit memos, on a sample basis, issued during the audit period to see if they were properly authorized and whether they were issued in the correct period. Also, review credit memos issued after the period end to see if they relate to transactions belonging to the period under audit. Where any deduction has been made against a bill, check the reason and correspondence for the same.
Trade receivable balances have been valued appropriately.	• Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.

- Obtain the ageing report of accounts receivable (both Dr/Cr balance), split between not currently due, 30 days old, 30-60 days old, 60- 180 days old, 180- 365 days old and more than 365 days old (refer screenshot below). Also, obtain the list of debtors under litigation and compare with previous year.

Particulars	Sundry Debtors - 1 1-Apr-2018 to 31-Mar-2017 30 to 60 days		Sundry Debtors - 2 1-Apr-2018 to 31-Mar-2017 60 to 180 days		Sundry Debtors - 3 1-Apr-2018 to 31-Mar-2017 180 to 365 days	
	Debit	Credit	Debit	Credit	Debit	Credit
HDC Power System Ltd Viz	3,99,994.00		5,08,147.00		1,68,883.00	12,96,894.00
Bata Kumar Battery Pvt Ltd	3,35,070.00		69,909.15		48,383.00	8,75,882.50
Kharibattary Ltd					6.25	29,84,951.75
Ram Enterprise	88,368.00		1,50,046.00			13,13,636.00
Shri Eminent Enterprises						2,21,526.00
Tantror Equipment						2,21,526.00
HDC Power Systems Ltd (BROD Division)					7,24,011.00	3,10,762.50
Grand Total	6,79,232.00		7,29,862.16		4,41,867.25	89,22,829.81

- Scrutinize the analysis and identify those debtors which appear doubtful; discuss with management about reasons as to why these debtors are not included in the provision for bad debts. Perform further testing where any disputes exist.
- Prepare schedule of movements of bad debts – Provision accounts and debts written off and compare the proportion of bad debt expense to sales for the current year in comparison to prior years to see if the current expense appears reasonable.
- Check that write-offs of the receivable balances have been approved by an appropriate authority i.e. the Board of Directors in case of a company.

Required disclosures for trade receivables have been appropriately made

- Check that the restatement of foreign currency trade receivables has been done properly.
- Verify that the split between more than 6 months and less than 6 months has been done from the due date and not from invoice date.
- Check classification of amount due is properly

	disclosed as: — Secured, considered good — Unsecured, considered good — Doubtful. • Verify that proper disclosure of amounts due from the following parties has been made: — Directors — Other officers of the company — Any of them either severally — Jointly with any other person — Firms — Private companies respectively in which any director is a partner or director or member. • Ensure that the transactions with parties covered under Section 189 of the Companies Act, 2013 are reported properly in Companies Auditors' Report Order (CARO).

3.5 Cash and Cash Equivalents

Cash and cash equivalent in the form of cash in hand, stamps in hand, balances held with bank in current accounts/ margin money accounts, cash credit accounts (debit balance), fixed deposits, cheques in hand etc. represent the most liquid assets of an enterprise. Utmost professional skepticism needs to be exercised while auditing such balances.



The below table summarises the audit procedures generally required to be undertaken while auditing cash and cash equivalents:

Brief description	Audit procedures
To establish the existence of cash and cash equivalent balances as at the period- end.	• Special care is necessary in regard to verification of cash balances. Unless they are checked by surprise, there can be no certainty that the cash produced for inspection was in fact held by the custodian. For this reason, the cash should be checked not only on the

Cash and cash equivalent balances that were supposed to be recorded have been recorded in the financial statements.	last day of the year, but also checked again sometime after the close of the year without giving notice of the auditor's visit either to the entity or to his staff. If there are more than one cash balances, e.g., when there is a cashier, a petty cashier, a branch cashier and, in addition, there are imprest balances with employees, all of them should be checked simultaneously, as far as practicable so that the shortage in one balance is not made good by transfer of amount from the others. It is desirable for the cashier to be present while cash is being counted and he should be made to sign the statement prepared containing details of the cash balance counted. If he is absent at the time the cash is being verified, he may hold the auditor responsible for the shortage, if any, in cash.
	• If there is any rough Cash Book or details of daily balance are separately kept, the auditor should test entries from the rough Cash Book with those in the Cash Book to prove that entries in the Cash Book are correct. If the auditor finds any slip, chit or I.O.U.s in respect of temporary advances paid to the employees included as part of the cash balance, he should check whether those are approved by an authorized official or not and recorded in the appropriate accounts. • The auditor should also perform a cash sensitivity analysis by compiling a summary of total cash receipts and payments each month and analyzing the trends to see if there have been variations in any specific month and request Brief discrepancies from the management. • The auditor needs to obtain bank reconciliation statements (BRS) for all bank accounts maintained by the entity as at the reporting period and additionally need to understand the client's process and periodicity of making the BRS.
	The auditor should ensure that BRS is signed by the authorized personnel so that he is able to assign responsibility in case of any errors.

	• Verification of BRS shall entail the following: — Tallying the balance as per bank book to the bank confirmation/ statement. — Checking of all material reconciling items included under cheques issued but presented for payment to the underlying bank book forming part of books of account. In addition, the auditor should request for bank statements of subsequent period and should verify if the cheques issued have subsequently been cleared by the bank. For all cases where cheques have become stale i.e. 3 months or more have lapsed since the issue date, the same should not appear in the BRS and should instead be taken to liabilities. — Checking of all material reconciling items included under cheques deposited but not credited by bank by requesting for bank deposit slips, duly acknowledged by bank and verifying if the balances were credited by bank subsequently by tallying to the bank statement of subsequent period. For any instances related to cheques not cleared beyond reasonable time, the auditor should seek brief descriptions from the management and in case such explanations are found to be unsatisfactory, the auditor should verify the revenue recognition related to such parties was in order and as per the Company's revenue recognition policy. — Checking of all material reconciling items included under amounts/ charges debited/ credited by bank but not accounted for by requesting for bank statements for the period under audit and tallying the same. If the amounts are found to be material, the auditor should ensure that the management records the adjustments for the same in its books of account.

	Direct confirmation procedure • A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, restrictive use accounts like dividend, escrow accounts as of the end of the reporting period under audit. This should necessarily be done for all account balances as at the period-end. • The Company should be asked to investigate and reconcile the discrepancies, if any, including seeking written explanations/ clarifications from the banks/ financial institutions on any unresolved queries. • The auditor should emphasize for confirmation of 100% of bank account balances. In remote situations, where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include: — Agreeing the balance to bank statement received by the Company or internet/ online login to account in auditor's personal presence; — Sending the audit team member to the bank branch along with the entity's personal to obtain balance confirmation from the bank directly.
Cash and cash equivalent balances have been valued appropriately.	In addition to the procedures performed above, the auditor should ensure that all bank accounts holding foreign currency have been restated at the closing exchange rates.
Required disclosures for cash and cash equivalents have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made: Cash and cash equivalents (i) Cash and cash equivalents shall be classified as: (a) Balances with banks; (b) Cheques, drafts on hand;

	(c) Cash on hand; (d) Others (specify nature) (ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated. (iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately. (iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated. (v) Bank deposits with more than 12 months' maturity shall be disclosed separately.

3.6 Inventories

Inventories are a form of current assets held for sale in the ordinary course of business or in the process of production for sale or consumption in the production of goods or services for sale or in the form of materials or supplies to be consumed in the production process or rendering of services. As per AS 2 - Valuation of Inventories, inventory is valued at lower of cost and net realisable value.



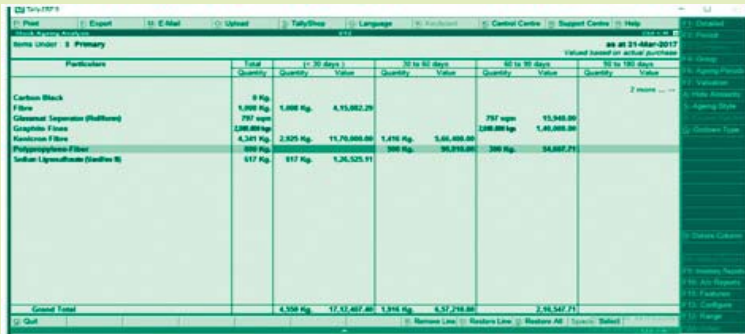
The below table summarises the audit procedures generally required to be undertaken while auditing inventories:

Brief description	Audit procedures
To establish the existence of Inventories as at the period- end.	• Review entity's plan for performing inventory count. • Ensure that consigned goods have been segregated. • Auditor should participate in the inventory count with the management. • Test counts of inventory by auditor should include: — observing employees are adhering to the agreed plan. — assuring that all items are properly tagged. — observing that proper amounts are shown on

	tags. — determining that tags and summary sheets are controlled and reconciled. — reconciliation of test counts with tags and summary sheets and discrepancies noted, if any, are summarized and agreed with client personnel. — Staying alert at all times and specifically being cautious about empty boxes, etc. and obsolete items. — Performing cut-off testing by documenting last 5-10 receiving reports and shipping documents as of the period end. — Ensuring exclusion of third party stock and damaged or obsolete stock. — Ensuring the accounting of all stock sheets. — Investigating any significant differences between the physical stock take and the stock records as per books. Further, the auditor should ask the entity's personnel to sign all stock count sheets and also agree the variances observed, if any, to avoid any conflicts. • When the entity uses periodic system for inventory count, it should be undertaken at the end of the period. If the entity uses perpetual system with proper and adequate records, inventory may be counted at interim dates. • Confirm or investigate any inventory of the entity lying with a third party (specifically relevant for cases where the entity gets job work done in its process of production).
Only the inventories held by entity have been recorded in the financial statements and do not include any	• Perform analytical procedures (comparison tests with industry averages, budgets, prior years, trend analysis, etc.). — Compute inventory turnover ratio (COGS/ average inventory) — Perform vertical analysis (inventory/ total assets) — Compare budgetary expectations vis-à-vis actuals

inventories that belong to third parties but does include inventories owned by the entity and lying with a third party	• Examine non-financial information related to inventory, such as weights and other measurements. • Perform purchase and sales cut-off tests. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after year-end. • With respect to tagged inventory, perform tests for omitted transactions and tests for invalid transactions. • Verify the clerical and arithmetical accuracy of inventory listings. • Reconcile physical inventory amounts with perpetual records. • Reconcile physical counts with general ledger control totals.
The entity has valid legal ownership rights over the inventories claimed to be held by the entity and recorded in the financial statements	• Vouch recorded purchases to underlying documentation (purchase requisition, purchase order, receiving report, vendor invoice and cancelled cheque or payment file). • Evaluate the consigned goods. • Examine client correspondence, sales and receivables records, purchase documents. • Determine existence of collateral agreements. • Review consignment agreements. • Review material purchase commitment agreements. • Examine invoices for evidence of ownership. • For instances of inventory held by third party, the auditor should insist on obtaining declaration from the third party on its business letterhead and signed by an authorized personnel of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit.
Inventories have been valued appropriately and as per generally	• Depending on how the business operates, the management may value inventory using First-in first-out (FIFO) or weighted average basis.

accepted accounting policies and practices	• Raw materials and consumables □ Ascertain what elements of cost are included e.g. carriage inward, non-refundable duties etc. □ If standard costs are used, enquire into basis of standards; how these are compared with actual costs and how variances are analyzed and accounted for/ treated in accounting records. □ Test check cost prices used with purchase invoices received in the month(s) prior to counting. □ Follow up valuation of all damaged or obsolete inventories noted during observance of physical counting with a view to establishing a realistic net realizable value. • Work in progress □ Ascertain how the various stages of production/ value add are measured and in case estimates are made, understand the basis for such estimates. □ Ascertain what elements of cost are included. If overheads are included, ascertain the basis on which they are included and compare such basis with the available costing and financial data/ information maintained by the entity. □ Ensure that material costs exclude any abnormal wastage factors. • Finished goods and goods for resale □ Enquire as to what costs are included, how these have been established and ensure that the overheads included have been determined based on normal costs and appear reasonable in relation to the information disclosed in the financial statements. □ Ensure that inventories are valued at net realizable value if they are likely to fetch a value lower than their cost. For any such items, also verify if the relevant semi/ partly processed inventories (work in progress) and raw materials

	have also been written down. □ Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. For the purpose, request the client to provide inventory ageing split between less than 30 days, 30-60 days old, 60- 90 days old, 90- 180 days old, 180- 365 days old and more than 365 days old (refer screenshot below)  □ Follow up any inventories which at time of observance of physical counting were noted as being damaged or obsolete. • Compare recorded costs with replacement costs. • Examine vendor price lists to determine if recorded cost is less than current prices. • Calculate inventory turnover ratio. Obsolete inventory may be revealed if ratio is significantly lower. • In manufacturing environments, test overhead allocation rates and ensure that only direct labor, direct material and overhead have been included. • Verify the correct application of lower-of-cost-or-net realizable value principles.
Required disclosures for inventories have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part 1) to the Companies Act, 2013 have been made: • Whether mode of valuation has been stated separately for each class of inventory • Whether inventory has been classified as: — Raw materials

	— Work-in-progress — Finished goods — Stock-in-trade (goods acquired for trading) — Stores and spares — Loose tools — Others (specify nature). • Whether goods-in-transit have been disclosed separately under each sub-head of inventory.

3.7 Tangible Assets Comprising Land, Buildings, Plant & Equipment, Furniture & Fixtures, Vehicles, Office Equipment, Computers etc. referred to as “Property, Plant and Equipment” (“PPE”)

The below table summarises the audit procedures generally required to be undertaken while auditing tangible fixed assets:



Brief description	Audit procedures
To establish the existence of PPE as at the period-end	• Review entity's plan for performing physical verification of PPE i.e. whether performed by own staff or by a third party and the policy regarding periodicity i.e. whether physical verification shall be done on annual basis or once in two years/ three years. • Evidence of appropriate supervision of those performing physical verification of PPE should be examined. • Obtain PPE physical verification report backed by the working sheets from the entity and perform the following procedures: — Assess if all items of PPE are properly tagged and carry identification marks/

	numbers and physical verification work papers do capture the asset identification numbers for assets physically verified. — Reconciliation of items of PPE as physically verified with the fixed asset register maintained by the entity as at the date/ period of undertaking physical verification. Specifically verify if the PPE additions up to the date of physical verification have been updated in the fixed asset register. — Verify the discrepancies noted, based on physical verification undertaken and the manner in which such discrepancies have been dealt with in the entity's books and financial statements. For example, any identified shortages/ assets not in working condition and/or active use should be accounted for as deletions in the books of account post approvals by the entity's the management and depreciation should have ceased to be charged after the date of deletion.
Additions to PPE during the period under audit have been recorded in the financial statements and do not include any PPE that belong to third parties but does include PPE owned and controlled by the entity although lying with a third party	• Verify the movement in the PPE schedule (asset class-wise like building, Plant & machinery etc.) compiled by the management i.e. Opening balances + Additions during the period – Deletions during the period = Closing balances. Tally the closing balance to the entity's books of account. • Check the arithmetical accuracy of the movement in PPE schedule. Tally the opening balances to the previous year audited financial statements. For additions during the period under audit, obtain a listing of all additions from the management and perform the following procedures: — For all material additions, verify if such expenditure meets the criteria of PPE as

	per AS 10 Revised. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it. Verify that the cost of an item of property, plant and equipment is as per AS 10 Revised. Verify and ensure that items such as spare parts, stand-by equipment and servicing equipment are recognised as property, plant and equipment only when they are held for more than one period as per the requirements of AS 10 Revised. - o Ensure that the entity is not recognizing costs of the day-to-day servicing in the carrying amount of an item of property, plant and equipment. - o Test the purchase invoice, installation certificate or report or other similar documentation maintained by the entity to verify the date of addition, for all additions samples of PPE during the period under audit. - o Verify whether the PPE additions have been approved by authorized personnel. - o Verify whether proper internal processes and procedures like inviting competitive quotations/ floating tenders etc. were followed prior to finalizing the vendor for procuring items of PPE/ awarding of work contract for capital projects by checking the supporting documents of the samples selected. • In relation to deletions to PPE, understand from the management the reason and rationale for deletion (example could be new purchase of similar asset once the old asset was no longer fit to be used in production process) and the

	manner of disposal. Obtain the management approval and discard note authorizing disposal of the asset from its active use. Verify the process followed for sale of discarded PPE, for example - inviting competitive quotes, tenders and the basis of calculation of sales proceeds. Verify that the management has accurately recorded the deletion of PPE (original cost and accumulated depreciation up to the date of disposal) and the resultant gain/ loss on disposal of PPE item in the entity's books of account.
PPE have been valued appropriately and as per generally accepted accounting policies and practises	It is a common understanding that the value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained and the values of PPE would be shown at higher amounts. The auditor should: • Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non- depreciable like freehold land; • Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. • The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 - Impairment of Assets.
The entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial	• In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the

statements	name of the entity that entitles legal title of ownership to the respective entity. For all additions to land and building in particular, the auditor should check the conveyance deed/sale deed to verify whether the entity is the legal and valid owner or not. The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date. In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security. In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.
Required disclosures for PPE have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made: - Whether all items of property, plant and equipment have been classified as: - Land - Buildings - Plant and equipment - Furniture and fixtures - Vehicles - Office equipment - Others (specify nature) - Whether the entity has disclosed assets "under lease" separately under each class of asset. The term "under lease" means assets given on operating lease and assets taken on finance lease. - For each class of Property, Plant and

	Equipment, whether the entity has disclosed a reconciliation of the gross and net carrying amounts at the beginning and end of the reporting period showing separately: - o Opening balance of gross carrying amount - o Additions - o Acquisitions through business combinations - o Disposals - o Disposals through demergers - o Other adjustments □ Borrowing costs capitalized - o Closing balance of gross carrying amount - o For each class of property, plant and equipment, whether the entity has disclosed: □ Opening accumulated depreciation □ Charge for the year □ Deduction/ other adjustments for depreciation □ Closing accumulated depreciation - o For each class of property, plant and equipment, whether the entity has disclosed: □ Opening accumulated impairment losses □ Impairment losses □ Impairment reversals □ Closing accumulated impairment losses.

3.8 Intangible Assets (comprising Goodwill, Brand/Trademarks, Computer Software etc.)

An intangible asset is an identifiable non-monetary asset, without physical

substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Enterprises frequently spend resources on the acquisition, development, maintenance or enhancement of intangible assets



such as scientific or technical knowledge, design and implementation of new processes or systems, licenses, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licenses, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or may be internally generated. As per AS 26 – Intangible Assets, internally generated goodwill is not recognized as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

The below table summarises the audit procedures generally required to be undertaken while auditing intangible fixed assets:

Brief description	Audit procedures
To establish the existence of intangible fixed assets as at the period- end	Since an intangible asset is an identifiable non-monetary asset, without physical substance, for establishing the existence of such assets, the auditor should verify whether such intangible asset is in active use in the production or supply of goods or services, for rental to others or for administrative purposes. Example- for verifying the existence of

	software, the auditor should verify whether such software is in active use by the entity and for the purpose, the auditor should verify the sale of related services/ goods during the period under audit, in which such software has been used. Example- For verifying the existence of design/ drawings, the auditor should verify the production data to establish if such products for which the design/ drawings were purchased, are being produced and sold by the entity. In case any intangible asset is not in active use, deletion should have been recorded in the books of account post approvals by the entity's management and amortization charge should have ceased beyond the date of deletion.
Additions to Intangible assets during the period under audit have been recorded appropriately in the financial statements	• Verify the movement in the intangible assets schedule (asset class wise like software, designs/ drawings, goodwill etc.) compiled by the management i.e. Opening balances + Additions – Deletions = Closing balances. Tally the closing balances to the entity's books of account. • Check the arithmetical accuracy of the movement in intangible assets schedule. For additions during the period under audit, obtain a listing of all additions from the management and undertake the following procedures: □ For all material additions, verify whether such expenditure meets the criterion for recognition of an intangible asset as per AS 26. □ Ensure that no cost related to research

	(or from the research phase of an internal project) gets recognized as intangible asset. □ Check the certificate or report or other similar documentation maintained by the entity to verify the date of use of the intangible which could be linked to date of commencement of commercial production/ economic use to the entity, for all additions to intangible assets during the period under audit. □ Verify whether the additions (acquisitions) have been approved by appropriate entity's personnel. □ Verify whether proper internal processes and procedures like inviting competitive quotations/ proper tenders etc. were followed prior to finalizing the vendor for procuring item of intangible assets by testing those documents on a sample basis. • In relation to deletions of intangible assets, understand from the management the reason and rationale for deletion and the manner of disposal. Obtain the management approval and disposal note authoring disposal of the asset from its active use. Verify the process followed for sale of discarded asset, example inviting competitive quotes, tenders and the basis of calculation of sales proceeds. Verify that the management has accurately recorded the deletion of intangible asset (original cost and accumulated amortization up to the date of disposal) and the resultant gain/ loss on disposal in the entity's books of account.

Intangible assets have been valued appropriately and as per generally accepted accounting policies and practices	The value of intangible assets may diminish due to efflux of time, use and/ or obsolescence. The diminution of the value represents cost to the entity for earning revenue during a given period. Unless this cost in the form of amortization is charged to the accounts, the profit or loss would not be correctly ascertained and the values of intangible asset would be shown at higher amounts. The auditor should: • Verify that the entity has charged amortization on all intangible assets; • Verify that the amortization method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. • The auditor should also verify whether the management has done an impairment assessment to determine whether an intangible asset is impaired. For this purpose, the auditor needs to verify whether the entity has applied AS 28 - Impairment of Assets for determining the manner of reviewing the carrying amount of its intangible asset, determining the recoverable amount of the asset to determine impairment loss, if any.
The entity has valid legal ownership rights over the Intangible Assets claimed to be held by the entity and recorded in the financial statements	• In addition to the procedures for verifying completeness of additions to intangible assets during the period under audit, the auditor while performing testing of additions should also verify that all expense invoices/ purchase contracts are in the name of the entity that entitles legal title of ownership to the entity.
Required disclosures for Intangible Assets have been	Ensure that the following disclosures as required under Schedule III (Part 1) to

appropriately made	Companies Act, 2013 have been made: • Whether all items of intangible assets have been classified as: □ Goodwill □ Brands/trademarks □ Computer software □ Mastheads and publishing titles □ Mining rights □ Copyrights, and patents and other intellectual property rights, services and operating rights □ Recipes, formulae, models, designs and prototypes □ Licenses and franchise □ Others (specify nature). • For each class of intangible asset, whether the entity has disclosed a reconciliation of the gross and net carrying amounts at the beginning and end of the reporting period showing separately: □ Opening balance of gross carrying amount □ Additions □ Disposals □ Impairments □ Other adjustments. • For each class of intangible assets, whether the entity has disclosed: □ Opening accumulated amortization □ Charge for the year □ Deduction/ other adjustments for amortization □ Closing accumulated amortization. • For each class of intangible assets,

	whether the entity has disclosed: □ Opening accumulated impairment losses □ Impairment losses □ Impairment reversals □ Closing accumulated impairment losses.

3.9 Trade Payables and Other Current Liabilities

Liabilities in addition to borrowings (discussed above), include trade payables and other current liabilities, deferred payment credits and provisions. Verification of liabilities is as important as that of assets, considering if any liability is omitted or understated or overstated, the financial statements would not show a true and fair view of the state of affairs of the entity.



The below table summarises the audit procedures generally required to be undertaken while auditing trade payables and other current liabilities:

Brief description	Audit procedures
To establish the existence of trade payables and other current liabilities as at the period-end	• Check whether there are controls in place to ensure that any purchase/ expense invoice does not get recorded more than once and payable balances are automatically recorded in the general ledger at the time of recording of expense. • Obtain the accounts payable ageing report and trace its balances to the general ledger. If there are any differences, investigate reconciling items. If there are journal entries in the accounts payable account in the general ledger, review the justification for larger amounts. Direct confirmation procedure An important audit activity is to contact vendors

	directly/independently and ask them to confirm the amounts of accounts payable as of the end of the reporting period under audit. This should necessarily be done for all significant account payable balances as at the period-end and for parties from whom material purchases have been made during the period under audit even if period-end balance of such parties is not significant.
	• The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain trade payables. In such cases, the auditor should consider whether there are valid grounds for such a request. In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations. • The trade creditors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be decided by the auditor in consultation with the Company. • The form of requesting confirmation from the trade creditor may be either (a) the form with balance as at year end wherein the trade creditor is requested to respond whether or not he is in agreement with the balance shown, or (b) the form with no balance wherein the trade creditor is requested to respond the balance as per his records. The use of the form with no balance is preferable.
	• The method of selection of the trade creditors to be circularised should not be revealed to the Company until the trial balance of the trade payables' ledger is handed over to the auditor.

	A list of trade creditors selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed. The auditor should maintain strict control to ensure the correctness and proper dispatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to trade creditors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client. • Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate and reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of trade payables taken as a whole. • Where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include: □ Testing of subsequent payments in respect of the trade payables to whom confirmations were rolled out but no replies received; □ Agreeing the details of the respective balance to the underlying vendor invoices; □ Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these purchases/ expense transactions actually occurred.

	• If there are any related party payables, review whether they were properly authorized and the value of such transactions were reasonable and at arm's length. • Review a trend line of purchases/ expenses and accounts payable, or a comparison of the two over time, to see if there are any unusual trends. Make inquiries about reasons for changes in trends from the management.
Trade payables and liability balances that were supposed to be recorded have been recognized in the financial statements.	• The auditor needs to perform the following cut off procedures: □ For the last 5 invoices received/ recorded at the end of the reporting date (cut off date) and which have been included in the trade payables; the goods should have been received/ risk and rewards of ownership in goods should have been transferred in favour of the entity; □ All goods received prior to the period/ year- end should have been booked in the form of purchases and included in trade creditors. • Test purchases/ expenses on a sample basis selecting the same from the accounts payable ledgers and checking their supporting documents to ensure that the purchases were recorded at the correct amounts and correct dates. • Match purchase invoice dates to the gate entry (inward) dates to check whether the purchases are being recorded in the correct accounting period. This can include an examination of purchase/ expense invoices received subsequent to the period being audited, to see if they should have been included in the period under audit.
	• Review subsequent expense vouchers. Review all material expense vouchers recorded post the

balance sheet date to see if they relate to transactions from within the audit period.

- For advance received from customers/ revenue received in advance, obtain the customer wise listing along with its ageing and the nature. Verify if any advances are outstanding beyond 6 months. Enquire from the entity's management if there has been any dispute with the customer and if there is any additional liability to be recorded. For all such advances, the auditor should verify the underlying documentation based on which the entity had received the advance.
- In relation to statutory dues liability like withholding tax (TDS) payable, GST payable, luxury tax payable, professional tax payable, PF and ESI payable etc., prepare a reasonability with respect to sales/ purchases/ employee benefit expenses. Example- GST liability for last month may be calculated by applying the applicable rate to the sales made and in case of any variance with the GST liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation.

Similarly, Provident Fund liability for last month may be calculated by applying the applicable rate to the employee benefit expense and in case of any variance with the liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation.

Further, the auditor should obtain and verify the challans for deposits made subsequent to the period-end for all statutory liabilities as at the balance sheet date and also analyse the reasons, if any, in consultation with the management for any variance between the amounts deposited subsequently vis-à-

	vis the liability recorded in books of account.
Trade payables and other liability balances have been valued appropriately.	- Review the process followed by the Company to identify if any old creditor balance/ liability needs to be written back. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment. - Obtain the ageing of payable balances, split between current, less than 30 days old, 30-60 days old, 60-180 days old, 180- 365 days old and more than 365 days old (refer screenshot below). Also, obtain the list of vendors with whom the Company has disputes and any claims from customers, under litigation and compare with previous year. - Check that write backs in the liability balances assessed as no longer payable have been approved by an appropriate and authorised member of senior management, for example – CEO/MD.

	could rely on the management process.
Required disclosures for trade payables and other liabilities have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made: • Whether the Company has classified a payable as a trade payable if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business. • Whether the Company has disclosed the following details relating to micro and small enterprises in the notes: □ the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year. □ the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year. □ the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006. □ the amount of interest accrued and remaining unpaid at the end of each accounting year. □ the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure

	under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006. - Whether the amount disclosed under other current liabilities are classified as below: - Current maturities of long-term debts. - Interest accrued - Income received in advance - Others (specify nature).

3.10 Loans and Advances and Other Current Assets

Loans and advances include loans and advances to related parties, security deposits, capital advances, amounts recoverable in cash or in kind or for value to be received, e.g., rates, taxes and insurance paid in advance/ prepaid.

Other current assets primarily include balances with statutory/ government authorities etc.



The below table summarises the audit procedures generally required to be undertaken while auditing loans and advances and other current assets:

Brief description	Audit procedures
To establish the existence of loans and advances and other current assets as at the period-end	For establishing existence of loans and advances, direct confirmation procedures, similar to those performed for Accounts receivable balances are should be performed with the only difference that while performing circularisation of direct confirmations, in addition to the principal amount, interest receivable, if any, as per the

	agreed terms between the parties, may also be included as part of the balance to be confirmed.
Loans and advances and other current asset balances that were supposed to be recorded have been recognized in the financial statements.	• Obtain a list of all advances and other current assets and compare them with balances in the ledger. • Verify loan agreements and acknowledgements of parties in respect of outstanding loans. A loan or an advance, if material, is granted only if authorised by the Memorandum and
	Articles of Association in the case of Company. In addition, the auditor should confirm that the loans advanced were within the competence of persons who had advanced the same, directors in the case of a Company, partners in the case of a firm and trustees in the case of a trust. • Inspect the minutes of meeting of board of directors to confirm if all material loans and advances were approved by the board of directors. • Verify that the loan has been acknowledged by the party and in addition, inspect if any security has been deposited against due repayment of the loan. Ascertain if loans are being recovered regularly as per agreed instalments. • If there are any related party loans and advances, review whether they were properly authorized and the value of such transactions were reasonable and at arm's length. • In relation to balances with statutory authorities like GST input credit, prepare a reasonability with respect to purchases/ expenses by applying the applicable rate to the purchases/ expenses and in case of any variance with the asset recorded by the entity, reasons for variance should be requested from the entity. • Further, the auditor should obtain statutory returns filed with the authorities like GST returns and verify whether the amount recorded as per

	books of account tallies with the claim made with the authorities.
Loans and advances and other current asset balances have been valued appropriately.	• Assess the allowance for doubtful accounts. Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment. • Obtain the ageing report of loans and advances, split between not currently due, 30 days old, 30-60 days old, 60- 180 days old, 180- 365 days old and more than 365 days old. Also, obtain the list of loans and advances under litigation and compare with previous year. • Scrutinize the analysis and identify those loans and advances that appear doubtful; discuss with management about the reasons as to why these loans/ advances are not included in the provision for doubtful balances. • Assess bad loans/ advances write-offs. Prepare schedule of movements on Bad loans/ advances – Provision Accounts and loans/ advances written off. • Check that write-offs or other reductions in the recoverable balances have been approved by the BOD. • Check that the restatement of foreign currency loans and advances/ other current assets has been done properly.
Required disclosures for loans and advances and other current assets have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made: • Whether loans have been classified as: □ Security deposits □ Loans to related parties (giving details
	□

	thereof) □ Capital advances □ Other loans (specify nature). • Whether all the above loans have been further sub-classified as: □ Secured, considered good □ Unsecured, considered good □ Doubtful. • Whether allowance for bad and doubtful loans has been disclosed separately under the relevant heads i.e. separately for each category of loans • For loans, whether separate disclosure has been made for amounts due by: □ Director(s) of the company □ Director(s) of the company jointly with other persons □ Other officer(s) of the company □ Other officer(s) of the company jointly with other persons □ Firm(s) in which director is a partner □ Private company(ies) in which director is a director or a member.

3.11 Provisions and Contingent Liabilities

A provision is recognised when:

- (i) an entity has a present obligation (legal or constructive) as a result of a past event;
- (ii) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- (iii) a reliable estimate can be made of the amount of the obligation. If the above conditions are not met, no provision is recognised.

Example

Provision may include provision for litigation, provision for warranties etc.

A contingent liability is:

- (i) a possible obligation that arises from past events and whose existence will be

confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

- (ii) a present obligation that arises from past events but is not recognized because:
- it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - the amount of the obligation cannot be measured with sufficient reliability.

The below table summarises the audit procedures generally required to be undertaken while auditing provisions and contingent liabilities:

Brief description	Audit procedures
To establish the existence of provisions as at the period-end Provisions that were supposed to be recorded have been recognized in the financial statements. Provision balances have been valued appropriately.	• Obtain a list of all provisions and compare them with balances in the ledger. • Inspect the underlying agreements like agreement with customers to assess warranty commitments, any legal and other claims on the entity i.e. litigations. • Obtain the underlying working and the basis for each of the provisions made, from the management and verify whether the same is complete and accurate. • Wherever required, obtain expert's report, calculation and underlying working for the provision amount, example for warranty involving complex calculations, some entities get that valued through an actuary. In such a case, the auditor may request the management to share the actuarial valuation report and in case of any matter under legal dispute, the auditor should request for assessment made by a legal expert in relation to likelihood of a liability devolving on the entity i.e. whether probable or possible or remote

	as defined above. The auditor should then verify the underlying assumptions used by the expert with the data shared by the management.
	• As per SA 500 - Audit Evidence, issued by ICAI, when using the work of a management's expert, audit evidence that the auditor should obtain include: □ Evaluate the competence, capabilities and objectivity of that expert: ▪ Whether the expert is employed by the entity or is an outside party. ▪ Whether the expert is independent in respect of the entity. ▪ Auditor's previous experience of the work of the expert. ▪ Knowledge of the expert, his qualification, membership of a professional body or industry association, etc. □ Obtain an understanding of the work of that expert: ▪ Whether the auditor has expertise to evaluate the work of the expert. ▪ Evaluating the assumptions and methods used by the management. ▪ Evaluating the nature of internal or external data used by the expert.
	□ Evaluate the appropriateness of his work as audit evidence for the relevant assertion: ▪ Relevance and

	reasonableness of the expert's findings or conclusions ▪ Evaluating the relevance, completeness and accuracy of the source data used by the expert.
Required disclosures for provisions have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made: • Whether current and non-current portions have been split for □ Provision for employee benefits □ Others (specify nature) • Whether for each class of provision, disclosure has been made for: □ the carrying amount at the beginning and end of the period; □ additional provisions made in the period, including increases to existing provisions; □ amounts used (i.e. incurred and charged against the provision) during the period; □ unused amounts reversed during the period. • Whether for each class of provision, disclosure has been made for: □ a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits; □ an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning

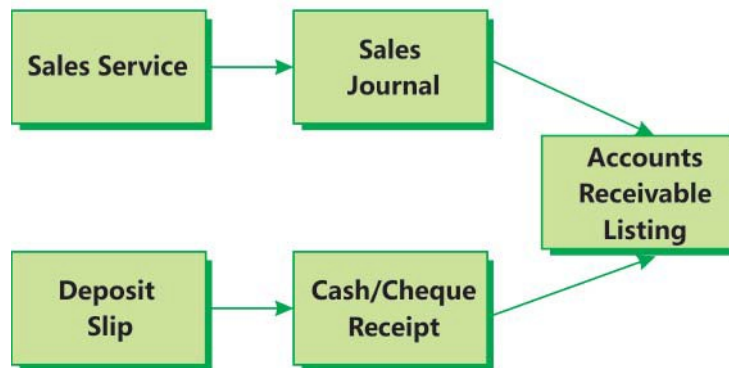
	future events; and
	□ the amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement. • Unless the possibility of any outflow in settlement is remote, whether disclosure has been made for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable: □ an estimate of its financial effect □ an indication of the uncertainties relating to the amount or timing of any outflow; and □ the possibility of any reimbursement.



4. STATEMENT OF PROFIT AND LOSS-CAPTIONS

4.1 Sale of Products and Services

The sales and collections cycle in a business refers to the set of processes that begin when a customer purchases goods or services and ends when the entity receives complete payment against the sales. As part of the year-end audit of an entity's financial statements, auditors test sales transactions and the internal controls over those transactions to ensure that the entity is not materially misstating its revenues or accounts receivable.

Revenue Cycle

Auditor needs to obtain a clear understanding about the organisation and its revenue centres.

Example

Type of services or products the entity provides, demand for the services or products, major selling product/service, introduction of new products/service line, discontinuance of products/services, major customers, sales term (Credit or cash sales).

1. An auditor needs to obtain an understanding of the management control in respect of sales process.

Example

Whether segregation of duties exist, who checks the credit limit (if applicable), who authorizes sales orders, who raises sales invoice, when and how the goods are delivered or services are provided, who ensures that the risks and rewards are transferred to the customer, how the sales have been recognised in the system.

2. An auditor tests the controls the entity has set up for the sales cycle to determine how strong and reliable they are. If they are strong, the auditor can reduce the extent of substantive testing.

Example

Common internal controls over the sales cycle include numbered sales invoices, customer purchase order authorization over a certain limit and authorization over receivables write-offs.

3. The auditor selects a random sample of transactions and examines the related customer purchase orders, invoices and customer statements. If the control being tested is numbered sales invoices

Example

The auditor ensures that all numbers in a section are accounted for and that none are missing.

4. Performing substantive audit procedures is a must. Substantive analytical procedures will consist of sales trend analysis, comparison with previous accounting period, category-wise sales analysis, any analysis the auditor may find relevant and most important of all, building a sales expectation and comparing that with the client's sales records. The auditor will need to know the sales prices of the products or services over the year, monthly average sales price per product or service, discount policy.

Example

For a manufacturing company, if the average sales price of product X is ₹ 10 and 1,500 units were sold in that month, the auditors expected sales will be ₹ 15,000. The auditor should compare this figure with the client's data and see what they have recorded against Product X. The auditor should consider discussing any variances (see if there were discounts or sales were wrongly booked in the system) between his expectations and client's records. The auditor will have to also identify and understand how the entity accounts for their sales discounts and sales return in the system and how those affect the gross sales.

The below table summarises the audit procedures generally required to be undertaken while auditing sales:

Brief description	Audit procedures
Recorded sales represent goods shipped/ services performed during the period	• Ensure revenue is not overstated by performing following audit procedures: □ Check whether a single sales invoice is recorded twice or a cancelled sales invoice could also be recorded. □ Whether any fictitious customers and sales have been recorded. □ Whether any shipments were done without the consent and agreement of the customer. □ Whether unearned revenue recorded as earned. □ Whether any substantial uncertainty exists about collectability. □ Whether customer obligations are contingent

	on other actions (financing, resale, etc.).
	• Review sequence of sales invoices • Review journal entries for unusual transactions • Calculate the ratio of sales return to sales and compare it with previous year and enquire for the reasons for increase/ decrease. • Check the sales return with sales invoice, challan, credit note, stock register, etc.
All sales made during the period were recorded and there is no understatement or overstatement.	• Perform cut-off procedures to ensure that revenues are recognised in the current accounting period and sales were not tampered towards the period end. • Cut-off errors will usually arise when companies recognise revenue based on the date on which the sales invoices are generated rather than the date on which the risks and rewards are transferred to the buyer. In order to perform a robust sales cut-off test, auditors need to understand and consider the specific cut-off error risk of each engagement. • Auditors should also verify the credit notes issued after the accounting period. Sometimes sales team or sales personnel can make fictitious sales before the year-end to meet performance target and cancel out those sales with a post year end credit note. • Trace from the shipping documents to the sales journal. • Check whether quantity is appearing in sales register or not and check reconciliation of total sales/goods dispatched as per stock records and financial records and statutory records like GST. • Review GST tax and GST returns and ensure that the same are reconciled with revenue reported in the profit and loss account. Prepare a reasonableness test of GST by applying the applicable rate to the gross sales value and compare the amount of GST as per statutory returns and analyze the reasons for variance, if any.
All sales are accurately measured	• Trace a few transactions from inception to

as per applicable accounting standards and correctly journalized, summarized, and posted	completion. • Auditor must understand client's operations and related GAAP issues e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable. • Compare the rate of sales affected with related parties and review them for collectability, as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.
Required disclosures for sales have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made: • Whether disclosure of sales in respect of each class of goods has been made. • Whether revenue from operations is disclosed separately in the notes as revenue arising from: □ Sale of products (including excise duty) □ Sale of services □ Other operating revenues. • Whether brokerage and discount on sales other than usual trade discount has been disclosed. • Whether the transactions with related parties are appropriately disclosed in notes to accounts.

4.2 Other Income comprising interest income, dividend income, gain/ loss on sale of investments etc.

Any form of income earned by an entity which is not linked to the entity's core business operations is generally classified as other income. Examples – interest on excess funds parked in fixed deposits with banks (the entity not being a bank or financial institution), interest on loans given to third parties/ within the group, return on mutual fund investment etc.

Interest income on fixed deposits is recognized on a time proportion basis taking into account the amount outstanding and the applicable interest rate.

Dividends are recognised in the statement of profit and loss only when:

- (i) the entity's right to receive payment of the dividend is established;
- (ii) it is probable that the economic benefits associated with the dividend will flow to the entity; and
- (iii) the amount of the dividend can be measured reliably.

Gain/(loss) on sale of investment in mutual funds is recorded as other income on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.

Brief description	Audit procedures
Recorded other income was earned during the Period Other income earned during the period was appropriately recorded and there is no understatement or overstatement. Other income has been measured appropriately as per the applicable accounting standards	• For verifying interest income on fixed deposits: □ Obtain a listing of fixed deposits opened during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period. Verify the arithmetical accuracy of the interest calculation made by the entity by recomputing i.e. multiplying the deposit amount with the applicable rate and number of days during the period under audit. □ For deposits still outstanding as at the period-end, trace the same to the direct confirmations obtained from the respective bank/ financial institution. □ Obtain a confirmation of interest income from the bank and verify that the interest income as per bank reconciles to the calculation shared by the entity. □ Also, obtain a copy of Form 26AS (TDS withholding by the bank/

	financial institution) and reconcile the interest reflected therein to the calculation shared by client.
	• For Dividends, verify that the same are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established. • Verify that Gain/(loss) on sale of investment in mutual funds is recorded as other income only on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments. For the purpose, obtain the mutual fund statement and trace the gain / loss as recorded in the books of account to the gain/ loss as reflected in the statement.
Required disclosures for other income have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Par 1) to Companies Act, 2013 have been made: • Whether 'other income' has been classified as: □ Interest income □ Dividend income □ Other non-operating income (net of expenses directly attributable to such income).

4.3 Purchases

Purchases is another significant process of an entity. Similar to sales as discussed above, purchases and disbursement cycle in a business refers to the set of processes that begin when an order for buying goods or services is placed based on requirements of the production/ user department and ends when the entity received the product and makes complete payment to the vendor. As part of the year-end audit of an entity's financial statements, auditors test purchase transactions and the internal controls over those transactions to ensure that the entity is not materially misstating its purchases or accounts payables.

Auditor needs to obtain a clear understanding about the organisation and its

production centres e.g. type of services or products they procure that are used in the production/ rendering of services, sources of procurement whether domestic or overseas, general availability and terms and conditions of purchase of the service or products, major vendors, credit period, quality checks, purchase terms (Credit or cash purchase) etc.

1. An auditor needs to identify the control points over purchases e.g. whether segregation of duties exist, whether competitive quotes are invited, whether a purchase committee exists who authorises purchase price, issues and authorizes purchase orders, when and how the goods are received and acknowledged, who checks the quality, quantity and specifications of the goods received and prepares Goods Receipt Note (GRN), who approves the vendor invoice, whether a 2 way/ 3 way match process exists (i.e. tally between purchase order, GRN and vendor invoice), how the purchases have been recognised in the system.
2. An auditor tests the controls the entity has set up for the purchase cycle to determine whether they are effective or not. If the controls are effective, the auditor can reduce the extent of substantive testing. Common internal controls over the purchase cycle include inviting competitive quotations for shortlisting the vendors, numbered purchase orders, purchase order authorization over a certain limit, generation of GRN on receipt of goods, quality inspection of goods, 2 way/ 3-way match, authorization of purchase invoices.
3. The auditor selects a random sample of transactions and examines the related purchase orders, GRN, purchase invoices, inward gate entry register and vendor reconciliation/ statements.
4. Performing substantive audit procedures is must. Substantive analytical procedure will consist of purchase trend analysis, comparison with previous accounting period, category wise purchases, any analysis auditor may find relevant and most important of all setting a purchase expectation in relation to the sales made during the period under audit and compare that with the client's purchase records. The auditor would need to know the purchase prices of the products or services over the year, monthly average purchase price per product or service etc.

The below table summarises the audit procedures generally required to be undertaken while auditing purchases:

Brief description	Audit procedures
Recorded purchases represent	• Ensure purchases are not understated/

goods actually received/ services availed during the period	overstated by performing following audit procedures: • Whether any fictitious vendors have been booked or purchases have been recorded by reviewing the vendor selection process followed by the entity and also performing procedures to ensure existence of the vendors. • Whether the goods were received at the factory gate and whether there exists an entry in the security gate inward register
	• Whether quality inspection of goods was done. • Whether a goods receipt note was prepared and signed by an appropriate client personnel. • Whether the purchase invoice was approved as per delegation of authority and whether a 3 or 2-way match (as discussed above) was done. • Whether stock record has been updated by the stores personnel. Special considerations during audit of purchases • The purchase invoice received should be the "Original" copy (and not photocopy/ carbon copy) against which the entity has recorded the purchase in its books of account. • Purchase invoice should have been booked only once risk and reward incidental to ownership has been transferred to the entity. Specific consideration for cases where the terms of delivery as agreed with vendor are F.O.B., C.I.F. etc. • Purchase invoice should be in the name of entity. However, in case of different

	branches, it should be addressed to the appropriate branch. • Input tax component should have been booked in the input tax ledger. The auditor should obtain tax returns filed with the authorities and tally the input tax as reflected in the books to the amount disclosed in the returns. • In case of purchases made from related parties or allied and associated concerns, the auditor needs to verify if requisite approval from Board of Directors (appropriate authority) has been obtained and should verify the selected samples and perform analytical procedures in relation to price of goods to confirm that the price charged is at arm's length.
	• The auditor should review whether purchases should be capitalized or expensed off in Statement of Profit and loss according to his professional judgement. • Review journal entries for unusual transactions.
All purchases made during the period were recorded and there in no understatement or overstatement. All purchases have been measured appropriately	In addition to the procedures for establishing occurrence of purchases as discussed above, the auditor should: • Perform cut-off test to ensure that purchases are recognised in the correct accounting period. For the purpose, the auditor should examine material inward records, say, last 5 transactions at the period end to check that all corresponding invoices have been duly entered in the Purchases book and none have been omitted. • Ensure correct accounting treatment of

	goods – in – transit as per the agreed terms with the vendor regarding transfer of risk and reward of ownership in goods. • Perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price which may include: □ Consumption Analysis: Auditor should scrutinize raw material consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from the management, if any significant variations are found. □ Stock Composition Analysis: Auditor to collect the reports from management for composition of stock i.e. raw materials as a percentage of total stock and compare the same with previous year and ask for reasons from management in case of significant variations.
	□ Ratios: Auditor should compare the creditors turnover ratios and stock turnover ratios of the current year with previous years. □ Auditor should review quantitative reconciliation of closing stocks with opening stock, purchases and consumption.
Required disclosures for purchases have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made: • Whether purchases of stock-in-trade have been specifically disclosed.

	• Whether changes in inventories of finished goods, stock-in-trade and work-in-progress have been specifically disclosed. • Whether the transactions with related parties are appropriately disclosed in notes to accounts.

4.4 Employee Benefits Expenses

Employee benefits expenses or commonly called payroll expenses represent the aggregate sum an entity pays to its employees for their labour/ efforts as well as associated expenses such as perquisites/ benefits, post-employment benefits like gratuity, superannuation, leave encashment, provident fund contribution etc. as well as towards their hiring, their welfare and training. In many industries, employee benefits expense is the biggest expense category and hence it is critical for businesses to manage this expenditure shrewdly and for the auditors to verify and ensure that such expenditure is appropriate and has been accounted as per applicable accounting standards and generally accepted accounting principles.

Auditor needs to obtain a clear understanding about the organisation and its hiring, appraisal and retirement process in the following manner:

1. An auditor tests the controls the entity has set around employee benefit payment process to determine how effective they are. If they are effective, the auditor can reduce the substantive testing. Common internal controls over the employee benefit payment cycle includes maintaining of attendance records, employee master, authorisation and approval of monthly payroll processing and disbursement, computation of employee deductions like payroll taxes, accrual of other benefits like gratuity, leave encashment, bonus etc.
2. The auditor selects a random sample of transactions and examines the related appointment letters, appraisal letters, attendance records, HR policies, employee master etc.
3. Performing substantive audit procedures is must. Substantive analytical procedure will consist of monthly expense reasonability, comparison with previous accounting period, any analysis auditor may find relevant and most important of all setting an expectation in relation to the expense incurred during the period under audit and compare that with the client's business operations and overall trend in the industry.

The below table summarises the audit procedures generally required to be

undertaken while auditing employee benefits expenses:

Brief description	Audit procedures
Recorded employee benefit expenses were actually incurred during the period	• Obtain an understanding of entity's process of capturing employee attendance. There is always a risk that an entity could record expense for fictitious employees. To address this risk, the auditor may choose to meet the employees in person, on a sample basis. Further, the auditor may choose to select a sample of employees and ask the payroll department to share their bank details/ identity proofs of the employees.
Employee benefit expenses pertaining to the period have been recorded appropriately and there is no understatement or overstatement.	
Employee benefit expenses have been measured appropriately	
	• Obtain a list of employees as at the period-end along with a monthly movement split between new hires, leavers and continuing employees. • For a sample (selected randomly) of new hires, obtain the appointment letter and verify whether the salary for first month and subsequent months was processed as per the agreed terms. • For a sample (selected randomly) of resigned employees, obtain their full and final computation and verify whether all their dues including post-retirement benefits like gratuity, leave encashment have been paid and whether the respective employee's acknowledgement on final computation has been obtained. • Obtain the monthly salary registers for all 12 months. Compile a monthly payroll reasonability by calculating the average salary per employee per month and compare with the previous year and preceding month and analyse the reasons for variance which could be attributable to annual increments, an

	employee at senior level joining/ leaving the entity, bonus pay-out etc.
	• Verify if accrual/ provision has been made for all employee benefits and obligations like bonus, gratuity, leave encashment, etc. • In case provident fund (PF), employee state insurance (ESI) are applicable to the entity, compile a reasonability by applying the rate to the basic wages and comparing to the amount recorded in books and analyse reasons for variance, if any. Also, obtain monthly deposit challans to verify if the month on month liability was subsequently deposited with the authorities and within the defined timelines. • Perform analytical procedures to obtain audit evidence as to overall reasonableness of employee benefit expenses which may include production per employee analysis. Auditor should analyse units produced per employee and compare the same with previous years and prevent industry trends and ask for the reasons from the management, if any significant variations are found.
Required disclosures for employee benefit expenses have been appropriately made	Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made: Whether employee benefit expense has been classified as: • Salaries and wages. • Contributions to provident and other funds. • Staff welfare expenses.

4.5 Depreciation and Amortisation

One of the key principles of accrual basis of accounting requires that an asset's cost is proportionally expensed based on the period over which the asset is expected to be used. Both depreciation and amortization are methods that are used to prorate the cost of a specific type of asset over its useful life. Depreciation represents systematic allocation of the depreciable value of an item of PPE over its useful life while amortisation represents systematic allocation of the depreciable amount of an intangible asset over its useful life.

Depreciation and amortisation generally constitute an entity's significant part of overall expenses and have direct impact on the profit/ loss of the entity, hence auditors need to verify and ensure that such expenditure is appropriate, accurately calculated and has been accounted as per applicable provisions of Companies Act or other statutes, to the extent applicable on the respective industry and as per generally accepted accounting principles.

Auditor needs to consider the following attributes while verifying for depreciation and amortisation expenses:

- Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- Ensure the Company policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act/ applicable accounting standards.
- Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- Whether depreciation and amortisation charges are valid.
- Whether depreciation and amortisation charges are accurately calculated and recorded.
- Whether all depreciation and amortisation charges are recorded in the appropriate period.
- Ensure the parts (components) of each item of property, plant and equipment that are to be depreciated separately have been properly identified.
- Whether the most appropriate depreciation method for each separately depreciable component has been used.

The below table summarises the audit procedures generally required to be undertaken while auditing depreciation and amortization expense:

Brief description	Audit procedures
Depreciation and amortization expenses pertaining to the period have been recorded appropriately and there is no understatement/overstatement. Depreciation and amortisation expenses have been measured appropriately. Recorded depreciation and amortisation expenses were actually incurred during the period.	Obtain an understanding of entity's process of charging depreciation and amortization. Obtain the fixed asset register maintained by the entity. There is always a risk that an entity could capitalize expense of revenue nature to increase its profit or charge capital expenditure directly in income and expense statement to reduce its profit. To address this risk, the auditor may choose to check the nature of asset from fixed asset register and further, there is always a risk that fake asset has been capitalized in the books and to mitigate this risk, auditors should physically verify the fixed assets, at least the ones that are material in value. Obtain a list of all additions/ deletions along with their proper approval from the authorised person for the same. Select the sample of assets from the Fixed Assets Register, on materiality considerations and verify the rates of depreciation, depreciation calculation. ▪ Obtain the list of all the components identified by the management. ▪ Ensure Intangible assets like patents, goodwill, copy rights have been properly amortized over the period. ▪ Ensure depreciation is charged on the assets from the date when it is ready to use. ▪ Ensure depreciation on revalued amount has been properly accounted from revaluation reserve. ▪ Depreciation computation as per Income tax Act, 1961- Ensure that additions are tallying with the additions as per Companies Act and the opening

	WDV to the Tax audit schedule for the assessment year preceding the previous year under audit.
	- Perform analytical procedures to obtain audit evidence as to overall reasonableness of depreciation and amortisation expense - check the arithmetical accuracy of records and perform independent calculations. For ex-Re-compute the depreciation expense for the year (Refer the format below that could be used for compiling reasonability of the expenditure for the year). - Ensure that the depreciation and amortization has been charged as per the useful lives of PPE and intangible assets. - Ensure that residual values have been properly verified as that impacts the computation of depreciation. - Ensure that the depreciation and amortization has been computed prospectively whenever there is any change in useful lives of PPE and intangible assets.
Required disclosures for depreciation and amortisation have been appropriately made	Ensure whether the following disclosures as required have been made: - Accounting policy for depreciation and amortization. - Useful lives of assets as per Schedule II to the Companies Act, 2013. - Residual value of assets. - Depreciation method.

Book Value			Useful life	Computation of Depreciation/ amortisation on the basis of useful life and residual value	Actual Depreciation/ amortisation as per books	Variance	Reasons for Variance
Opening Balance	Closing Balance	Average Balance	%				
A	B	$C = (A + B)/2$ #	D	E	F	$G = F - E$	H

Alternatively, any other most accurate number/ estimate can also be used

4.6 Other Expenses like Power and Fuel, Rent, Repair to Building, Plant and Machinery, Insurance, Travelling, Legal and Professional, Miscellaneous Expenses

An entity in addition to making purchases and incurring employee benefit expenses, also incurs other expenditures like rent, power and fuel, repairs and maintenance, insurance, travelling, miscellaneous expenses etc., that are essential and incidental to running of business operations.

While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel, an auditor generally prefers to vouch for other expenses to verify following attributes:

- ◆ Whether the expenditure pertained to current period under audit;
- ◆ Whether the expenditure qualified as a revenue and not capital expenditure;
- ◆ Whether the expenditure had a valid supporting like travel tickets, insurance policy, third party invoice etc.;
- ◆ Whether the expenditure has been classified under the correct expense head;
- ◆ Whether the expenditure was authorised as per the delegation of authority matrix;
- ◆ Whether the expenditure was in relation to the entity's business and not a personal expenditure.

The below table summarises the audit procedures generally required to be undertaken while auditing other expenses:

Brief description	Audit procedures
Recorded other expenses were actually incurred during the period	• Rent expense- Obtain a month wise expense schedule along with the rent agreements. Verify if expense has been recorded for all 12 months and whether the rent amount is as per the underlying
Other expenses	

pertaining to the period have been recorded appropriately and there is no understatement or overstatement Other expenses have been measured appropriately	agreement. Specific consideration should be given to escalation clause in the agreement to verify if the rent was required to be recorded on a straight-line basis during the period under audit. Also, verify if the agreement is in the name of the entity and whether the expense pertains to premises used for running business operations of the entity. • Power and fuel expense - Obtain a month wise expense schedule along with the power bills. Verify if expense has been recorded for all 12 months. Also, compile a month wise summary of power units consumed and the applicable rate and check the arithmetical accuracy of the bill raised on monthly basis. In relation to the units consumed, analyse the monthly power units consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends.
	• Insurance expense - Obtain a summary of insurance policies taken along with their validity period. Verify whether the expense has been correctly classified between prepaid and expense for the period based on number of days. • Legal and professional expenses - Obtain a month-wise and consultant-wise summary. In case of monthly retainerhip agreements, verify whether the expenditure for all 12 months has been recorded correctly. For non- recurring expenses, select a sample and vouch for the attributes discussed above. The auditor should be cautious while vouching for legal expenses as the same may highlight a dispute for which the entity may not have made any provision and the matter may also not have been discussed/ highlighted to the auditor for his specific consideration. • Travel, repair and maintenance, printing and stationery, miscellaneous expenses - The auditor should select a sample and vouch for the

	attributes discussed above. Wherever possible, the auditor should try to prepare a summary of expenditure on monthly basis and then analytically compare the trends. • Perform analytical procedures to obtain audit evidence as to overall reasonableness of other expense which may include expenditure per unit of production analysis. Auditor should analyse expense per unit produced and compare the same with previous years and prevent industry trends and ask for the reasons from the management, if any significant variations are found.
Required disclosures for other expenses have been appropriately made	Ensure other expense have been classified under: • Rent. • Insurance. • Power and fuel. • Repairs and maintenance- Building, Plant and machinery, others. • Legal and professional. • Printing and stationary. • Travel expenses. • Miscellaneous expenses.

SUMMARY

Companies prepare their financial statements in accordance with the framework of **generally accepted accounting principles**. A **financial statement audit** comprises the examination of an entity's **financial statements** by an independent **auditor**. The result of this examination is a report by the **auditor**. In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding the completeness, cutoff, existence/ occurrence, valuation/ measurement, rights and obligations and presentation and disclosure of assets, liabilities, equity, income, expenses and disclosures in accordance with the applicable accounting standards. The auditor then needs to draw an audit programme to verify and obtain sufficient and appropriate audit evidence for each of the assertions made by the management.

TEST YOUR KNOWLEDGE

MCQs

1. Which assertion is common among the statement of profit and loss and balance sheet captions:
 - (a) Existence
 - (b) Valuation
 - (c) Completeness
 - (d) Measurement
2. Direct confirmation procedures are performed during audit of accounts receivable balances to address the following balance sheet assertion:
 - (a) Rights and obligations
 - (b) Existence
 - (c) Valuation
 - (d) Completeness
3. Where no reply is received during the performance of direct confirmation procedures as part of audit of accounts receivable balances, the auditor should perform:
 - (a) No additional testing
 - (b) Additional testing including subsequent collections testing and agreeing the detail of the respective balance to the customer's remittance advice.
 - (c) Additional testing including preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred.
 - (d) Both (b) and (c)
4. Obtaining trade receivables ageing report and analysis and identification of doubtful debts is performed during audit of accounts receivable balances to address the following balance sheet assertion:
 - (a) Valuation
 - (b) Rights and obligations
 - (c) Existence

- (d) Completeness
5. Observing inventory being counted and personally performing test counts to verify counts is performed during audit of inventory balances to address the following balance sheet assertion:
- (a) Rights and obligations
 - (b) Valuation
 - (c) Completeness
 - (d) Existence
6. Wages paid to workers would qualify as:
- (a) Revenue expenditure
 - (b) Capital expenditure
 - (c) Revenue or capital expenditure depending upon facts and circumstances.
 - (d) None of the above
7. During the course of audit of intangible assets, expenditure incurred during following phase is not capitalised:
- (a) Development phase
 - (b) Research phase
 - (c) None of the above
 - (d) Both (a) and (b)
8. Search for unrecorded liability is performed during audit of current liabilities to address the following balance sheet assertion:
- (a) Valuation
 - (b) Rights and obligations
 - (c) Existence
 - (d) Completeness
9. Cut-off testing is performed during audit of sales to address the following assertion:
- (a) Occurrence
 - (b) Measurement

- (c) Cut-off
- (d) All of the above
10. ABC's investee company- XYZ declares final dividend for financial year 2016-17 in the meeting of board of directors held on April 10, 2017. In which financial year should ABC account for the dividend income:
- (a) Proportionately i.e. considering 10 days of financial year 2017-18 and 355 days of financial year 2016-17
- (b) Financial year 2016- 17
- (c) Financial year 2017- 18
- (d) Equally between financial year 2016-17 and financial year 2017-18
11. All inventory units held by the audit entity and that should have been recorded, have been recognized in the financial statements. The assertion involved is :
- (a) Existence
- (b) Completeness
- (c) Rights and Obligations
- (d) Valuation
12. Which of the following is not an example of revenue expenditure -
- (a) Salaries and wages of employees engaged directly or in-directly in production
- (b) Repairs, maintenance and renewals of fixed assets
- (c) Legal and professional expenses
- (d) development expenditure on land

Correct/Incorrect

State with reasons (in short) whether the following statement is correct or incorrect:

1. Employee benefits expenses represent the sum an entity pays to its employees for their labour/ efforts only.
2. Dividends are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established.
3. "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a premium or for consideration other than cash for

providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

4. Capital reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose.
5. A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised.
6. If Company X's balance sheet shows building with carrying amount of ₹ 100 lakh, the auditor shall assume only one point that the management has only asserted that the building recognized in the balance sheet exists as at the period-end.
7. The securities premium account may only be applied by the Company towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares.

Theoretical Questions

1. How will you vouch and/or verify the following:
 - (a) Goods sent out on Sale or Return Basis.
 - (b) Borrowing from Banks.
2. How will you vouch/verify the following:
 - (a) Goods sent on consignment.
 - (b) Foreign travel expenses.
 - (c) Receipt of capital subsidy.
 - (d) Provision for income tax.
3. How will you vouch and/or verify payment of taxes?
4. How would you vouch/verify the following:
 - (a) Advertisement Expenses.
 - (b) Sale of Scrap.

ANSWERS/SOLUTIONS

Answers to MCQs

1. (c) 2. (b) 3. (b) 4. (a) 5. (d) 6. (c)

7. (b) 8. (d) 9. (c) 10. (c) 11. (b) 12. (d)

Answers to Correct/Incorrect

1. **Incorrect:** Employee benefits expenses, commonly called payroll expenses, represent the aggregate sum an entity pays to its employees for their labour/ efforts, as well as associated expenses such as perquisites/ benefits, post-employment benefits like gratuity, superannuation, leave encashment, provident fund contribution etc. as well as towards their hiring, their welfare and training.
2. **Incorrect:** Dividends are recognised in the statement of profit and loss only when:
 - (i) the entity's right to receive payment of the dividend is established;
 - (ii) it is probable that the economic benefits associated with the dividend will flow to the entity; and
 - (iii) the amount of the dividend can be measured reliably.
3. **Incorrect:** "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.
4. **Incorrect:** Revenue reserves represent profits that are available for distribution to shareholders.
5. **Correct:** A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised. But the amount of share premium or capital redemption reserve account can be utilised only for the purpose specified in Sections 52 and 55 respectively of the Companies Act, 2013.
6. **Incorrect:** If Company X's balance sheet shows building with carrying amount of ₹ 100 lakh, the auditor shall assume that the management has claimed/ asserted that:
 - The building recognized in the balance sheet exists as at the period-end (existence assertion);
 - Company X owns and controls such building (Rights and obligations assertion);
 - The building has been valued accurately in accordance with the measurement principles (Valuation assertion);

All buildings owned and controlled by Company X are included within the carrying amount of ₹ 100 lakh (Completeness assertion).

7. **Incorrect:** The securities premium account may be applied by the Company:
- (a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
 - (b) in writing off the preliminary expenses of the Company;
 - (c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
 - (d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
 - (e) for the purchase of its own shares or other securities under section 68.

Answer to Theoretical Questions

1. (a) **Goods Sent Out on Sale or Return Basis:**

- (i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.
 - (ii) Verify that price of such goods is unloaded from the sales account and the trade receivables record. Check the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.
 - (iii) Ensure that the goods in respect of which the period of approval has expired at the end of the year, have either been received back or customers' accounts have been debited.
 - (iv) Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the end of the year lying with the party, has been included in the closing inventory.
- (b) **Borrowing from Banks:** Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows-
- (i) Reconcile the balances in the overdrafts or loan accounts with that shown in the pass book(s) and confirm the last mentioned balance

by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.

- (ii) Obtain independent balance confirmation from the bank showing balances, particulars of securities deposited with the bank as security for the loans or of the charge created on an asset and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.
- (iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.
- (iv) Confirm, in the case of a company, that the restraint contained in Section 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened.

Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

2. (a) Goods Sent on Consignment:

- (i) Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods in hand.
- (ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment inventory was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.
- (iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.
- (iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the inventory in hand

of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.

- (v) See that goods in hand with the consignee have been shown separately under the head inventories.

(b) Foreign Travel Expenses:

- (i) Examine Travelling Allowance bills submitted by the employees stating the details of tour, details of expenses, etc.
- (ii) Verify that the tour programme was properly authorised by the competent authority.
- (iii) Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill and hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.
- (iv) See that the tour report accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms to the authorisation for the tour.
- (v) Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange. For a company the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Schedule III to the Companies Act, 2013 and Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates".

(c) Receipt of Capital Subsidy:

- (i) Check the 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) Ensure that the 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.

(d) Provision for Income Tax:

- (i) Obtain the computation of income and income tax prepared by the entity and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.
- (ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.
- (iii) Examine relevant records and documents pertaining to advance tax, self-assessment tax and other demands.
- (iv) Compute tax payable as per the latest applicable rates in the Finance Act.
- (v) Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc.
- (vi) Ensure that the requirements of AS 22 on Accounting for Taxes on Income have been appropriately followed for the period under audit.

3. Vouching of Payment of Taxes:

- (i) Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the receipted challan.
- (ii) Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid.
- (iii) The interest allowed on advance payments of income-tax should be included as income and penal interest charged for non-payment should be debited to the interest account.
- (iv) Nowadays, electronic payment of taxes is also in trend. Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards.
- (v) The entity can make electronic payment of taxes also from the account of any other person. However, the challan for making such payment

must clearly indicate the Permanent Account Number (PAN) of the assessee on whose behalf the payment is made. This should be checked by the auditor.

- (vi) It is not necessary for the entity to make payment of taxes from his own account in an authorized bank. While vouching such e-payment, the auditor should cross verify the payments of taxes through the receipted challan along with PAN No /TAN No. etc.

4. (a) **Advertisement Expenses:**

- (i) Verify the bills/invoices from advertising agency to ensure that rates charged for different types of advertisement are as per the contract.
- (ii) See that the advertisement relates to client's business.
- (iii) Inspect the receipt issued by the agency.
- (iv) Ascertain the nature of expenditure – revenue or capital expenditure and see that it has been recorded properly.
- (v) Ascertain the period for which payment is made and see that prepaid amount, if any, is carried to the balance sheet.
- (vi) See that all outstanding advertisement bills have been provided for.

(b) **Sale of Scrap:**

- (i) Review the internal control as regards generation, storage and disposal of scrap.
- (ii) Check whether the organization is maintaining reasonable record for generation of scrap.
- (iii) Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.
- (iv) Check the rates at which scrap has been sold and compare the rate with previous year.
- (v) Vouch sales, with invoices raised, advertisement for tender, rate contract with scrap dealers.
- (vi) Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.
- (vii) Make an overall assessment of the value of realization from scrap as to its reasonableness.

THE COMPANY AUDIT



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ☐ Understand qualification and disqualification of an auditor.
- ☐ Know the procedures of appointment, reappointment, filling up of the casual vacancies and removal of auditor.
- ☐ Understand powers and duties of auditor.
- ☐ Understand the provisions relating to rotational retirement.

CHAPTER OVERVIEW



Company Audit

- Appointment of Auditor
- Rotation of Auditor
- Audit Committee
- Auditor's Remuneration
- Removal of Auditor
- Ceiling Limit
- Powers & Duties of Auditor
- Audit Report as per Co., Act 2013
- Joint Audit
- Audit of Branch
- Cost Audit
- Punishment for non-compliance



INTRODUCTION

Companies Act, 2013 is rule based Act. Sections 139 to 148 of the Companies Act, 2013 (hereinafter referred to as the Act unless otherwise mentioned) deal with provisions relating to audit of companies. Therefore, it is quite important to understand these provisions very carefully. You may also study sections 128 to 138 relating to "Accounts" of companies for better understanding of the subject. The provisions relating to 'audit' broadly deal with who can be appointed as an auditor under the Act, i.e., qualifications and disqualifications, the manner of appointment and removal of an auditor and rights and duties of an auditor. A scheme of the provisions of the Act relating to audit is given below for quick reference:

SECTIONS COVERED IN THIS CHAPTER

- 139. Appointment of auditors.
- 140. Removal, resignation of auditor and giving of special notice.
- 141. Eligibility, qualifications and disqualifications of auditors.
- 142. Remuneration of auditors.
- 143. Powers and duties of auditors and auditing standards.
- 144. Auditor not to render certain services.
- 145. Auditors to sign audit reports, etc.
- 146. Auditors to attend general meeting.
- 147. Punishment for contravention.
- 148. Central Government to specify audit of items of cost in respect of certain companies.



1. ELIGIBILITY, QUALIFICATIONS AND DISQUALIFICATIONS OF AN AUDITOR

The provisions relating to eligibility, qualifications and disqualifications of an auditor are governed by **section 141** of the Companies Act, 2013 (hereinafter referred as the Act). The main provisions are stated below:

- (1) A person shall be eligible for appointment as an auditor of a company only if he is a chartered accountant.

It may be noted that a firm whereof majority of partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company.

- (2) Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.
- (3) Under **sub-section (3) of section 141** along with **Rule 10** of the Companies (Audit and Auditors) Rules, 2014 (hereinafter referred as CAAR), the following persons shall not be eligible for appointment as an auditor of a company, namely-



Fig.: Is the person eligible for appointment as auditor?*

- (a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;
- (b) an officer or employee of the company;
- (c) a person who is a partner, or who is in the employment, of an officer or employee of the company;
- (d) a person who, or his relative or partner -
 - (i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company;

It may be noted that the relative may hold security or interest in the company of face value not exceeding ₹ 1,00,000.

It may also be noted that the condition of ₹ 1,00,000 shall, wherever relevant, be also applicable in the case of a company not having share capital or other securities.

Students may also note that in the event of acquiring any security or interest by a relative, above the threshold prescribed, the corrective action to maintain the limits as specified above shall be taken by the auditor **within 60** days of such acquisition or interest.

The following points merit consideration in this regard:

- (i) The value of shares of ₹ 1,00,000 that can be hold by relative is the face value not the market value.

- (ii) The limit of ₹ 1,00,000 would be applicable where the securities are held by the relative of an auditor and not where the securities are held by an auditor himself or his partner. In case of an auditor or his partner, securities of even small value shall be a disqualification.
- (iii) Grace period of 60 days for corrective action shall apply only in respect of securities held by relatives. This would not apply to auditor or his partner.

[The term “**relative**”, as defined under the Companies Act, 2013, means anyone who is related to another as members of a Hindu Undivided Family; husband and wife; Father (including step- father), Mother (including step-mother), Son (including step- son), Son’s wife, Daughter, Daughter’s husband, Brother (including step- brother), Sister (including step-sister).]

Example

Ex 1: Mr. A, a practicing Chartered Accountant, is holding securities of XYZ Ltd. having face value of ₹ 900. Whether Mr. A is qualified for appointment as an auditor of XYZ Ltd.?

As per section 141(3)(d)(i), an auditor is disqualified to be appointed as an auditor if he, or his relative or partner holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

In the present case, Mr. A is holding security of ₹ 900 in XYZ Ltd. Therefore, he is not eligible for appointment as an auditor of XYZ Ltd.

Ex 2: Mr. P is a practicing Chartered Accountant and Mr. Q, the relative of Mr. P, is holding securities of ABC Ltd. having face value of ₹ 90,000. Whether Mr. P is qualified from being appointed as an auditor of ABC Ltd.?

As per section 141(3)(d)(i), a person is disqualified to be appointed as an auditor if he, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. Further, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the present case, Mr. Q. (relative of Mr. P), is having securities of ₹ 90,000 face value in ABC Ltd., which is as per requirement of proviso to section 141(3)(d)(i). Therefore, Mr. P will not be disqualified to be appointed as an auditor of ABC Ltd.

Ex 3: M/s BC & Co. is an Audit Firm having partners Mr. B and Mr. C, and Mr. A the relative of Mr. C, is holding securities of MWF Ltd. having face value of ₹ 1,01,000. Whether M/s BC & Co. is qualified from being appointed as an auditor of MWF Ltd.?

As per section 141(3)(d)(i), a person is disqualified to be appointed as an auditor if he, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. Further as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the instant case, M/s BC & Co, will be disqualified for appointment as an auditor of MWF Ltd. as the relative of Mr. C (i.e. partner of M/s BC & Co.) is holding the securities in MWF Ltd. which is exceeding the limit mentioned in proviso to section 141(3)(d)(i).

Ex 4: M/s RM & Co. is an audit firm having partners CA. R and CA. M. The firm has been offered the appointment as an auditor of Enn Ltd. for the Financial Year 2016-17. Mr. Bee, the relative of CA. R, is holding 5,000 shares (face value of ₹ 10 each) in Enn Ltd. having market value of ₹ 1,50,000. Whether M/s RM & Co. is disqualified to be appointed as auditors of Enn Ltd.?

As per section 141(3)(d)(i), a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. However, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹1,00,000.

In the instant case, M/s RM & Co. is an audit firm having partners CA. R and CA.

M. Mr. Bee is a relative of CA. R and he is holding shares of Enn Ltd. of face value of ₹ 50,000 only (5,000 shares x ₹ 10 per share).

Therefore, M/s RM & Co. is not disqualified for appointment as an auditors of Enn Ltd. as the relative of CA. R (i.e. partner of M/s RM & Co.) is holding the securities in Enn Ltd. which is within the limit mentioned in proviso to section 141(3)(d)(i) of the Companies Act, 2013.

- (ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of ₹ 5,00,000; or

- (iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the Company or its Subsidiary, or its Holding or Associate Company or a Subsidiary of such Holding Company, in excess of ₹ 1,00,000.
- (e) a person or a firm who, whether directly or indirectly has business relationship with the Company, or its Subsidiary, or its Holding or Associate Company or Subsidiary of such holding company or associate company, of such nature as may be prescribed;

Students may note that for the purpose of clause (e) above, the term "business relationship" shall be construed as any transaction entered into for a commercial purpose, except –

- (i) commercial transactions which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Act and the Chartered Accountants Act, 1949 and the rules or the regulations made under those Acts;
 - (ii) commercial transactions which are in the ordinary course of business of the company at arm's length price - like sale of products or services to the auditor, as customer, in the ordinary course of business, by companies engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses.
- (f) a person whose relative is a Director or is in the employment of the Company as a director or key Managerial Personnel.
 - (g) a person who 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.
 - (h) a person who has been convicted by a Court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction.
 - (i) **a person who, directly or indirectly, renders any service referred to in section 144 to the company or its holding company or its subsidiary company.**

It may be noted that, for the purposes of this clause, the term "directly or indirectly" shall have the same meaning as assigned to it in the Explanation to section 144, i.e.

In case of auditor being an individual, either himself or through his relative or any other person connected or associated with such individual or through any other entity, whatsoever, in which such individual has significant influence or control, or whose name or trade mark or brand is used by such individual, shall be termed as rendering of services directly or indirectly by the auditor; and

In case of auditor being a firm, either itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity, whatsoever,

in which the firm or any partner of the firm has significant influence or control, or whose name or trade mark or brand is used by the firm or any of its partners, shall be termed as rendering of services directly or indirectly by the auditor.

Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:



- (i) accounting and book keeping services;
- (ii) internal audit;
- (iii) design and implementation of any financial information system;
- (iv) actuarial services;
- (v) investment advisory services;

Fig.: Auditor restrained from entering into certain services *

- (vi) investment banking services;
- (vii) rendering of outsourced financial services;
- (viii) management services; and

* Source of image: webuildbuzz.com

(ix) any other kind of services as may be prescribed.

It may be noted that an auditor or audit firm who or which has been performing any non-audit services on or before the commencement of this Act shall comply with the provisions of this section before the closure of the first financial year after the date of such commencement.

Example

CA. Poshin is providing the services of investment banking to C Ltd. Later on, he was also offered to be appointed as an auditor of the company for the current financial year. Advise.

Section 141(3)(i) of the Companies Act, 2013 disqualifies a person for appointment as an auditor of a company who, directly or indirectly, renders any service referred to in section 144 to the company or its holding company or its subsidiary company. Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor which includes investment banking services.

Therefore, CA. Poshin is advised not to accept the assignment of auditing as the investment banking service is specifically notified in the list of services not to be rendered by him as per section 141(3)(i) read with section 144 of the Companies Act, 2013.

(4) Where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in **sub-section (3)** after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

CASE STUDY

Facts of the Case: *Mr. A, a chartered accountant, has been appointed as an auditor of Laxman Ltd. in the Annual General Meeting of the company held in September, 2016, which assignment he accepted. Subsequently in January, 2017 he joined Mr. B, another chartered accountant, who is the Manager Finance of Laxman Ltd., as partner.*

Provisions and Explanation: *Section 141(3)(c) of the Companies Act, 2013 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company. Sub-section (4) of Section 141 provides that an auditor who becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (3) of Section 141, he shall be deemed to have vacated his office as an auditor.*

Conclusion: In the present case, Mr. A, an auditor of Laxman Ltd., joined as partner with Mr. B, who is Manager Finance of Laxman Limited. The given situation has attracted sub-section (3)(c) of Section 141 and, therefore, he shall be deemed to have vacated office of the auditor of Laxman Limited in accordance with sub-section (4) of section 141.

2. APPOINTMENT OF AUDITOR

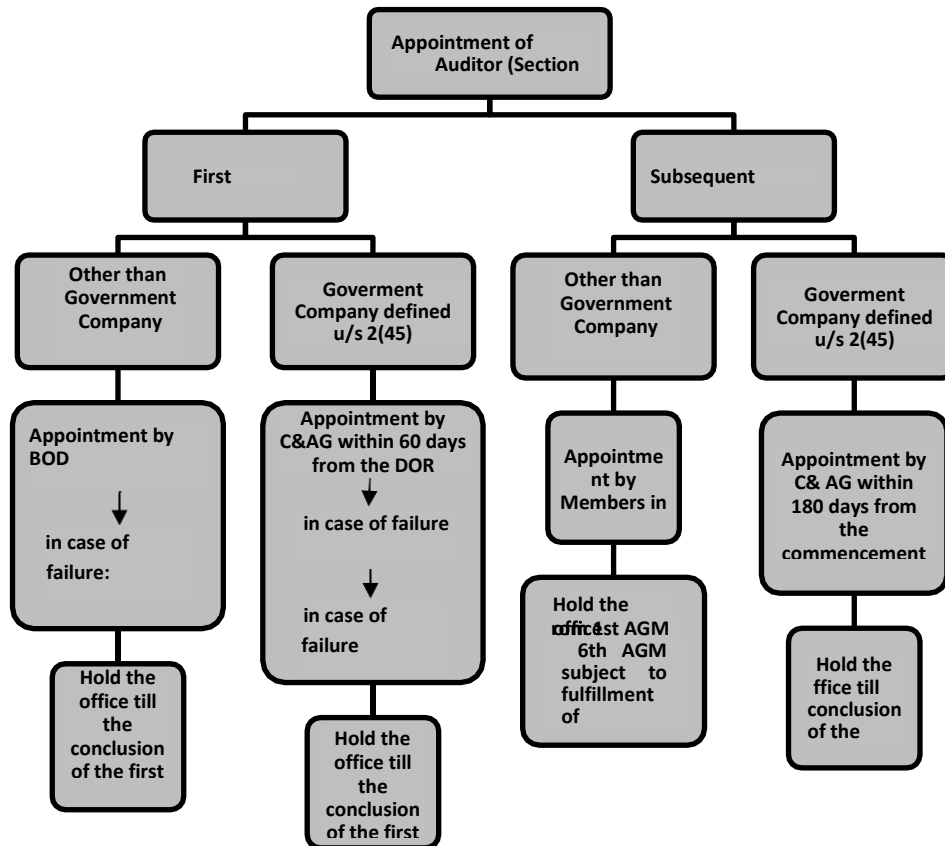
Section 139 of the Companies Act, 2013 contains provisions regarding Appointment of Auditors. Discussion on appointment of auditors may be grouped under two broad headings-

- (I) Appointment of First Auditors.
- (II) Appointment of Subsequent Auditors.



Fig: Meeting for appointment of Auditor*

* Source of image : <http://newhavenscience.org>



2.1 Appointment of First Auditor

2.1.1 Appointment of First Auditors in the case of a company, other than a Government Company

As per **Section 139(6)**, 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.

CASE STUDY

Facts of the Case: Managing Director of Pigeon Ltd. himself wants to appoint CA. Champ, a practicing Chartered Accountant, as first auditor of the company.

Provisions and Explanation: Section 139(6) of the Companies Act, 2013 lays down that the first auditor of a company shall be appointed by the Board of Directors within 30 days from the date of registration of the company. In the instant case, the proposed appointment of CA. Champ, a practicing Chartered Accountant, as first auditor by the Managing Director of Pigeon Ltd. by himself is in violation of Section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company.

Conclusion: In view of the above, the Managing Director of Pigeon Ltd. should be advised not to appoint the first auditor of the company.

2.1.2 Appointment of First Auditors in the case of Government Company:

A "Government company" is a company in which not less than 51% of the paid-up share capital is held 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, and includes a company which is a subsidiary company of such a Government company.

Section 139(7) 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.

CASE STUDY

Facts of the Case: The first auditor of Bhartiya Petrol Ltd., a Government company, was appointed by the Board of Directors.

Provisions and Explanation: In the case of a Government Company, the appointment of first auditor is governed by the provisions of Section 139(7) of the Companies Act, 2013 which states that 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. Hence, in the case of Bhartiya Petrol Ltd., being a government company, the first auditor shall be appointed by the Comptroller and Auditor General of India.

Conclusion: *Thus, the appointment of first auditor made by the Board of Directors of Bhartiya Petrol Ltd., is null and void.*

2.2 Appointment of Subsequent Auditor/Reappointment of Auditor

2.2.1 Appointment of Subsequent Auditors in case of Non Government Companies:

Section 139(1) of the Companies Act, 2013 provides that 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.

The following points need to be noted in this regard-

- (i) Before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.
- (ii) The certificate shall also indicate whether the auditor satisfies the criteria provided in **section 141**.
- (iii) The company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within 15 days of the meeting in which the auditor is appointed.

2.2.2 Appointment of Subsequent Auditors in case of Government Companies:

As per **section 139(5)**, 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.

2.3 Filling of a Casual Vacancy

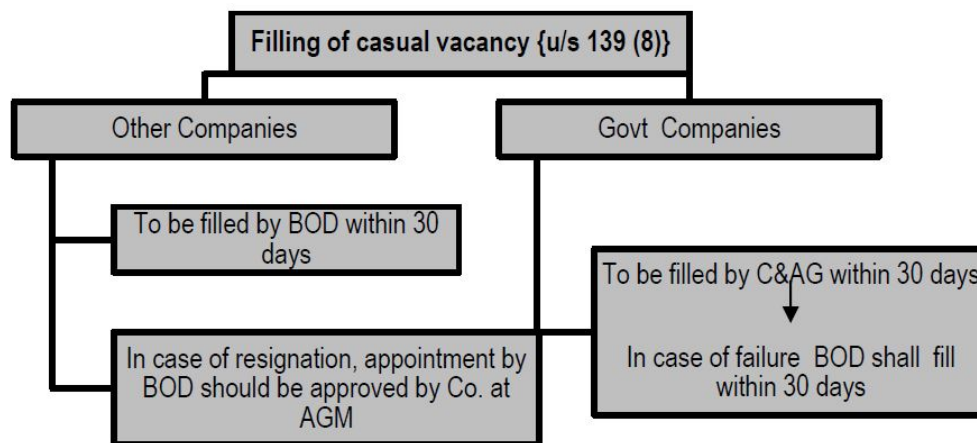
As per **Section 139(8)**, any casual vacancy in the office of an auditor shall-

- (i) **In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India**, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

- (ii) **In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India**, be filled by the Comptroller and Auditor-General of India within 30 days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period the Board of Directors shall fill the vacancy within next 30 days.



2.3.1 Casual Vacancy by Resignation:

As per section 140(2) of the Act, the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed Form ADT-3 (as per Rule 8 of CAAR) with the company and the Registrar.

In case of the companies referred to in section 139(5) i.e. Government company, the auditor shall also file such statement with the CAG along with the company and the Registrar.

The auditor shall indicate the reasons and other facts as may be relevant with regard to his resignation.

In case of failure, the auditor shall be liable to a penalty of fifty thousand rupees or the remuneration of the auditor, whichever is less, and in case of continuing failure, with further penalty of five hundred rupees for each day after the first during which such failure continues, subject to a maximum of five lakh rupees as per section 140(3).

CASE STUDY

Facts of the Case: CA. Donald was appointed as the auditor of PS Ltd. at the remuneration of Rs. 30,000. However, after 4 months of continuing his services, he could not continue to hold his office of the auditor as his wife got a government job at a distant place and he needs to shift along with her to the new place. Thus, he resigned from the company and did not perform his responsibilities relating to filing of statement to the company and the registrar indicating the reasons and other facts as may be relevant with regard to his resignation.

How much fine may he be punishable with under section 140(3) for non-compliance of section 140(2) of the Companies Act, 2013?

Provisions and Explanation: For non-compliance of sub-section (2) of section 140 of the Companies Act, 2013, the auditor shall be punishable with fine, which shall not be less than fifty thousand rupees or the remuneration of the auditor, whichever is less but which may extend to five lakh rupees, under section 140(3) of the said Act.

Conclusion: Thus, the fine under section 140(3) of the Companies Act, 2013 shall not be less than Rs. 30,000 but which may extend to Rs. 5,00,000 .

Other Important Provisions Regarding Appointment of Auditors

- (1) A retiring auditor may be re-appointed at an annual general meeting, if-
 - (a) he is not disqualified for re-appointment;
 - (b) he has not given the company a notice in writing of his unwillingness to be re - appointed; and
 - (c) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.

- (2) Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

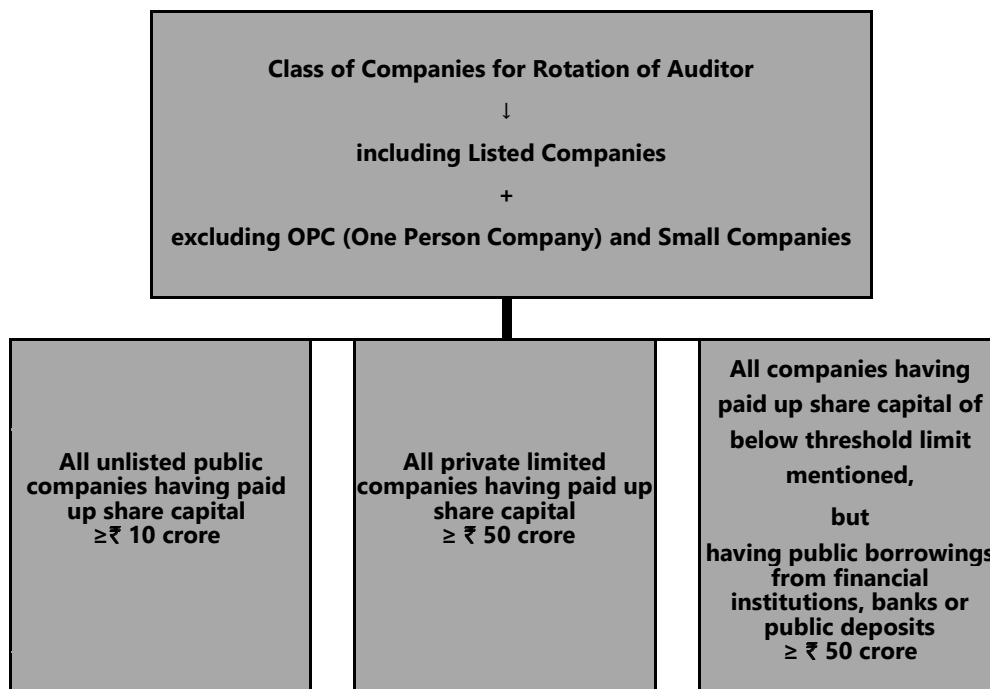
3 ROTATION OF AUDITOR

3.1 Applicability of Section 139(2) Rotation of Auditor:

As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the **class of companies** shall mean the following classes of companies excluding one person companies and small companies-



Fig: Rotation of Auditors*



- (i) all unlisted public companies having paid up share capital of rupees ten crore or more;
- (ii) all private limited companies having paid up share capital of rupees fifty crore or more;

* Source of image: the hindu business line.com

- (iii) all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more.

Example

Rano Pvt. Ltd. is a private limited Company, having paid up share capital of ₹42 crore but having public borrowing from nationalized banks and financial institutions of ₹72 crore, manner of rotation of auditor will be applicable.

As per **section 139(2)**, no listed company or a company belonging to such class or classes of companies as mentioned above, shall appoint or re-appoint-

- (a) an individual as auditor for more than one term of five consecutive years; and
- (b) an audit firm as auditor for more than two terms of five consecutive years. Provided that -
 - (i) an individual auditor who has completed his term under clause (a) shall not be eligible for re-appointment as auditor in the same company for five years from the completion of his term;
 - (ii) an audit firm which has completed its term under clause (b), shall not be eligible for re-appointment as auditor in the same company for five years from the completion of such term.

Example

Jolly Ltd., a listed company, appointed M/s Polly & Co., a Chartered Accountant firm, as the statutory auditor in its AGM held at the end of September, 2016 for 11 years. Here, the appointment of M/s Polly & Co. is not valid as the appointment can be made only for one term of five consecutive years and then another one more term of five consecutive years. It can't be appointed for two terms in one AGM only. Further, a cooling period of five years from the completion of term is required i.e. the firm can't be re-appointed for further 5 years after completion of two terms of five consecutive years.

The following points merit consideration in this regard-

- (1) As on the date of appointment, no audit firm having a common partner or partners to the other audit firm, whose tenure has expired in a company immediately preceding the financial year, shall be appointed as auditor of the same company for a period of five years.

Example

M/s XYZ & Co., is an audit firm having partner Mrs. X, Mr. Y and Mr. Z, whose tenure has expired in the company immediately preceding the financial year. M/s ABZ & Co., another audit firm in which Mr. Z is a common partner, will also be disqualified for the same company along with M/S XYZ & Co. for the period of five years.

- (2) Every company, existing on or before the commencement of this Act which is required to comply with provisions of this sub-section, shall comply with the requirements of this sub-section within a period which shall not be later than the date of the first annual general meeting of the company held, within the period specified under sub-section (1) of section 96, after three years from the date of commencement of this Act.

Examples

Ex 1: *Mr. Raj, a Chartered Accountant, is an individual auditor of Binaca Limited for last 5 years as on March, 2013 (i.e. existing on or before the date of Commencement of Companies Act, 2013). Keeping in view the transition period as stated in the Companies Act, 2013, Mr. Raj can continue the audit of Binaca Ltd. upto the first annual general meeting to be held after three years from the date of commencement of the Act.*

Ex 2: *M/s Raj & Associates, a Chartered Accountants Audit Firm, is doing audit of Binaca Limited for last 11 years as on March, 2013 (i.e. existing on or before the date of Commencement of Companies Act, 2013). Keeping in view the transition period as stated in the Companies Act, 2013, M/s Raj Associates can continue the audit of Binaca Ltd. upto the first annual general meeting to be held after three years from the date of commencement of the Act.*

Students may interlink the above example with Illustrative table explaining rotation in case of individual auditor as well as audit firm which has been given after the 3.2 i.e. Manner of rotation of Auditors by the Companies on Expiry of their Term.*

- (3) It has also been provided that right of the company to remove an auditor or the right of the auditor to resign from such office of the company shall not be prejudiced.
- (4) Subject to the provisions of this Act, members of a company may resolve to provide that -

- (a) in the audit firm appointed by it, the auditing partner and his team shall be rotated at such intervals as may be resolved by members; or
 - (b) the audit shall be conducted by more than one auditor.
- (5) The Central Government may, by rules, prescribe the manner in which the companies shall rotate their auditors.

3.2 Manner of Rotation of Auditors by the Companies on Expiry of their Term:

Rule 6 of the Companies (Audit and Auditors) Rules, 2014 prescribes the manner of rotation of auditors on expiry of their term which is given below-

- (1) The Audit Committee shall recommend to the Board, the name of an individual auditor or of an audit firm who may replace the incumbent auditor on expiry of the term of such incumbent.
- (2) Where a company is required to constitute an Audit Committee, the Board shall consider the recommendation of such committee, and in other cases, the Board shall itself consider the matter of rotation of auditors and make its recommendation for appointment of the next auditor by the members in annual general meeting.
- (3) For the purpose of the rotation of auditors-
 - (i) in case of an auditor (whether an individual or audit firm), the period for which the individual or the firm has held office as auditor prior to the commencement of the Act shall be taken into account for calculating the period of five consecutive years or ten consecutive years, as the case may be;
 - (ii) the incoming auditor or audit firm shall not be eligible if such auditor or audit firm is associated with the outgoing auditor or audit firm under the same network of audit firms.

Explanation I - For the purposes of these rules the term "same network" includes the firms operating or functioning, hitherto or in future, under the same brand name, trade name or common control.

Explanation II - For the purpose of rotation of auditors,

- (a) a break in the term for a continuous period of five years shall be considered as fulfilling the requirement of rotation;

- (b) if a partner, who is in charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of five years.

***Illustration explaining rotation in case of individual auditor**

Number of consecutive years for which an individual auditor has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which he may be appointed in the same company (including transitional period)	Aggregate period which the auditor would complete in the same company in view of column I and II
I	II	III
5 Years (or more than 5 years)	3 years	8 years or more
4 years	3 years	7 years
3 years	3 years	6 years
2 years	3 years	5 years
1 year	4 years	5 years

Note:

- (1) Individual auditor shall include other individuals or firms whose name or trade mark or brand is used by such individual, if any.
- (2) Consecutive years shall mean all the preceding financial years for which the individual auditor has been the auditor until there has been a break by five years or more.

***Illustration explaining rotation in case of audit firm**

Number of consecutive years for which an audit firm has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which the firm may be appointed in the same company (including transitional period)	Aggregate period which the firm would complete in the same company in view of column I and II
I	II	III
10 Years (or more than 10years)	3 years	13 years or more
9 years	3 years	12 years
8 years	3 years	11 years
7 years	3 years	10 years
6 year	4 years	10 years
5 years	5 years	10 years
4 years	6 years	10 years
3 year	7 years	10 years
2 years	8 years	10 years
1 years	9 years	10 years

Note:

- (i) Audit Firm shall include other firms whose name or trade mark or brand is used by the firm or any of its partners.
 - (ii) Consecutive years shall mean all the preceding financial years for which the firm has been the auditor until there has been a break by five years or more.
- (4) Where a company has appointed two or more individuals or firms or a combination thereof as joint auditors, the company may follow the rotation of auditors in such a manner that both or all of the joint auditors, as the case may be, do not complete their term in the same year.



4 PROVISIONS RELATING TO AUDIT COMMITTEE

4.1 Applicability of section 177 i.e. Constitution of Audit Committee:

Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

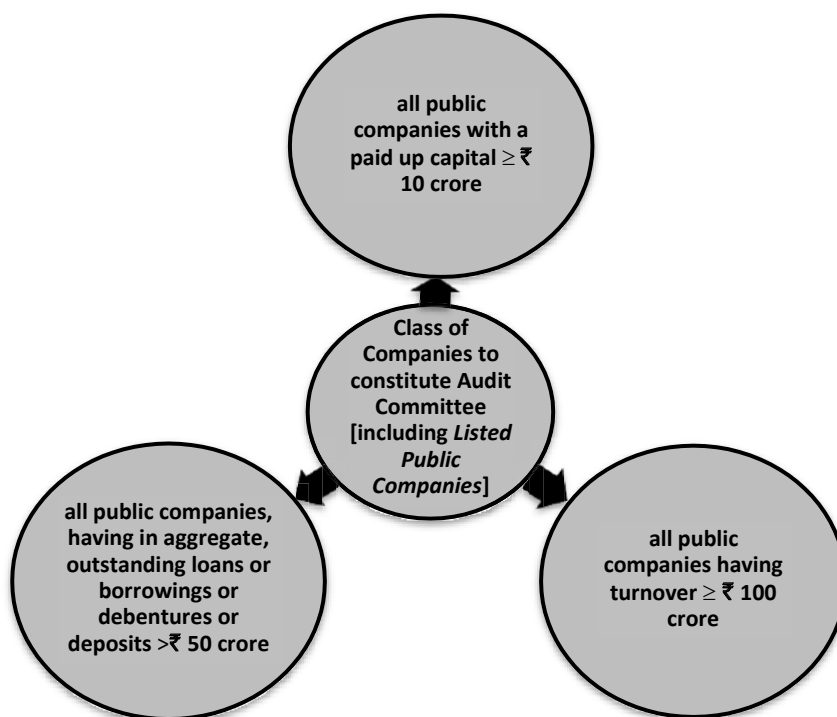


Diagram showing class of companies to constitute Audit Committee

It is important to know that in addition to **listed public companies**, following classes of companies shall constitute an Audit Committee -

- (i) all public companies with a paid up capital of ten crore rupees or more;
- (ii) all public companies having turnover of one hundred crore rupees or more;
- (iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

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

Example

XYZ Ltd., a public company having paid up capital of ₹9 crore but having turnover of ₹150 crore, will be required to constitute an Audit Committee under section 177 because the requirement for constitution of Audit Committee arises if the company falls into any of the prescribed category.

4.2 Manner and procedure of selection and appointment of auditors

Rule 3 of CAAR, 2014 prescribes the following manner and procedure of selection and appointment of auditors-

- (1) In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, the Board, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.

It may be noted that while considering the appointment, the Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.

- (2) The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.
- (3) Subject to the provisions of sub-rule (1), where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases, the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.
- (4) If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.

- (5) If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.
- (6) If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.
- (7) The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.



5 AUDITOR'S REMUNERATION

As per section 142 of the Act, the remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein. However, board may fix remuneration of the first auditor appointed by it.

Further, the remuneration, in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company. Therefore, it has been clarified that the remuneration to Auditor shall also include any facility provided to him.



6 REMOVAL OF AUDITORS

6.1 Removal of Auditor Before Expiry of Term



Fig: Auditor leaving office of the auditor*

According to **Section 140(1)**, the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per **Rule 7 of CAAR, 2014-**

- (1) The application to the Central Government for removal of auditor shall be made in **Form ADT-2** and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.
- (2) The application shall be made to the Central Government within 30 days of the resolution passed by the Board.
- (3) The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.

It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard.

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 in 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.

6.2 Appointment of Auditor Other Than Retiring Auditor

Section 140(4) lays down procedure to appoint an auditor other than retiring auditor who was removed-

- (1) Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing

expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or as the case may be, ten years, as provided under **sub-section (2) of section 139**.

- (2) On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.
- (3) Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company (not exceeding a reasonable length) and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so,-
 - (a) in any notice of the resolution given to members of the company, state the fact of the representation having been made; and
 - (b) send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company. and if a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting.

Students may note that if a copy of representation is not sent as aforesaid, a copy thereof shall be filed with the Registrar.

Curtailling 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. CEILING ON NUMBER OF AUDITS

It has been mentioned earlier that before appointment is given to any auditor, the company must obtain a certificate from him to the effect that the appointment, if made, will not result in an excess holding of company audit by the auditor concerned over the limit laid down in **section 141(3)(g)** of the Companies Act, 2013 which prescribes that a person who 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, shall not be eligible for appointment as an Auditor of a Company.

In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.

This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be $3 \times 20 = 60$ company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account. Subject to the overall ceiling of company audits, how they allocate the 20 audits between themselves is their affairs.

CASE STUDY

"ABC & Co." is an Audit Firm having partners "Mr. A", "Mr. B" and "Mr. C", Chartered Accountants. "Mr. A", "Mr. B" and "Mr. C" are holding appointment as an Auditor in 4, 6 and 10 Companies respectively.

- (i) *Provide the maximum number of Audits remaining in the name of "ABC & Co."*
- (ii) *Provide the maximum number of Audits remaining in the name of individual partner i.e. Mr. A, Mr. B and Mr. C.*
- (iii) *Can ABC & Co. accept the appointment as an auditor in 60 private companies having paid-up share capital less than ₹ 100 crore, 2 small companies and 1 dormant company?*
- (iv) *Would your answer be different, if out of those 60 private companies, 45 companies are having paid-up share capital of ₹ 110 crore each?*

Fact of the Case: *In the instant case, Mr. A is holding appointment in 4 companies, whereas Mr. B is having appointment in 6 Companies and Mr. C is having appointment in 10 Companies. In aggregate all three partners are having 20 audits.*

Provisions and Explanations: *Section 141(3)(g) of the Companies Act, 2013 states that the following persons shall not be eligible for appointment as an auditor of a company i.e. a person who 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.

As per section 141(3)(g), this limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be $3 \times 20 = 60$ company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account.

Conclusion:

- (i) Therefore, ABC & Co. can hold appointment as an auditor of 40 more companies:

Total Number of Audits available to the Firm Number = $20 \times 3 = 60$
of Audits already taken by all the partners

In their individual capacity = $4 + 6 + 10 = 20$

Remaining number of Audits available to the Firm = 40

- (ii) With reference to above provisions an auditor can hold more appointment as auditor = ceiling limit as per section 141(3)(g)- already holding appointments as an auditor. Hence (1) Mr. A can hold: $20 - 4 = 16$ more audits. (2) Mr. B can hold $20 - 6 = 14$ more audits and (3) Mr. C can hold $20 - 10 = 10$ more audits.

- (iii) In view of above discussed provisions, ABC & Co. can hold appointment as an auditor in all the 60 private companies having paid-up share capital less than ₹ 100 crore, 2 small companies and 1 dormant company as these are excluded from the ceiling limit of company audits given under section 141(3)(g) of the Companies Act, 2013.

- (iv) As per fact of the case, ABC & Co. is already having 20 company audits and they can also accept 40 more company audits. In addition they can also conduct the audit of one person companies, small companies, dormant companies and private companies having paid up share capital less than ₹ 100 crores. In the given case, out of the 60 private companies, ABC & Co. is offered 45 companies having paid-up share capital of ₹ 110 crore each.

Therefore, ABC & Co. can also accept the appointment as an auditor for 2 small companies, 1 dormant company, 15 private companies having paid-up share capital less than ₹ 100 crore and 40 private companies having paid-up share capital of ₹ 110 crore each in addition to above 20 company audits already holding.

Council General Guidelines, 2008 (Chapter VIII): In exercise of the powers conferred by clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India hereby specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the "specified number of audit assignments of the companies under Section 224 and /or Section 226 of the Companies Act, 1956 (now section 141(3)(g) of the Companies Act, 2013).

It may be noted that in the case of a firm of chartered accountants in practice, the specified number of audit assignments shall be construed as the specified number of audit assignments for every partner of the firm.

It may also be noted that where any partner of the firm of chartered accountants in practice is also a partner of any other firm or firms of chartered accountants in practice, the number of audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the specified number of audit assignments in the aggregate.

It is further provided that where any partner of a firm or firms of chartered accountants in practice accepts one or more audit assignments in his individual capacity, or in the name of his proprietary firm, the total number of such assignment which may be accepted by all firms in relation to such chartered accountant and by him shall not exceed the specified number of audit assignments in the aggregate.

- (1) In computing the specified number of audit assignments-
 - (a) the number of such assignments, which he or any partner of his firm has accepted whether singly or in combination with any other chartered accountant in practice or firm of such chartered accountants, shall be taken into account.
 - (b) the number of partners of a firm on the date of acceptance of audit assignment shall be taken into account.
 - (c) a chartered accountant in full time employment elsewhere shall not be taken into account.
- (2) A chartered accountant in practice as well as firm of chartered accountants in practice shall maintain a record of the audit assignments accepted by him or by the firm of chartered accountants, or by any of the partner of the firm in his individual name or as a partner of any other firm as far as possible, in the prescribed manner.

Ceiling on Tax Audit Assignments: The specified number of tax audit assignments that an auditor, as an individual or as a partner of a firm, can accept is **60 numbers**. ICAI has notified that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he accepts in a financial year, more than the specified number of tax audit assignments u/s 44AB.



8. POWERS/RIGHTS OF AUDITORS

The auditor has the following powers/rights while conducting an audit:

(a) Right of access to books, etc. – Section 143(1) of the Act provides that the auditor of a company, at all times, shall have a right of access to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and he is entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor.

It may be noted that according to **section 2(59)** of the Act, the term 'officer' includes any director, manager or key managerial personnel or any person in accordance with whose directions or instructions the Board of Directors or any one or more of the directors is or are accustomed to act;

The phrase 'books, accounts and vouchers' includes all books which have any bearing, or are likely to have any bearing on the accounts, whether these be the usual financial books or the statutory or statistical books; memoranda books, *e.g.*, inventory books, costing records and the like may also be inspected by the auditor. Similarly the term 'voucher' includes all or any of the correspondence which may in any way serve to vouch for the accuracy of the accounts. Thus, the right of access is not restricted to books of account alone and it is for the auditor to determine what record or document is necessary for the purpose of the audit.

The right of access is not limited to those books and records maintained at the registered or head office so that in the case of a company with branches, the right also extends to the branch records, if the auditor considers it necessary to have access thereto as per **Section 143(8)**.

Example

X Ltd. restrains its company auditor from visiting another branch at different location and having access to the inventory records maintained at that branch because the branch is already audited by another auditor and the report has been received. Here, it may be noted that the company auditor has right to visit the branch, even if the

branch accounts are audited by another auditor, if he considers it necessary to do so for the performance of his duties as auditor.

(b) Right to obtain information and explanation from officers - This right of the auditor to obtain from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor is a wide and important power. In the absence of such power, the auditor would not be able to obtain details of amount collected by the directors, etc. from any other company, firm or person as well as of any benefits in kind derived by the directors from the company, which may not be known from an examination of the books. It is for the auditor to decide the matters in respect of which information and explanations are required by him. When the auditor is not provided the information required by him or is denied access to books, etc., his only remedy would be to report to the members that he could not obtain all the information and explanations he had required or considered necessary for the performance of his duties as auditors.

(c) Right to receive notices and to attend general meeting – The auditors of a company are entitled to attend any general meeting of the company (the right is not restricted to those at which the accounts audited by them are to be discussed); also to receive all the notices and other communications relating to the general meetings, which members are entitled to receive and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors.

Section 146 of the Companies Act, 2013 discusses right as well as duty of the auditor. According to the section 146:

"all notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company, and the auditor shall, unless otherwise exempted by the company, attend either by himself or through his authorised representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor."

Thus, it is right of the auditor to receive notices and other communications relating to any general meeting and to be heard at such meeting, relating to the matter of his concern, however, it is duty of the auditor to attend the same or through his authorised representative unless otherwise exempted.

(d) Right to report to the members of the company on the accounts examined by him – The auditor shall make a report to the members of the

company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made there under or under any order made under this section and to the best of his information and knowledge, the said accounts, 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.

(e) Right to Lien – In terms of the general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property. On this premise, auditor can exercise lien on books and documents placed at his possession by the client for non payment of fees, for work done on the books and documents. The Institute of Chartered Accountants in England and Wales has expressed a similar view on the following conditions:

- (i) Documents retained must belong to the client who owes the money.
- (ii) Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the Board of Directors.
- (iii) The auditor can retain the documents only if he has done work on the documents assigned to him.
- (iv) Such of the documents can be retained which are connected with the work on which fees have not been paid.

Under **section 128** of the Act, books of account of a company must be kept at the registered office. These provisions ordinarily make it impracticable for the auditor to have possession of the books and documents. The company provides reasonable facility to auditor for inspection of the books of account by directors and others authorised to inspect under the Act. Taking an overall view of the matter, it seems that though legally, auditor may exercise right of lien in cases of companies, it is mostly impracticable for legal and practicable constraints. His working papers being his own property, the question of lien, on them does not arise.

SA 230 issued by ICAI on Audit Documentation (explanatory text, A- 25), "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, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation 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.”

9. DUTIES OF AUDITORS

Sections 143 of the Companies Act, 2013 specifies the duties of an auditor of a company in a quite comprehensive manner. It is noteworthy that scope of duties of an auditor has generally been extending over all these years.

(1) Duty of Auditor to Inquire on certain matters: It is the duty of auditor to inquire into the following matters-

- (a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;
- (b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;
- (c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
- (d) whether loans and advances made by the company have been shown as deposits;
- (e) whether personal expenses have been charged to revenue account;
- (f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

The opinion of the Research Committee of the Institute of Chartered Accountants of India on section 143(1) is reproduced below:

"The auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. In such a case, the content of the Auditor's Report will remain exactly the same as the auditor has to inquire and apply his mind to the information elicited by the enquiry, in deciding whether or not any reference needs to be made in his report. In our opinion, it is in this light that

the auditor has to consider his duties under section 143(1)."

Therefore, it could be said that the auditor should make a report to the members in case he finds answer to any of these matters in adverse.

- (2) **Duty to Sign the Audit Report:** As per **section 145** of the Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company, in accordance with the provisions of **section 141(2)**.

Section 141(2) of the Companies Act, 2013 states that where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

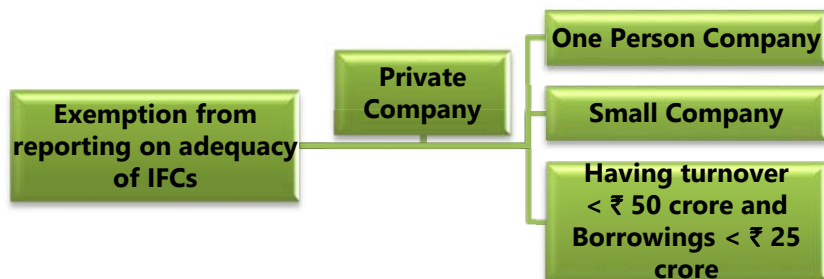
The qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report shall be read before the company in general meeting.

- (3) **Duty to comply with Auditing Standards:** As per **section 143(9)** of the Companies Act, 2013, every auditor shall comply with the auditing standards. Further, as per **section 143(10)** of the Act, the Central Government may prescribe the standards of auditing as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.
- (4) **Duty to report:** As per **section 143(3)**, the auditor's report shall also state—
- (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

- (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- (c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;
- (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
- (e) whether, in his opinion, the financial statements comply with the accounting standards;
- (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
- (g) whether any director is disqualified from being appointed as a director under sub-section (2) of the section 164;
- (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
- (i) whether the company has adequate internal financial controls **with reference to financial statements** in place and the operating effectiveness of such controls;

However, it may be noted that the reporting requirement on adequacy of internal financial controls (IFCs) with reference to financial statements shall not be applicable to a private company which is a–

- (i) One person company; or**
- (ii) Small company; or**
- (iii) Company having turnover less than ₹ 50 crore as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial year less than ₹ 25 crore.**



- (j) such other matters as may be prescribed. Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely:-
- (i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
 - (ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;
 - (iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

[Notes: (1) Students may note that the auditor is also required to report on certain additional matters specified under CARO, 2016 which is discussed later under Para 10 Reporting under Companies (Auditor's Report) Order, 2016.

(2) Students are also required to refer Guidance note on Reporting under section 143(3)(f) and (h) of the Companies Act, 2013.]

(5) Duty to report on frauds:

- A. Reporting to the Central Government-** As per **section 143(12)** of the Companies Act, 2013 read with **Rule 13** of the Companies (Audit and Auditors) Rules, 2014, 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, which involves or is expected to involve individually an amount of ₹ 1 crore or above, 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 prescribed.

- B. Reporting to the Audit Committee or Board-** 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 prescribed.
- C. Disclosure in the Board's Report:** 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 prescribed.

Sub-section (13) of section 143 of the Companies Act, 2013 safeguards the act of fraud reporting by the auditor if it is done in good faith. It states that no duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter above if it is done in good faith.

It is very important to note that the provisions regarding fraud reporting shall also apply, *mutatis mutandis*, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively. If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12) of section 143, he shall be punishable with fine which shall not be less than ₹ 1 lakh but which may extend to ₹ 25 lakh.

The auditor is also required to report under **clause (x) of paragraph 3 of Companies (Auditor's Report) Order, 2016 [CARO, 2016]**, 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.

[Notes: For detailed provisions of CARO, 2016, students may refer Para 10 Reporting under Companies (Auditor's Report) Order, 2016]

Example

The head accountant of a company entered fake invoices of credit purchases in the books of account aggregate of ₹ 50 lakh and cleared all the payments to such bogus creditor. Here, the auditor of the company is required to report the fraudulent activity to the Board or Audit Committee (as the case may be) within 2 days of his knowledge of fraud. Further, the company is also required to disclose the same in Board's Report.

It may be noted that the auditor need not to report the central government as the amount of fraud involved is less than ₹1 crore, however, reporting under CARO, 2016 is required.

- (6) Duty to report on any other matter specified by Central Government:** The Central Government may, in consultation with the National Financial Reporting Authority (NFRA), by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.

However, as per the notification dated 29.03.2016, till the time NFRA is constituted, the Central Government may hold consultation required under this sub-section with the Committee chaired by an officer of the rank of Joint Secretary or equivalent in the MCA and the Committee shall have the representatives from the ICAI and Industry Chambers and also special invitees from the National Advisory Committee on Accounting Standards (NACAS) and the office of the C&AG.

[Note: Students may note that Companies (Auditor's Report) Order, 2016 has been notified in this perspective which is discussed later under Para 10 Reporting under Companies (Auditor's Report) Order, 2016]

- (7) Duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor are discussed separately in the chapter under heading 13 branch audit.**
- (8) Duty to state the reason for qualification or negative report:** As per **section 143(4)**, where any of the matters required to be included in the audit report is answered in the negative or with a qualification, the report shall state the reasons there for.



10. REPORTING UNDER COMPANIES (AUDITOR'S REPORT ORDER, 2016 [CARO, 2016]

The Central Government, after consultation with the committee constituted under proviso to **section 143(11)** of the Companies Act, 2013, and in supersession of the Companies (Auditor's Report) Order, 2015 dated the 10th April, 2015, has issued the Companies (Auditor's Report) Order, 2016, (CARO, 2016) under section 143(11) of the Companies Act, 2013, dated 29th March, 2016. The requirements of the Order

are supplemental to the existing provisions of section 143 of the Act regarding the auditor's report.

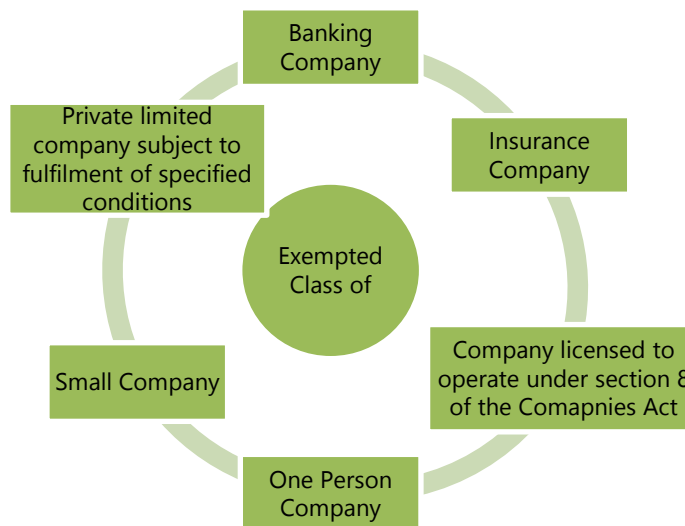
The Order is not intended to limit the duties and responsibilities of auditors but only requires a statement to be included in the audit report in respect of the matters specified therein.

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, 2013.

However, the Order specifically **exempts** the following class of companies-

- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;
- (ii) an insurance company as defined under the Insurance Act, 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;
- (v) a small company as defined under clause (85) of section 2 of the Companies Act; and
- (vi) 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 ₹ 1 crore as on the balance sheet date and which does not have total borrowings exceeding ₹ 1 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 ₹ 10 crore during the financial year as per the financial statements.

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



Example

Ex. 1: 'Educating Child' is a limited company registered under section 8 of the Companies Act, 2013.

In the given case, 'Educating Child' is licensed to operate under section 8 of the Companies Act, 2013. Therefore, CARO, 2016 shall not be applicable to 'Educating Child' accordingly.

Ex. 2: Ashu Pvt. Ltd. has fully paid capital and reserves of ₹ 50 lakh. During the year, the company had borrowed ₹ 70 lakh each from a bank and a financial institution independently. It has the turnover of ₹ 900 lakh.

In the given case of Ashu Pvt. Ltd., it has paid capital and reserves of ₹ 50 lakh i.e. less than

₹ 1 crore, turnover of ₹ 9 crore i.e. less than ₹ 10 crore. However, it has maximum outstanding borrowings of ₹ 1.40 crore (₹ 70 lakh + ₹ 70 lakh) collectively from bank and financial institution.

Therefore, it fails to fulfill the condition relating to borrowings. Thus, CARO, 2016 shall be applicable to Ashu Pvt. Ltd. accordingly.

Matters to be included in the Auditor's Report: Paragraph 3 of the Order requires the auditor to include a statement in the auditor's report 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) where maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 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 with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at 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 constitute 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, 2013? 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.

Reasons to be Stated for Unfavourable or Qualified Answers: Where the answer to any of the questions referred to in **paragraph 3 of the Order** is unfavourable or qualified, in the auditor's report, the auditor shall also state the basis for such unfavourable or qualified answer, as the case may be.

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

Example

The company has dispensed with the practice of taking inventory of their inventories at the year-end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations. Explain reporting requirement under CARO, 2016.

Reporting for Physical Verification of Inventory: Clause (ii) of Para 3 of CARO, 2016, requires the auditor to report 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.

The physical verification of inventory is the responsibility of the management of the company which should verify all material items at least once in a year and more often in appropriate cases.

In the given case, the above requirement of physical verification of inventory by the management has not been taken place and therefore the auditor should point out the same under CARO, 2016. He may consider the impact on financial statement and report accordingly.



11. DISCLOSURE IN THE AUDITOR'S REPORT

The following paragraphs deal with the manner of qualification and the manner of disclosure, if any, to be made in the auditor's report.

AS-1 – Disclosure of Accounting Policies

In the case of a company, members should qualify their audit reports in case –

- (a) accounting policies required to be disclosed under Schedule III or any other provisions of the Companies Act, 2013 have not been disclosed, or
- (b) accounts have not been prepared on accrual basis, or
- (c) the fundamental accounting assumption of going concern has not been followed and this fact has not been disclosed in the financial statements, or
- (d) proper disclosures regarding changes in the accounting policies have not been made.

Where a company has been given a specific exemption regarding any of the matters stated above but the fact of such exemption has not been adequately disclosed in the accounts, the member should mention the fact of exemption in his audit report without necessarily making it a subject matter of audit qualification.

In view of the above, the auditor will have to consider different circumstances whether the audit report has to be qualified or only disclosures have to be given.

In the case of enterprises not governed by the Companies Act, the member should examine the relevant statute and make suitable qualification in his audit report in case adequate disclosures regarding accounting policies have not been made as per the statutory requirements. Similarly, the member should examine if the fundamental accounting assumptions have been followed in preparing the financial statements or not. In appropriate cases, he should consider whether, keeping in view the requirements of the applicable laws, a qualification in his report is necessary.

In the event of non-compliance by enterprises not governed by the Companies Act, in situations where the relevant statute does not require such disclosures to be made, the member should make adequate disclosure in his audit report without necessarily making it a subject matter of audit qualification.

In making a qualification / disclosure in the audit report, the auditor should consider the materiality of the relevant item. Thus, the auditor need not make qualification / disclosure in respect of items which, in his judgement, are not material.

A disclosure, which is not a subject matter of audit qualification, should be made in the auditor's report in a manner that it is clear to the reader that the disclosure does not constitute an audit qualification. The paragraph containing the auditor's opinion on true and fair view should not include a reference to the paragraph containing the aforesaid disclosure.

12. JOINT AUDIT

The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

In specific terms the **advantages** that flow may be the following:

- (i) Sharing of expertise.
- (ii) Advantage of mutual consultation.
- (iii) Lower workload.
- (iv) Better quality of performance.
- (v) Improved service to the client.
- (vi) Displacement of the auditor of the company taken over in a take - over often obviated.
- (vii) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- (viii) Lower staff development costs.
- (ix) Lower costs to carry out the work.
- (x) A sense of healthy competition towards a better performance.

The general **disadvantages** may be the following:

- (i) The fees being shared.
- (ii) Psychological problem where firms of different standing are associated in the joint audit.
- (iii) General superiority complexes of some auditors.

- (iv) Problems of co-ordination of the work.
- (v) Areas of work of common concern being neglected.
- (vi) Uncertainty about the liability for the work done.

The Institute of Chartered Accountants of India has issued Standard on Auditing (SA) 299 (Revised), “Joint Audit of Financial Statements” which lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200 “Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with Standards on Auditing”. This Standard deals with the special considerations in carrying out audit by joint auditors. It requires that–

- (i) *the engagement partner and other key members of the engagement team from each of the joint auditors should be involved in planning the audit.***
- (ii) *the joint auditors should jointly establish an overall audit strategy which sets the scope, timing and direction of the audit, and also guides the development of the audit plan.***
- (iii) *before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:***
 - (a) *identify division of audit areas and common audit areas;***
 - (b) *ascertain the reporting objectives of the engagement;***
 - (c) *consider and communicate among all joint auditors the factors that are significant***
 - (d) *in directing the engagement team’s efforts;***
 - (e) *consider the results of preliminary engagement activities, or similar engagements performed earlier.***
 - (f) *ascertain the nature, timing and extent of resources necessary to accomplish the engagement.***
- (iv) *each of the joint auditors should consider and assess the risks of material misstatement and communicate to other joint auditors.***
- (v) *the joint auditors should discuss and document the nature, timing, and the extent of the audit procedures for (I) common and (II) specific allotted areas of audit to be performed.***

- (vi) the joint auditors should obtain common engagement letter and common management representation letter.**
- (vii) the work allocation document should be signed by all the joint auditors and communicated to** those charged with governance.

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

- (i) the audit work which is not divided among the joint auditors and is carried out by all joint auditors;**
- (ii) decisions taken by all the joint auditors under audit planning in respect of common audit areas;**
- (iii) matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;**
- (iv) examining that the financial statements of the entity comply with the requirements of the relevant statutes;**
- (v) presentation and disclosure of the financial statements as required by the applicable financial reporting framework;**
- (vi) ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.**

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

It may be noted that the joint auditors are required to issue common audit report. However, where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to each other's audit report(s).

[Note: Student may refer SA 299 (revised) "Joint Audit of Financial Statements" reproduced in "Auditing Pronouncements" for comprehensive knowledge.]



13. AUDIT OF BRANCH OFFICE ACCOUNTS

As per **section 128(1)** of the Companies Act, 2013, 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, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting.

It may be noted that all or any of the books of account aforesaid and other relevant papers may be kept at such other place in India as the Board of Directors may decide and where such a decision is taken, the company shall, within 7 days thereof, file with the Registrar a notice in writing giving the full address of that other place.

Students may also note that the company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.

Sub-section (2) provides that where a company has a branch office in India or outside India, it shall be deemed to have complied with the provisions of sub-section (1), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns periodically are sent by the branch office to the company at its registered office or the other place referred in (1).

Further, sub-section (8) of section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:

It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per **rule 12 of the Companies (Audit and Auditors) Rules, 2014**, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

Using the Work of another Auditor: When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole; also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of the Institute of Chartered Accountants of India has dealt with these issues in **SA 600, "Using the Work of another Auditor"**. It makes clear that in certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component. Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

- (a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as are as requiring special consideration, procedures for the identification of inter -component transactions that may require disclosure and the time-table for completion of audit; and
- (b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This

knowledge may have been enhanced from the review of the previous audit work of the other auditor.



14. COST AUDIT

Cost Audit is an audit process for verifying the cost of manufacture or production of any article, on the basis of accounts as regards utilisation of material or labour or other items of costs, maintained by the company.

It is covered by **Section 148** of the Companies Act, 2013. The audit conducted under this section shall be in addition to the audit conducted under section 143.

As per section 148 the Central Government may by order specify audit of items of cost in respect of certain companies.

Further, the Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies.

In this regard, the Central Government has notified the Companies (Cost Records and Audit) Rules, 2014 which prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc.

Applicability for 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 (A) Regulated sectors and (B) Non-regulated sectors.

Maintenance of Cost Records: As per Rule 5 of the Companies (Cost Records and Audit) Rules, 2014, every company under these rules including all units and branches thereof, shall, in respect of each of its financial year, is required to maintain cost records in Form CRA-1. The cost records shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products

and activities for every financial year on monthly or quarterly or half-yearly or annual basis.

Additionally, as per **clause (vi) to Paragraph 3 of the CARO, 2016**, the auditor has to report 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.

Applicability of Cost Audit: Rule 4 of the Companies (Cost Records and Audit) Rules, 2014 states the provisions related to the applicability of cost audit depending on the turnover of the company as follows-

- (i) Classes of companies specified under item (A) "Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 50 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is ₹ 25 crore or more.
- (ii) Classes of companies specified under item (B) "Non-Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 100 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is ₹ 35 crore or more.

Who can be Cost Auditor: The audit shall be conducted by a Cost Accountant who shall be appointed by the Board of such remuneration as may be determined by the members in such manner as may be prescribed.

It may be noted that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records.

It may also be noted that the auditor conducting the cost audit shall comply with the cost auditing standards ("cost auditing standards" mean such standards as are issued by the Institute of Cost Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government).

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 180 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.

Every referred company shall inform the cost auditor concerned of his or its appointment as such and file a notice of such appointment with the Central Government within a period of 30 days of the Board meeting in which such appointment is made or within a period of 180 days of the commencement of the financial year, whichever is earlier, through electronic mode, in Form CRA-2, along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014.

The cost auditor appointed as such shall continue in such capacity till the expiry of 180 days from the closure of the financial year or till he submits the cost audit report, for the financial year for which he has been appointed.

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.

Casual Vacancy in the Office of a Cost Auditor: Any casual vacancy in the office of a Cost Auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors within 30 days of occurrence of such vacancy and the company shall inform the central government in Form CRA-2 within 30 days of such appointment of cost auditor.

Remuneration of Cost Auditor: As per rule 14 of the Companies (Audit and Auditors) Rules, 2014-

- (a) in the case of companies which are required to constitute an audit committee-
 - (i) the Board shall appoint an individual, who is a cost accountant, or a firm of cost accountants in practice, as cost auditor on the recommendations of the Audit committee, which shall also recommend remuneration for such cost auditor;
 - (ii) the remuneration recommended by the Audit Committee under (i) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders;
- (b) in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.

Qualification, Disqualification, Rights, Duties and Obligations of Cost Auditor:

The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

Submission of Cost Audit Report:

(i) To the Board of Directors of the Company- The cost auditor shall submit the cost audit report along with his reservations or qualifications or observations or suggestions, if any, in Form CRA-3. He shall forward his report to the Board of Directors of the company within a period of 180 days from the closure of the financial year to which the report relates and the Board of Directors shall consider and examine such report particularly any reservation or qualification contained therein.

(ii) To the Central Government- The company shall within 30 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.

Provided that the companies which have got extension of time of holding AGM under section 96 (1) of the Companies Act, 2013, may file form CRA-4 within resultant extended period of filing financial statements under section 137 of the Companies Act, 2013.

If, after considering the cost audit report and the, information and explanation furnished by the company as above, the Central Government is of the opinion, that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.

Duty to Report on Fraud: The provisions of **section 143(12)** of the Companies Act, 2013 and the relevant rules on duty to report on fraud shall apply mutatis mutandis to a cost auditor during performance of his functions under section 148 of the Act and these rules.

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.

Penal Provisions in Case of Default: If any default is made in complying with the provisions of this section,

- (a) the company and every officer of the company who is in default shall be punishable in the manner as provided in sub-section (1) of section 147;
- (b) the cost auditor of the company who is in default shall be punishable in the manner as provided in sub-sections (2) to (4) of section 147.



15. PUNISHMENT FOR NON-COMPLIANCE

Section 147 of the Companies Act, 2013 prescribes following punishments for contravention:

- (1) If any of the provisions of sections 139 to 146 (both inclusive) is contravened, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with

imprisonment for a term which may extend to one year or with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees, or with both.

- (2) If an auditor of a company contravenes any of the provisions of section 139 section 143, section 144 or section 145, the auditor shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees or four times the remuneration of the auditor, whichever is less.

It may be noted that if an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than **fifty thousand** rupees but which may extend to twenty-five lakh rupees **or eight times the remuneration of the auditor, whichever is less** .

- (3) Where an auditor has been convicted under sub-section (2), he shall be liable to-
- (i) refund the remuneration received by him to the company;
 - (ii) and pay for damages to the company statutory bodies or authorities or to **members or creditors of the company** for loss arising out of incorrect or misleading statements of particulars made in his audit report.
- (4) The Central Government shall, by notification, specify any statutory body or authority of an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub-section (3) and such body, authority or officer shall after payment of damages the such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.
- (5) Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in an fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil or criminal as provided in this Act or in any other law for the time being in force, for such act shall be of the partner or partners concerned of the audit firm and of the firm jointly and severally.

It may be noted that in case of criminal liability of an audit firm, in respect of liability other than fine, the concerned partner(s), who acted in a fraudulent manner or abetted or, as the case may be, colluded in any fraud shall only be liable.

TEST YOUR KNOWLEDGE

Correct/Incorrect:

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

- (i) The first auditor of a Government company was appointed by the Board in its meeting after 10 days from the date of registration.
- (ii) Director's relative can act as an auditor of the company.
- (iii) If an LLP (Limited Liability Partnership Firm) is appointed as an auditor of a company, every partner of a firm shall be authorized to act as an auditor.
- (iv) AB & Co. is an audit firm having partners Mr. A and Mr. B. Mr. C, the relative of Mr. B is holding securities having face value of ₹ 2,00,000 in XYZ Ltd. AB & Co. is qualified for being appointed as an auditor of XYZ Ltd.
- (v) 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.
- (vi) Manner of rotation of auditor will not be applicable to company A, which is having paid up share capital of ₹ 15 crores and having public borrowing from nationalized bank of ₹ 50 crore because it is a Private Limited Company.
- (vii) The auditor should study the Memorandum and Articles of Association to see the validity of his appointment.
- (viii) Managing director of A Ltd. himself appointed the first auditor of the company.
- (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) Mr. N, a member of the Institute of Company Secretary of India, is qualified to be appointed as auditor of XYZ Limited.

Theoretical Questions

1. An auditor purchased goods worth ₹ 501,500 on credit from a company being audited by him. The company allowed him one month's credit, which it normally allowed to all known customers. Comment.
2. (a) Ram and Hanuman Associates, Chartered Accountants in practice have been appointed as Statutory Auditor of Krishna Ltd. for the accounting year 2017-2018. Mr. Hanuman holds 100 equity shares of Shiva Ltd., a subsidiary company of Krishna Ltd. Comment.

- (b) Managing Director of PQR Ltd. himself wants to appoint Shri Ganpati, a practicing Chartered Accountant, as first auditor of the company. Comment on the proposed action of the Managing Director.
3. Under what circumstances the retiring Auditor cannot be reappointed?
4. Discuss the following:
- Ceiling on number of audits in a company to be accepted by an auditor.
 - Filling of a casual vacancy of auditor in respect of a company audit.
 - In Joint Audit, "Each Joint Auditor is responsible only for the work allocated to him".

ANSWER

Answers to Correct/Incorrect

- (i) **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 CAG fails to make the appointment within 60 days, the Board shall appoint in next 30 days.
- (ii) **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.
- (iii) **Incorrect:** As per section 141(2) of the Companies Act, 2013, where a firm including a limited liability partnership (LLP) is appointed as an auditor of a company, only the partners who are Chartered Accountants shall be authorised to act and sign on behalf of the firm.
- (iv) **Incorrect:** As per the provisions of the Companies Act, 2013, a person is disqualified to be appointed as an auditor of a company if his relative is holding any security of or interest in the company of face value exceeding ₹ 1 lakh.

Therefore, AB & Co. shall be disqualified for being appointed as an auditor of XYZ Ltd. as Mr. C, the relative of Mr. B who is a partner in AB & Co., is holding securities in XYZ Ltd. having face value of ₹ 2 lakh.

(v) **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.

(vi) **Incorrect:** According to section 139 of the Companies Act, 2013, the provisions related to rotation of auditor are applicable to all private limited companies having paid up share capital of ₹ 20 crore or more; and all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of ₹ 50 crore or more.

Although company A is a private limited company yet it is having public borrowings from nationalized bank of ₹ 50 crores, therefore it would be governed by provisions of rotation of auditor.

(vii) **Incorrect:** The auditor should study the Memorandum of Association to check the objective of the company to be carried on, amount of authorized share capital etc. and Articles of Association to check the internal rules, regulations and ensuring the validity of transactions relating to accounts of the company.

To see the validity of appointment, the auditor should ensure the compliance of the provisions of section 139, 140 and 141 of the Companies Act, 2013.

In addition, the auditor should study the appointment letter & the prescribed Form submitted to the Registrar of the Companies to see the validity of his appointment.

(viii) **Incorrect:** 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.

Therefore, the appointment of first auditor made by the managing director of A Ltd. is in violation of the provisions of the Companies Act, 2013.

(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.

As the chartered accountant is holding securities of S Ltd. having face value of ₹ 950, he is not eligible for appointment as an auditor of S Ltd.

- (x) **Incorrect:** As per section 141 of the Companies Act, 2013, a person shall be eligible for appointment as an auditor of a company only if he is a chartered accountant.

Thus, Mr. N is disqualified to be appointed as an auditor of XYZ Limited.

Answers to Theoretical Questions

1. **Purchase of Goods on Credit by the Auditor:** Section 141(3)(d)(ii) of the Companies Act, 2013 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding five lakh rupees.

Where an auditor purchases goods or services from a company audited by him on credit, he is definitely indebted to the company and if the amount outstanding exceeds rupees five lakh, he is disqualified for appointment as an auditor of the company.

It will not make any difference if the company allows him the same period of credit as it allows to other customers on the normal terms and conditions of the business. The auditor cannot argue that he is enjoying only the normal credit period allowed to other customers. In fact, in such a case he has become indebted to the company and consequently he has deemed to have vacated his office.

2. (a) **Auditor Holding Securities of a Company:** As per sub-section (3)(d)(i) of Section 141 of the Companies Act, 2013 read with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. However, the relative may hold security or interest in the company of face value not exceeding ₹ 1 lakh.

Also, as per sub-section 4 of Section 141 of the Companies Act, 2013, where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

In the present case, Mr. Hanuman, Chartered Accountant, a partner of M/s Ram and Hanuman Associates, holds 100 equity shares of Shiva Ltd. which is a subsidiary of Krishna Ltd. Therefore, the firm, M/s Ram and Hanuman Associates would be disqualified to be appointed as statutory

auditor of Krishna Ltd., which is the holding company of Shiva Ltd., because one of the partners Mr. Hanuman is holding equity shares of its subsidiary.

- (b) **Appointment of First Auditor of Company:** Section 139(6) of the Companies Act, 2013 lays down that the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company.

In the instant case, the appointment of Shri Ganapati, a practicing Chartered Accountant as first auditors by the Managing Director of PQR Ltd. by himself is in violation of Section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company within 30 days of registration of the company.

In view of the above, the Managing Director of PQR Ltd. should be advised not to appoint the first auditor of the company.

3. Circumstances where Retiring Auditor Cannot be Reappointed: In the following circumstances, the retiring auditor cannot be reappointed-

- (i) A specific resolution has not been passed to reappoint the retiring auditor.
- (ii) The auditor proposed to be reappointed does not possess the qualification prescribed under section 141 of the Companies Act, 2013.
- (iii) The proposed auditor suffers from the disqualifications under section 141(3), 141(4) and 144 of the Companies Act, 2013.
- (iv) He has given to the company notice in writing of his unwillingness to be reappointed.
- (v) A resolution has been passed in AGM appointing somebody else or providing expressly that the retiring auditor shall not be reappointed.
- (vi) A written certificate has not been obtained from the proposed auditor to the effect that the appointment or reappointment, if made, will be in accordance within the limits specified under section 141(3)(g) of the Companies Act, 2013.

4. Hints:

- (a) **Refer Para 7 Ceiling on number of Audits.**
- (b) **Refer Para 2.3 Filling of a Casual Vacancy**
- (c) **Refer Para 12 Joint Audit.**

AUDIT REPORT



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ The objectives of the auditor as per SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements." Also, whether the auditor has obtained reasonable assurance. Understand the evaluation by the auditor and Qualitative Aspects of the Entity's Accounting Practices. Elements of Auditor's report.
- ❑ The basics of Standard on Auditing (SA) 705 "Modifications to The Opinion in The Independent Auditor's Report".
- ❑ The basics of SA 701- "Communicating Key Audit Matters in The Independent Auditor's Report".
- ❑ The Emphasis of Matter Paragraphs and Other Matter Paragraphs in The Independent Auditor's Report as per SA 706.

CHAPTER OVERVIEW



INTRODUCTION

Management is responsible for the preparation of the financial statements. Management also accepts responsibility for necessary internal controls to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

The purpose of an audit is to enhance the degree of confidence of intended users of the financial statements. The aforesaid purpose is achieved by the expression of an independent reporting by the auditor as to whether the financial statements exhibit a true and fair view of the affairs of the entity.

Thus, an Audit report is an opinion drawn on the entity's financial statements to make sure that the records are true and fair representation of the transactions they claim to represent. This involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements. The main users of audit report are shareholders, members and all other stakeholders of the company.

1 FORMING AN OPINION ON THE FINANCIAL STATEMENTS- OBJECTIVE OF THE AUDITOR

1.1 Objective of the Auditor as per SA 700

The objectives of the auditor as per SA 700 (Revised), "Forming An Opinion And Reporting On Financial Statements" are:

- (a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and
- (b) To express clearly that opinion through a written report.

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

1.2 To Form Opinion - Auditor to Obtain Reasonable Assurance

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

That conclusion shall take into account:

- (a) whether sufficient appropriate audit evidence has been obtained;
- (b) whether uncorrected misstatements are material, individually or in aggregate;
- (c) The evaluations.

1.3 Evaluations by the Auditor

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

1.3.1 Qualitative Aspects of the Entity's Accounting Practices

1. Management makes a number of judgments about the amounts and disclosures in the financial statements.
2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.
3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:
 - (i) The selective correction of misstatements brought to management's attention during the audit.

Example

- ◆ Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
- ◆ The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgment and involvement of audit executives.

- (ii) Possible management bias in the making of accounting estimates.
4. SA 540 addresses possible management bias in making accounting estimates.

Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

1.4 Specific Evaluations by the Auditor

In particular, the auditor shall evaluate whether:

- (a) The financial statements adequately disclose the significant accounting policies selected and applied;

- (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- (c) The accounting estimates made by management are reasonable;
- (d) The information presented in the financial statements is relevant, reliable, comparable, and understandable;
- (e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
- (f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

- If an amount or disclosure in the financial statements is under greater scrutiny by users of the financial statements, then a smaller misstatement may be considered more significant.
- A misstatement may be objectively determinable or may involve a degree of subjectivity through estimation, allocation or uncertainty.



2 FORM OF OPINION

Unmodified Opinion: 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.

Modified Opinion: If the auditor:

(a) concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement,

the auditor shall modify the opinion in the auditor's report in accordance with SA 705.



3 AUDITOR'S REPORT

The auditor's report shall be in writing. A written report encompasses reports issued in hard copy and those using an electronic medium.

This SA-700 requires the use of specific headings, which are intended to assist in making auditor's reports that refer to audits that have been conducted in accordance with SAs more recognizable.

3.1 Auditor's Report for Audits Conducted in Accordance with Standards on Auditing

Basic Elements of an Audit Report are given below:

1 Title: The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.

For example, "Independent Auditor's Report," distinguishes the independent auditor's report from reports issued by others.

2 Addressee: The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed.

The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

3 Auditor's Opinion: The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

The Opinion section of the auditor's report shall also:

- (a) Identify the entity whose financial statements have been audited;
- (b) State that the financial statements have been audited;
- (c) Identify the title of each statement comprising the financial statements;
- (d) Refer to the notes, including the summary of significant accounting policies; and
- (e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

Unmodified Opinion: The auditor shall express an unmodified opinion when the **Expressing an unmodified opinion on financial statements**

When expressing an unmodified opinion on financial statements, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

- (a) In our opinion, the accompanying financial statements **present fairly, in all material respects**, [...] in accordance with [the applicable financial reporting framework]; or
- (b) In our opinion, the accompanying financial statements **give a true and fair view of** [...] in accordance with [the applicable financial reporting framework].

"Present fairly, in all material respects" or "give a true and fair view"

The phrases "present fairly, in all material respects," and "give a true and fair view" are regarded as being equivalent

When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as "with the foregoing explanation" or "subject to" in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

4. Basis for Opinion:

The auditor's report shall include a section, directly following the Opinion section, with the heading **"Basis for Opinion"**, that:

- (a) States that the audit was conducted in accordance with Standards on Auditing;
- (b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
- (c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.
- (d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

5. Going Concern: Where applicable, the auditor shall report in accordance with SA 570 (Revised).

6. Key Audit Matters: For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with SA 701.

When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with SA 701.

Law or regulation may require communication of key audit matters for audits of entities other than listed entities.

Example

Entities characterized in such law or regulation as public interest entities.

The auditor may also decide to communicate key audit matters for 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 charitable institutions.

7. Responsibilities for the Financial Statements: The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."

SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

This section of the auditor's report shall describe management's responsibility for:

(a) Preparing the financial statements in accordance with the applicable financial reporting framework, **and for such internal control** as management determines is necessary to enable the preparation of financial statements that

are free from material misstatement, whether due to fraud or error;[because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud.] and

- (b) Assessing the entity's ability to continue as a going concern** and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

- Auditor cannot conclude that management has provided with all relevant information agreed in the terms of the audit engagement agreement without confirming with management whether such information has been provided.
- When those individuals who have signed the engagement agreement at the start of the audit have left the entity, the auditor would request those who are giving the representations to acknowledge their responsibilities within the letter of representations.
- A management representation as to the amount required for a particular provision is not a substitute for the audit procedures regarding the provision that the auditor would expect to perform.

Periods covered by the letter: The auditor to obtain representations for all financial statements and periods referred to in our auditor's report. Auditor would obtain a specific representation if a restatement is made to correct a material misstatement in the prior period financial statements that affects the comparative information in the financial statements. If current management was not present during all periods covered by auditor's report, hestill would obtain written representations from current management on all such periods.

SA 210 requires the auditor to agree management's responsibilities in an engagement letter or other suitable form of written agreement.

Oversight of the financial reporting process: This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from Management. In this case, the heading of this section shall also refer to "Those Charged with Governance"

8. Auditor's Responsibilities for the Audit of the Financial Statements:

The auditor's report shall include a section with the heading "**Auditor's Responsibilities for the Audit of the Financial Statements.**"

This section of the auditor's report shall:

- (a) State that the objectives of the auditor are to:
 - (i) **Obtain reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
 - (ii) **Issue an auditor's report** that includes the auditor's opinion.
- (b) State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists; and
- (c) State that misstatements can arise from fraud or error, and either:
 - (i) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or
 - (ii) Provide a definition or description of materiality in accordance with the applicable financial reporting framework.

The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further:

- (a) State that, as part of an audit in accordance with SAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and
- (b) Describe an audit by stating that the auditor's responsibilities are:
 - (i) To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

1. To identify and assess the risks of material misstatement of the financial statements.
2. To design and perform audit procedures in response to those risks.
3. To obtain sufficient and appropriate audit evidence.

- (ii) To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances.
- (iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- (iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, 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.

The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall:

- (a) State that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;
- (b) For audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and
- (c) For audits of financial statements of listed entities and any other entities for which key audit matters are communicated in accordance with SA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. The auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure.

9. Location of the description of the auditor's responsibilities for the audit of the financial statements: The description of the auditor's responsibilities for the audit of the financial statements shall be included:

- (a) Within the body of the auditor's report;
- (b) Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix; or
- (c) By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so.

ILLUSTRATION

The following is an illustration of how such a reference to an appendix could be made in the auditor's report:

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is included in appendix X of this auditor's report. This description, which is located at *[indicate page number or other specific reference to the location of the description]*, forms part of our auditor's report.

10. Other Reporting Responsibilities: If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the SAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled-

"Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the SAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the SAs.

If other reporting responsibilities are presented in the same section as the related report elements required by the SAs, the auditor's report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the SAs.

If the auditor's report contains a separate section that addresses other reporting responsibilities, the requirements stated above shall be included under a section with a heading "Report on the Audit of the Financial Statements." The "Report on Other Legal and Regulatory Requirements" shall follow the "Report on the Audit of the Financial Statements."

11. Signature of the Auditor: The auditor's report shall be signed. The report is signed by the auditor (i.e. the engagement partner) in his personal name. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm.

The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

12. Auditor's Address: The auditor's report shall name specific location, which is ordinarily the city where the audit report is signed.

13 Date of the Auditor's Report: The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that:

- (a) All the statements that comprise the financial statements, including the related notes, have been prepared; and
- (b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

The date of the auditor's report informs the user of the auditor's report that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor's responsibility for events and transactions after the date of the auditor's report is addressed in SA 560.



4 AUDITOR'S REPORT PRESCRIBED BY LAW OR REGULATION

If the auditor is required by law or regulation to use a specific layout, or wording of the auditor's report, the auditor's report shall refer to Standards on Auditing only if the auditor's report includes, at a minimum, each of the following elements:

- (a) A title.
- (b) An addressee, as required by the circumstances of the engagement.
- (c) An Opinion section containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements.
- (d) An identification of the entity's financial statements that have been audited.
- (e) A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI.
- (f) Where applicable, a section that addresses, and is not inconsistent with, the reporting requirements relating to going concern as per SA 570 (Revised).
- (g) Where applicable, a Basis for Qualified (or Adverse) Opinion section that addresses, and is not inconsistent with, the reporting requirements relating to going concern as per SA 570 (Revised).
- (h) Where applicable, a section that includes the information required by SA 701, or additional information about the audit that is prescribed by law or regulation and that addresses, and is not inconsistent with, the reporting requirements in that SA.
- (i) A description of management's responsibilities for the preparation of the financial statements and an identification of those responsible for the oversight of the financial reporting process that addresses, and is not inconsistent with, the requirements as contained in this SA 700.
- (j) A reference to Standards on Auditing and the law or regulation, and a description of the auditor's responsibilities for an audit of the financial statements that addresses, and is not inconsistent with, the requirements as contained in this SA 700.
- (k) The auditor's signature.

- (l) The Place of signature.
- (m) The date of the auditor's report.

ILLUSTRATION

Auditor's Report on Financial Statements of a Listed Entity Prepared in Accordance with a Fair Presentation Framework

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 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 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 comprise the Code of Ethics issued by ICAI together with the other relevant ethical requirements relating to the audit and the auditor refers to both.
- ◆ Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- ◆ 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 Statements¹

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*)² 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)]³.

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 generally accepted in India, of the state of affairs of the Company as at March 31, 20XX, and profit/loss, (*changes in equity*)⁴ 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.

¹ 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.

² Where applicable

³ Where applicable

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.

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

Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act")⁴ with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (changes in equity)⁵ and cash flows of the Company in accordance with⁶ the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate implementation and maintenance of accounting policies; making judgments and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those Board of Directors are also responsible for overseeing the Company's financial reporting process.

⁴ Where applicable

⁵ Where applicable

⁶ Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ..."

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 40(b) of this SA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or applicable auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with SAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- ◆ Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- ◆ Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances. Under section 143(3)(i) of the Companies Act, 2013, we are also responsible for expressing our opinion on whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.
- ◆ Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- ◆ Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether

a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- ◆ Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Other Matter

We did not audit the financial statements/ information of (number) branches included in the stand alone financial statements of the Company whose financial statements/financial information reflect total assets of Rs. as at 31st March 20XX and the total revenue of ₹ for the year ended on that date, as considered in the standalone financial statements/information of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures

included in respect of branches, is based solely on the report of such branch auditors.

Our opinion is not modified in respect of these matters.

Report on Other Legal and Regulatory Requirements

As required by the Companies (Auditor's Report) Order, 2016 ("the Order"), issued by the Central Government of India in terms of sub-section (11) of section 143 of the Companies Act, 2013, we give in the Annexure a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.

As required by Section 143(3) of the Act, we report that:

- (a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.
- (b) In our opinion, proper books of account as required by law have been kept by the Company so far as it appears from our examination of those books *[and proper returns adequate for the purposes of our audit have been received from the branches not visited by us⁷]*
- (c) *[The reports on the accounts of the branch offices of the Company audited under Section 143(8) of the Act by branch auditors have been sent to us and have been properly dealt with by us in preparing this report⁸.]*
- (d) The Balance Sheet, the Statement of Profit and Loss, and the Cash Flow Statement dealt with by this Report are in agreement with the books of account *[and with the returns received from the branches not visited by us⁹]*.
- (e) In our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014.
- (f) On the basis of the written representations received from the directors as on 31st March, 20XX taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164 (2) of the Act.
- (g) With respect to the adequacy of the internal financial controls over financial reporting of the Company and the operating effectiveness of such controls, refer to our separate Report in "Annexure A".

⁷ Where applicable

⁸ Where applicable

⁹ Where applicable

- (h) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:
- (i) The Company has disclosed the impact of pending litigations on its financial position in its financial statements – Refer Note XX to the financial statements; *[or the Company does not have any pending litigations which would impact its financial position¹⁰]*
 - (ii) The Company has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts – Refer Note XX to the financial statements; *[or the Company did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.¹¹]*
 - (iii) There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company *{or, following are the instances of delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Company¹²}.*

For XYZ & Co

Chartered Accountants
(Firm's Registration No.)

Signature

(Name of the Member Signing the Audit Report)

(Designation¹³)

(Membership No. XXXXX)

Place of Signature:

Date:

¹⁰ As may be applicable

¹¹ As may be applicable

¹² As may be applicable

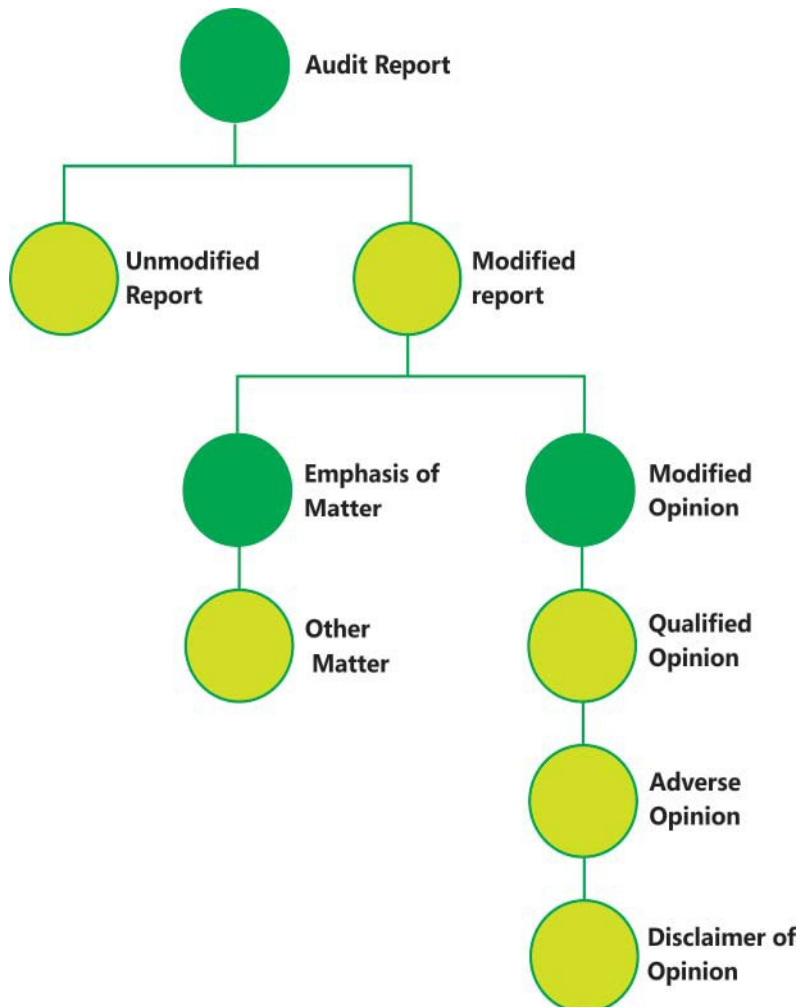
¹³ Partner or Proprietor, as the case may be



5 MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

Standard on Auditing (SA) 705 “Modifications To The Opinion In The Independent Auditor’s Report” deals with the auditor’s responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised) **“Forming An Opinion And Reporting On Financial Statements”**, the auditor concludes that a modification to the auditor’s opinion on the financial statements is necessary.

This SA also deals with how the form and content of the auditor’s report is affected when the auditor expresses a modified opinion.



5.1 Circumstances When a Modification to the Auditor's Opinion Is Required

The auditor shall modify the opinion in the auditor's report when:

- (a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

5.2 Objective of the Auditor- To Express Clearly an Appropriately modified Opinion

As per Standard on Auditing (SA) 705 "Modifications To The Opinion In The Independent Auditor's Report", the objective of the auditor is **to express clearly an appropriately modified opinion** on the financial statements that is necessary when:

- (a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

5.3 Types of Modified Opinions

There are three types of modified opinions, namely-

1. A qualified opinion
2. An adverse opinion
3. A disclaimer of opinion

Qualified Opinion	Adverse Opinion	Disclaimer of Opinion
The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements are material, but not pervasive.	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.	The auditor shall disclaim an opinion when he is unable to obtain sufficient appropriate audit evidence and he concludes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive.

Qualified Opinion

The auditor shall express a qualified opinion when:

- (a) 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
- (b) 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.

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.

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.

Definition of Pervasive – A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

Pervasive effects on the financial statements are those that, in the auditor's judgment:

- (i) Are not confined to specific elements, accounts or items of the financial statements;
- (ii) If so confined, represent or could represent a substantial proportion of the financial statements; or
- (iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.

5.4 Which type of opinion is appropriate?

The decision regarding which type of modified opinion is appropriate depends upon:

- (a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
- (b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

The table below illustrates how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material Pervasive But Not	Material and Pervasive
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

5.5 Basis for Opinion

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised):

- (a) Amend the heading "Basis for Opinion" required by para of SA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and
- (b) Within this section, include a description of the matter giving rise to the modification.



6. EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT.

6.1 Objective of the Auditor as per SA 706

As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

- (a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or
- (b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Definitions

Emphasis of Matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Other Matter paragraph – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

6.2 Emphasis of Matter Paragraphs in the Auditor's Report

If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

- (a) The auditor would not be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter; and

- (b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

6.2.1 Separate section for Emphasis of Matter paragraph

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- (a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
- (b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
- (c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

6.3 Other Matter Paragraphs in the Auditor's Report

If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the auditor shall include an Other Matter paragraph in the auditor's report, provided:

- (a) This is not prohibited by law or regulation; and
- (b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

6.3.1 Separate section for Other Matter paragraph

When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading.



7. COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT

Definition of Key Audit Matters : Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

7.1 Purpose of Communicating Key Audit Matters

As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", the purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements.

7.2 Objectives of the Auditor regarding Key Audit Matters

As per SA 701, "Communicating Key Audit Matters in The Independent Auditor's Report", the objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.

7.3 Determining Key Audit Matters

The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit.

In making this determination, the auditor shall take into account the following:

- (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.
- (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- (c) The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters determined in accordance with above stated para were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

7.4 Communicating Key Audit Matters

The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters".

The introductory language in this section of the auditor's report shall state that:

- (a) Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements [of the current period]; and
- (b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

7.5 Communicating Key Audit Matters- not a substitute for disclosure in the Financial Statements etc.

Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:

- (a) A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
- (b) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);
- (c) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
- (d) A separate opinion on individual matters.



8. STANDARD ON AUDITING-710, "COMPARATIVE INFORMATION-CORRESPONDING FIGURES AND COMPARATIVE FINANCIAL STATEMENTS"

8.1 The Nature of the Comparative Information

The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of

engagement.

The essential audit reporting differences between the approaches are:

- (a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas
- (b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

Definition of Comparative information–The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

8.2 Audit Procedures regarding comparative information

The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

- (a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and
- (b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

8.3 Audit Reporting regarding Corresponding Figures

Definition of Corresponding figures – Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures"). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances .

1. If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for

Modification paragraph in the auditor's report, the auditor shall either:

- (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
- (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

2. If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified.

3. Prior Period Financial Statements Not Audited- If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

8.4 Comparative Financial Statements

Definition: Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

Auditor's opinion- to refer each period: When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed.

When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with SA 706.

SUMMARY

Management is responsible for the preparation of the financial statements. The purpose of an audit is to enhance the degree of confidence of intended users of the financial statements. The aforesaid purpose is achieved by the expression of an independent reporting by the auditor.

The objectives of the auditor as per SA 700 (Revised), "Forming An Opinion And Reporting On Financial Statements" are to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and to express clearly that opinion through a written report. The auditor shall modify the opinion in the auditor's report when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

There are three types of modified opinions, namely-a qualified opinion, an adverse opinion, and a disclaimer of opinion. As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the objective of the auditor is to draw users' attention by way of clear additional communication in the auditor's report, to a matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or as appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

As per SA 701, "Communicating Key Audit Matters in The Independent Auditor's Report", the objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report. There are two different broad approaches to the auditor's reporting responsibilities in respect of comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement. The essential audit reporting differences between the approaches are: for corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas for comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

TEST YOUR KNOWLEDGE

MCQs

1. In order to form the opinion, the auditor shall conclude as to whether the auditor has obtained _____ about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.
 - (a) reasonable assurance
 - (b) absolute assurance
 - (c) Limited assurance
 - (d) None of the above
2. Which of the following is not a type of modified opinion:
 - (a) qualified opinion
 - (b) adverse opinion
 - (c) disclaimer of opinion
 - (d) None of the above
3. The auditor shall express _____ 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.
 - (a) Adverse
 - (b) Qualified
 - (c) Disclaimer
 - (d) None of the above
4. SA-700 requires the use of specific headings, which are intended to assist in making auditor's reports that refer to audits that have been conducted in accordance with SA more recognizable. Which of the following is the specific heading:
 - (a) Key audit matters
 - (b) Basis of opinion
 - (c) Date
 - (d) All of the above

5. The Opinion section of the auditor's report shall:
- (a) Identify the entity whose financial statements have been audited;
 - (b) State that the financial statements have been audited;
 - (c) Identify the title of each statement comprising the financial statements;
 - (d) All of the above

Correct/Incorrect

State with reasons (in short) whether the following statement is correct or incorrect:

- (i) 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. ● ● ●
- (ii) There is no need of addressee in the Auditor's report.
- (iii) The auditor shall modify the opinion in the auditor's report only when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.
- (iv) The auditor shall express a disclaimer of 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.
- (v) Communicating key audit matter in the auditor's report constitutes a substitute for disclosure in the financial statements.

Theoretical Questions

- 1. "The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework." Explain
- 2. "The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments." Discuss stating clearly qualitative aspects of the entity's accounting practices

3. Discuss the factors affecting the decision of the auditor regarding which type of modified opinion is appropriate.
4. Discuss the objective of the auditor as per Standard on Auditing (SA) 705 "Modifications to The Opinion in The Independent Auditor's Report"

ANSWERS/SOLUTIONS

Answers to MCQs

1. (a) 2. (d) 3. (a) 4. (d) 5. (d)

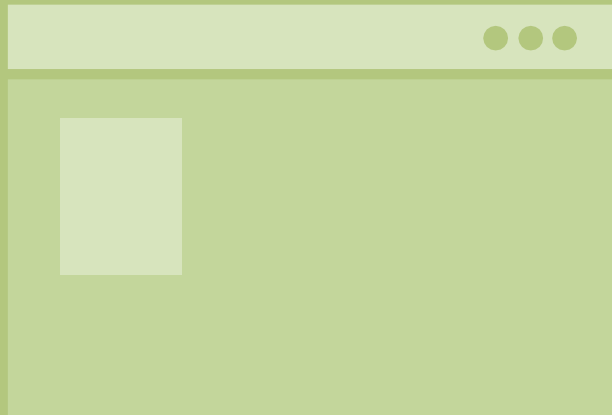
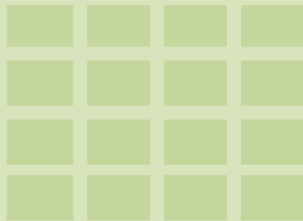
Answer to Correct/Incorrect

- (i) **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.
- (ii) **Incorrect:** The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed. The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.
- (iii) **Incorrect:** The auditor shall modify the opinion in the auditor's report when:
- (a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
 - (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.
- (iv) **Correct:** 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.
- (v) **Incorrect:** Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not a substitute for disclosures in the financial statements that the applicable

financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;

Answers to Theoretical Questions

1. Refer Para 1.2
2. Refer Para 1.3.
3. Refer Para 5.4
4. Refer Para 5.2



AUDIT OF BANKS

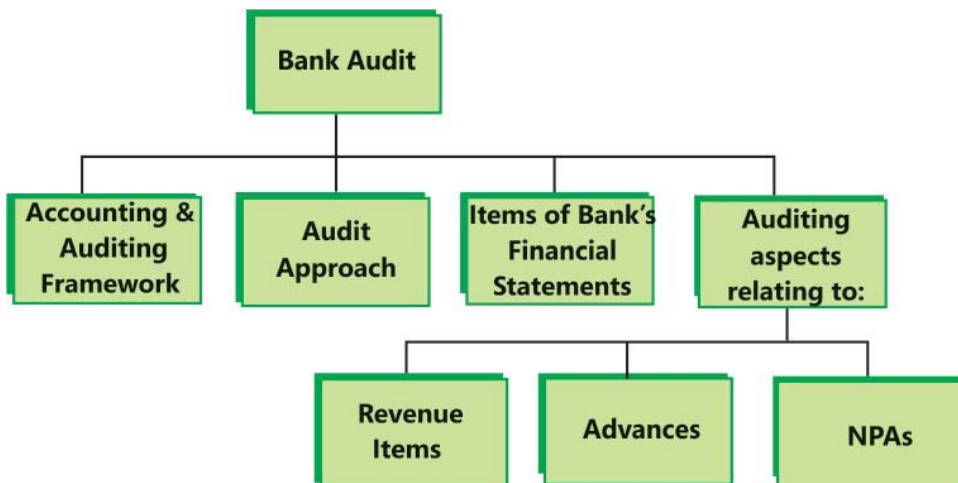


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ☐ Understand the legal framework for the bank audit.
- ☐ Gain the knowledge of financial statements of the banks in brief.
- ☐ Understand the audit approach for items of profit and loss in case of banks.
- ☐ Learn the important items such as Advances, NPAs etc. and related audit

CHAPTER OVERVIEW



INTRODUCTION



Banking sector is the backbone of any economy as it is essential for sustainable socio-economic growth and financial stability in the economy. The banking sector is also crucial as it deals with mammoth amounts of public monies and is highly sensitive to reputational risk. Like all economic activities, the banking sector is also exposed to various risks in its operations.

Source of image : busybuddie

It is of utmost importance to ensure that banking sector stays healthy, safe and sound. For safe and sound banking sector, one of the most important factors is reliable financial information supported by quality bank audits.

Types of Banks

There are different types of banking institutions prevailing in India which are as follows:

Commercial Banks.	Regional Rural Banks.
Co-operative Banks.	Payment Banks.
Development Banks (more commonly known as 'Term-Lending Institutions').	Small Finance Banks.

Commercial banks are the most wide spread banking institutions in India, that provide a number of products and services to general public and other segments of economy. Two of its main functions are (1) accepting deposits and (2) granting advances.

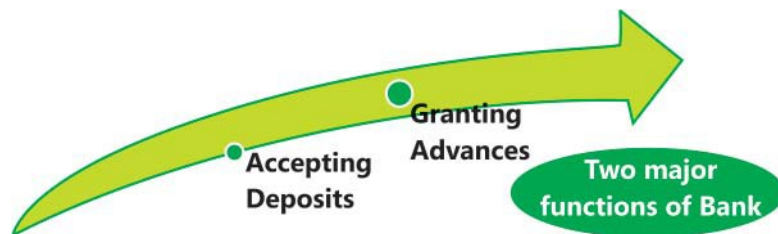


Diagram showing Two Major Functions of Banks

Reserve Bank of India: Regulating Body

The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country. RBI is responsible for development and supervision of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions) as well as for determining, in conjunction with the Central Government, the monetary and credit policies keeping in with the need of the hour.

Important functions of RBI are issuance of currency; regulation of currency issue; acting as banker to the central and state governments; and acting as banker to commercial and other types of banks including term-lending institutions. Besides, RBI has also been entrusted with the responsibility of regulating the activities of commercial and other banks. No bank can commence the business of banking or open new branches without obtaining licence from RBI. The RBI also has the power to inspect any bank.

Independent audit of financial statement of banks is important for a healthy, safe and sound banking system.

Banking Operations - Conducted only at Branches

Banking operations are conducted only at the branches, while other offices act as controlling authorities or administrative offices that lay down policies, systems and internal control procedures for conduct of business, in compliance with the statutory/ regulatory impositions and in compliance of accepted accounting principles and practices that cover all transactions and economic events. These controlling/ administrative offices also stipulate the delegation of powers and fix responsibilities and accountability and these are involved generally in effective supervision, monitoring and control over the business activities and operations, including seeking faithful compliance of the bank's laid down policies/ procedures /controls and deal with deviations therefrom.

Regulatory Framework

Banking Regulation Act, 1949.	State Bank of India Act, 1955.
Companies Act, 2013.	State Bank of India (Subsidiary Banks) Act
Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.	
Regional Rural Banks Act, 1976.	
Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.	
Information Technology Act,	Prevention of Money Laundering Act, 2002.

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

Credit Information Companies Regulation Act, 2005.

Payment and Settlement Systems Act, 2007.

Besides, the above enactments, the provisions of the Reserve Bank of India Act, 1934, (RBI Act) also affect the functioning of banks. The RBI Act gives wide powers to the RBI to give directions to banks which also have considerable effect on the functioning of banks.

Peculiarities involved:

- Huge volumes and complexity of transactions;
- Wide geographical spread of banks' network;
- Large range of products and services offered;
- Extensive use of technology;
- Strict vigilance by the banking regulator etc.

Types of Audit Reports to be issued (generally):

Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:

- (a) Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.
- (b) Long Form Audit Report.
- (c) Report on compliance with SLR requirements.
- (d) Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
- (e) Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.
- (f) Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.

- (g) Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jilani Committee on internal control and inspection/credit system.
- (h) Report on instances of adverse credit-deposit ratio in the rural areas.



1. UNDERSTANDING OF ACCOUNTING SYSTEM IN BANKS

From the time that customers had to physically visit and deal with a bank, there is a sea change in banking as use of technology and its continuous evolution has enabled banks to reach their customers in providing them the convenience and comfort of *anytime-anywhere-banking* by letting them access their information/data on real time basis, as stored in a safe and secure environment on the bank's servers. With many customers having access to Internet and mobile connectivity, monetary transactions from inception to finish have become expeditious through E-banking; but for Core banking technology and extensive advancement therein and the availability and extensive use of technology tools, banks could not have achieved such phenomenal and accelerated growth, and could not have ventured into and offered a wide range of innovative products and services to their customers. The transactions in banks have become voluminous and it needs to be ensured that in the system of recording, transmission and storage of information/ data, integrity thereof is optimally maintained and control systems ensure that the same is free of errors, omissions, irregularities and frauds. Considering the challenges of technology, bank managements continuously endeavour to make their internal control systems robust, safe and secure as well as convenient and expeditious for the customers.

Banks may be divided into three board categorises based on the level of computerisation:

- Non-computerised banks
- Partially computerised banks
- Fully computerised banks.

In the computerized environment, it is imperative that the auditor is familiar with and satisfied that all the norms/parameters as per the latest applicable RBI guidelines are incorporated and built into the system that generates information/data having a bearing on the classification/ provisions and income

recognition. The auditor should not go by the assumption that the system generated information is correct and can be relied upon without evidence that demonstrates that the system driven information is based on the required parameters.



2. BANK AUDIT APPROACH

Based on the nature and level of operations, nature of adverse features, level of compliance based on previous reports and audit risks based on inadequacy in or breach of internal controls and the familiarization exercise carried out, an audit plan should be drawn up.

A bank should have appropriate controls to mitigate its risks, including effective segregation of duties (particularly, between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting up limits, reporting and approval of exceptions, physical security and contingency planning.

The following are certain common questions /steps, which have to be kept in mind while undertaking/ performing control activities:

Nature of Questions	Questions to be considered / answered
Who	- Who performs the control? - Does the above person have requisite knowledge and authority to perform the control?
What	What evidence is available to demonstrate /prove that the control is performed?
When	- When and with what frequency is the control performed? - Is the frequency enough to prevent, detect and correct risk of material misstatements?
Where	- Where is the evidence of performance of the control retained? - For how long is the evidence retained? - Is the evidence accessible/ available for audit?
Why	- Why is the control being performed? - What type of errors are prevented or detected through the performance of the control?

How	● How is the control performed? ● What are the control activities? ● Can these activities be bypassed? ● Can the bypass, if any, be detected? ● How are exceptions / deviations resolved on identification? ● What is the time frame for resolving the exceptions /

Engagement Team Discussions

The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference.

The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's branch financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit. Specific emphasis should be provided to the susceptibility of the bank's financial statements to material misstatement due to fraud, that enables the engagement team to consider an appropriate response to fraud risks, including those related to engagement risk, pervasive risks, and specific risks. It further enables the audit engagement partner to delegate the work to the experienced engagement team members, and to determine the procedures to be followed when fraud is identified. Further, audit engagement partner may review the need to involve specialists to address the issues relating to fraud.



3. INCOME RECOGNITION POLICY

The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations.

Income from non-performing assets (NPA) is not recognized on accrual basis but is booked as income only when it is actually received.



4. FORM AND CONTENT OF FINANCIAL STATEMENTS

Sub-sections (1) and (2) of Section 29 of the Banking Regulations Act, 1949 deal with the form and content of financial statements of a banking company and their

authentication. These sub-sections are also applicable to nationalised banks, State Bank of India, subsidiaries of the State Bank of India, and Regional Rural Banks.

Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

Every banking company needs to comply with the disclosure requirements under the various Accounting Standards, as specified under section 133 of the Companies Act, 2013, read with Rule 7 of the Companies (Accounts) Rules 2014, in so far as they apply to banking companies or the Accounting Standards issued by the ICAI.

5. AUDIT OF ACCOUNTS

Sub-section (1) of section 30 of the Banking Regulations Act, 1949 requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies.

6. ELIGIBILITY, QUALIFICATIONS AND DISQUALIFICATIONS OF AUDITOR

Refer Section 141 of the Companies Act, 2013 discussed in the "Chapter-10 The Company Audit".

7. APPOINTMENT OF AUDITOR

As per the provisions of the relevant enactments, the auditor of a banking company is to be appointed at the annual general meeting of the shareholders, whereas the auditor of a nationalised bank is to be appointed by the bank concerned acting through its Board of Directors. In either case, approval of the Reserve Bank of India is required before the appointment is made. The auditors of the State Bank of India are to be appointed by the Comptroller and Auditor General of India in consultation with the Central Government. The auditors of the subsidiaries of the State Bank of India are to be appointed by the State Bank of India. The auditors of regional rural banks are to be appointed by the bank concerned with the approval of the Central Government.



8. REMUNERATION OF AUDITOR

The remuneration of auditor of a banking company is to be fixed in accordance with the provisions of Section 142 of the Companies Act, 2013 (i.e., by the company in general meeting or in such manner as the company in general meeting may determine). The remuneration of auditors of nationalised banks and State Bank of India is to be fixed by the Reserve Bank of India in consultation with the Central Government.



9. POWERS OF AUDITOR

The auditor of a banking company, nationalised bank, State Bank of India, subsidiary of State Bank of India or regional rural bank has the same powers as those of a company's auditor in the matter of access to the books, accounts, documents and vouchers.



10. AUDITOR'S REPORT

In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:

- (a) whether, in his opinion, the financial statements present a true and fair view of the affairs of the bank and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;
- (b) whether or not the transactions of the bank, which have come to his notice, have been within the powers of that bank;
- (c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit; and
- (d) any other matter which he considers should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank.

10.1 Format of Report

The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of Standards on Auditing discussed in Chapter 11 on Audit Report. The auditor should ensure that not only information

relating to number of unaudited branches is given but quantification of advances, deposits, interest income and interest expense for such unaudited branches has also been disclosed in the audit report. Such disclosure in the audit report is not only in accordance with the best international trends but also provides useful information to users of financial statements.

It may be noted that, in addition to the aforesaid, the auditor of a banking company is also required to state in his report the matters covered by Section 143 of the Companies Act, 2013. However, it is pertinent to mention that the reporting requirements relating to the Companies (Auditor's Report) Order, 2016 is not applicable to a banking company, as defined in clause (c) of Section 5 of the Banking Regulation Act, 1949.

10.2 Long Form Audit Report

Besides the audit report as per the statutory requirements discussed above, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks (as well as their branches), require the auditors to also furnish a long form audit report (LFAR). The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India.

The LFAR is to be submitted before 30th June every year. To ensure timely submission of LFAR, proper planning for completion of the LFAR is required. While the format of LFAR does not require an executive summary to be given, members may consider providing the same to bring out the key observations from the whole document.

10.3 Reporting to RBI

The RBI issued a Circular relating to implementation of recommendations of Committee on Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks). Regarding liability of accounting and auditing profession, the said circular provided as under:

“If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action”.

As per the above requirement, the member shall be required to report the kind of matters stated in the circular to RBI.

Auditor should also consider the provisions of **SA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements”**. The said Standard

explains that the duty of confidentiality is over-ridden by statute, law or courts.

SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" states that an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

It must be noted that auditor is not expected to look into each and every transaction but to evaluate the system as a whole. Therefore, if the auditor while performing his normal duties comes across any instance, he should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.

10.4 Duty to report on Frauds under the Companies Act, 2013

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. Students may refer Chapter 5 - Fraud and Responsibilities of the Auditor in this regard for detailed understanding.

11. CONDUCTING AN AUDIT

The audit of banks or their branches involves the following stages –

1. Initial consideration by the statutory auditor

- (i) **Declaration of Indebtedness:** The RBI has advised that the banks, before appointing their statutory central/branch auditors, should obtain a declaration of indebtedness.
- (ii) **Internal Assignments in Banks by Statutory Auditors:** The RBI decided that the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year.
- (iii) **Planning:** Standard on Auditing (SA) 300, "Planning an Audit of Financial Statements" requires that the auditor shall undertake the following activities prior to starting an initial audit:

- (a) Performing procedures required by SA 220, "Quality Control for Audit Work" regarding the acceptance of the client relationship and the specific audit engagement; and
 - (b) Establish understanding of terms of engagement as per **SA 210, "Agreeing the Terms of Audit Engagements"**.
- (iv) **Communication with Previous Auditor:** As per Clause (8) of the Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice cannot accept position as auditor previously held by another chartered accountant without first communicating with him in writing.
- (v) **Terms of Audit Engagements: SA 210, "Terms of Audit Engagements"** requires that for each period to be audited, the auditor should agree on the terms of the audit engagement with the bank before beginning significant portions of fieldwork. It is imperative that the terms of the engagement are documented, in order to prevent any confusion as to the terms that have been agreed in relation to the audit and the respective responsibilities of the management and the auditor, at the beginning of an audit assignment.
- (vi) **Initial Engagements:** The auditor needs to perform the audit procedures as mentioned in **SA 510 "Initial Audit Engagements-Opening Balances"** and if after performing that procedures, the auditor concludes that the opening balances contain misstatements which materially affect the financial statements for the current period and the effect of the same is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.
- (vii) **Assessment of Engagement Risk:** The assessment of engagement risk is a critical part of the audit process and should be done prior to the acceptance of an audit engagement since it affects the decision of accepting the engagement and also in planning decisions if the audit is accepted.
- (viii) **Establish the Engagement Team:** The assignment of qualified and experienced professionals is an important component of managing engagement risk. The size and composition of the engagement team would depend on the size, nature and complexity of the bank's operations.
- (ix) **Understanding the Bank and its Environment: SA 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"** lays down that the auditor should obtain an understanding of the entity and its environment, including its internal

control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error and sufficient to design and perform further audit procedures.

2. Identifying and Assessing the Risks of Material Misstatements: SA 315 requires the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level for classes of transactions, account balances and disclosures to provide a basis for designing and performing further audit procedures.

3. Understanding the Bank and Its Environment including Internal Control: An understanding of the bank and its environment, including its internal control, enables the auditor:

- to identify and assess risk;
- to develop an audit plan so as to determine the operating effectiveness of the controls and to address the specific risks.

4. Understanding the Bank's Accounting Process: The accounting process produces financial and operational information for management's use and it also contributes to the bank's internal control. Thus, understanding of the accounting process is necessary to identify and assess the risks of material misstatement whether due to fraud or not and to design and perform further audit procedures.

5. Understanding the Risk Management Process: Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:

- (a) **Oversight and involvement in the control process by those charged with governance:** Those charged with governance (Board of Directors/Managing Director) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.
- (b) **Identification, measurement and monitoring of risks:** Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.
- (c) **Control activities:** A bank should have appropriate controls to mitigate its risks including effective segregation of duties (particularly between front and back offices), accurate measurement and reporting of positions, verification

and approval of transactions, reconciliation of positions and results, setting up limits, reporting and approval of exceptions, physical security and contingency planning.

- (d) **Monitoring activities:** Risk management models, methodologies and assumptions used to measure and mitigate risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.
- (e) **Reliable information systems:** Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.

6. Engagement Team Discussions: The engagement team should hold discussions to gain better understanding of banks and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements.

7. Establish the Overall Audit Strategy: SA 300 "Planning an Audit of financial Statements" states that the objective of the auditor is to plan the audit so that it will be performed in an effective manner. For this purpose, the audit engagement partner should:

- establish the overall audit strategy, prior to the commencement of an audit; and
- involve key engagement team members and other appropriate specialists while establishing the overall audit strategy, which depends on the characteristics of the audit engagement.

8. Develop the Audit Plan: SA 300 deals with the auditor's responsibility to plan an audit of financial statements in an effective manner. It requires the involvement of all the key members of the engagement team while planning an audit.

9. Audit Planning Memorandum: The auditor should summarise the audit plan by preparing an audit planning memorandum in order to:

- Describe the expected scope and extent of the audit procedures to be performed by the auditor.

- Highlight all significant issues and risks identified during their planning and risk assessment activities, as well as the decisions concerning reliance on controls.
- Provide evidence that they have planned the audit engagement appropriately and have responded to engagement risk, pervasive risks, specific risks, and other matters affecting the audit engagement.

10. Determine Audit Materiality: The auditor should consider the relationship between the audit materiality and audit risk when conducting an audit. The determination of audit materiality is a matter of professional judgment and depends upon the knowledge of the bank, assessment of engagement risk and the reporting requirements for the financial statements.

11. Consider Going Concern: While obtaining an understanding of the bank, the auditor should consider whether there are events and conditions which may cast significant doubt on the bank's ability to continue as a going concern.

12. Assess the Risk of Fraud including Money Laundering: As per **SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"**, the auditor's objective is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately. The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.

The RBI has framed specific guidelines that deal with prevention of money laundering and "Know Your Customer (KYC)" norms. The RBI has from time to time issued guidelines ("Know Your Customer Guidelines – Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

13. Assess Specific Risks: The auditors should identify and assess the risks of material misstatement at the financial statement level which refers to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions.

14. Risk Associated with Outsourcing of Activities: The modern day banks make extensive use of outsourcing as a means of both reducing costs as well as making use of services of an expert not available internally. There are, however, a number of risks associated with outsourcing of activities by banks and therefore, it is quintessential for the banks to effectively manage those risks.

15. Response to the Assessed Risks: SA 330 “The Auditor’s Responses to Assessed Risks” requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. The auditor should design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

16. Stress Testing: RBI has required that all commercial banks shall put in place a Board approved ‘Stress Testing framework’ to suit their individual requirements which would integrate into their risk management systems.

17. BASEL III framework: The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) has undertaken an extensive review of the regulatory framework in the wake of the sub-prime crisis. In the document titled ‘Basel III: A global regulatory framework for more resilient banks and banking systems’, released by the BCBS in December 2010, it has inter alia proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital.

18. Reliance on / review of other reports: The auditor should take into account the adverse comments, if any, on advances appearing in the following-

- Previous year’s audit reports.
- Latest internal inspection reports of bank officials.
- Reserve Bank’s latest inspection report.
- Concurrent / Internal audit report.
- Report on verification of security.
- Any other internal reports specially related to particular accounts.
- Manager’s charge-handing-over report when incumbent is changed.

The above reports should be reviewed in detail. The Statutory Central Auditors must review the Annual Financial Inspection report of RBI relating to the bank and ensure that the variations in provisions, etc. reported by RBI have been properly considered by the bank management.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts, however, need to be examined in detail unless the amount involved is insignificant. The extent of sample checking would also depend on the auditor’s assessment of efficacy of internal controls. What constitutes

a 'large advance' would need to be determined in the context of volume of operations of the branch eg. an advance may be considered to be a large advance if the year-end balance is in excess of ₹2 crore or 5% of the aggregate year-end advances of the branch, whichever is less.



12. ADVANCES

Lending constitutes a major activity of a bank besides the investment function. The core business of banks is accepting deposits for onward lending. Advances, generally, constitute the largest item on the assets side of the balance sheet of a bank and are major source of its income.

Audit of advances is one of the most important areas covered by auditors in bank audit. It is necessary that auditors should have adequate knowledge of the banking industry and the regulations governing the banks. Auditors must be aware of the various functional areas of the bank/branches, its processes, procedures, systems and prevailing internal controls with regard to advances.

12.1 What do ADVANCES comprise:

Advances comprise of funded amounts by way of:

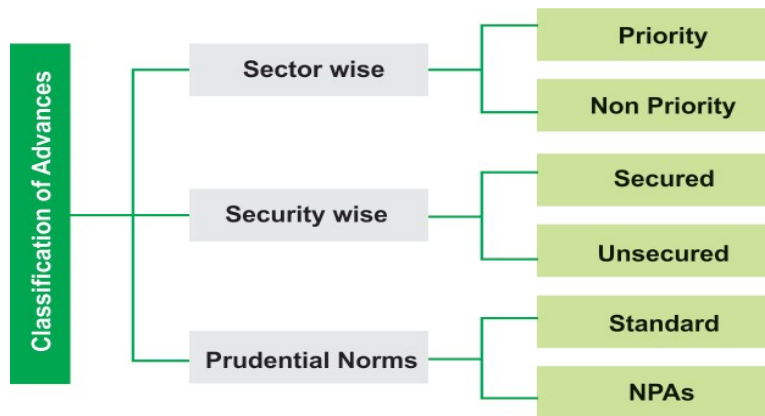
- Term loans
- Cash credits, Overdrafts, Demand Loans
- Bills Discounted and Purchased
- Balances in Deposit Accounts
- Participation on Risk Sharing basis
- Interest-bearing Staff Loans

12.2 Legal requirements of Disclosure in the Balance Sheet:

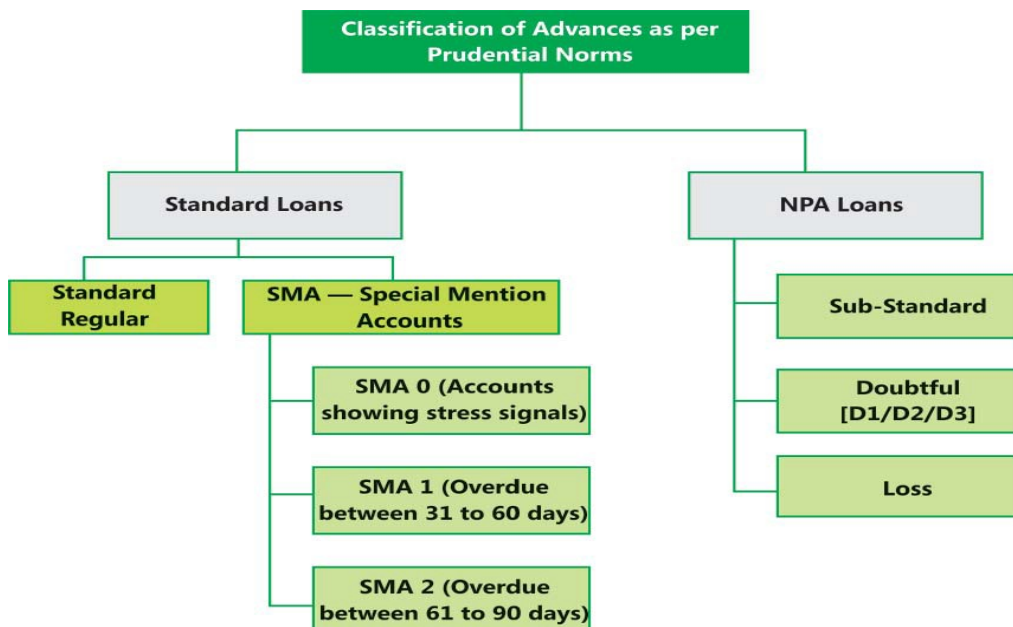
A.	(i) Bills purchased and discounted
	(ii) Cash credits, Overdrafts and loans repayable on demand
	(iii) Term Loans
B.	(i) Secured by tangible assets
	(ii) Covered by Bank/Government guarantees
	(iii) Unsecured

C. I. Advances in India:	C. II. Advances outside India:
(i) Priority sectors	(i) Due from Banks
(ii) Public sector	(ii) Due from Others:
(iii) Banks	(a) Bills Purchased and discounted
(iv) Others	(b) Syndicated loans
	(c) Others

12.3 Classification of Advances



12.3.1 Classification of Advances as per RBI Prudential Norms



12.4 Nature of Security

A. Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.

B. Collateral security is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of most common types of securities accepted by banks are the following:

- Personal Security of Guarantor
- Goods/Stocks/Debtors/Trade Receivables
- Gold Ornaments and Bullion
- Immovable Property
- Plantations (For Agricultural Advances)
- Third Party Guarantees
- Banker's General Lien
- Life Insurance Policies
- Stock Exchange Securities and Other Instruments

12.5 Mode of Creation of Security

Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien.

(i) Mortgage: Mortgage are of several kinds but the most important are the Registered Mortgage and the Equitable Mortgage.

- **Registered Mortgage** can be affected by a registered instrument called the 'Mortgage Deed' signed by the mortgagor. It registers the property to the mortgagee as a security.
- **Equitable mortgage**, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

(ii) Pledge: A pledge thus involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods. The pledge of goods constitutes a specific (or fixed) charge.

(iii) Hypothecation: The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favour of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.

Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank.

The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

(iv) Assignment: Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favour of another person. Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.

An assignment gives the assignee absolute right over the moneys/debts assigned to him.

(v) Set-off: Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor. The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right (i.e., the capacity of the account holder in both the accounts should be the same).

For the purpose of set-off, all the branches of a bank are treated as one single entity. The right of set-off can be exercised in respect of time-barred debts also.

(vi) Lien: Lien is creation of a legal charge with consent of the owner, which gives lender a legal right to seize and dispose / liquidate the asset under lien.

12.6 Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances:

(i) Non-performing Assets: An asset becomes NPA when it ceases to generate income for the Bank.

A non-performing asset (NPA) is a loan or an advance where -:

- interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a term loan;

- (ii) Out of Order:** An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

Categories of Non-Performing Assets:	Provision required
Substandard Assets: Would be one, which has remained NPA for a period less than or equal to 12 months.	15%
Doubtful Assets: Would be one, which has remained in the substandard category for a period of 12 months.	(Secured + Unsecured)
<u>Sub-categories:</u> Doubtful up to 1 Year (D1)	25% + 100%
Doubtful 1 to 3 Years (D2)	40% + 100%
Doubtful more than 3 Years (D3)	100% + 100%
Loss Assets: Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA.

(iv) Accounts regularized near the Balance Sheet Date: The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as NPA.

Central Govt. guaranteed Advances, where the guarantee is not invoked/repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.

(v) Advances under Consortium: Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

(vi) Drawing Power Allocation in case of Cash Credit Account: The Lead Bank would be responsible for computing the drawing power (DP) of the borrower and allocate the same to member banks. In certain special circumstances, at the request of the Borrower, the Lead Bank may allot a higher or lower share of drawing power to the member bank, as against their share of advances. The proforma DP Allocation Letter is presented hereunder for reference:

**DRAWING POWER FOR DECEMBER 2015
AS PER STOCK STATEMENT NOVEMBER, 2015**

(Rs. in Crores)

Description of Stocks	Market Value	Margin	Advance Value
Raw Materials	636.27	25	477.20
Finished Goods	372.75	25	279.56
Stock in process	659.35	25	494.51
Stores and Spares	124.51	25	93.38
Book Debts (Upto 120/180 days)	37379.90	35	24296.94

Stock in Transit	52.31	25	39.23
Total	39225.09		25680.82
Less: Unpaid Stocks under LC	0.00	100	0.00
Total	39225.09		25680.82

(Rs. in Crores)

BANKS	Share %	LIMIT/D.P.
State Bank of India	32.25	500.00
Bank of Baroda	2.58	40.00
Bank of India	6.45	100.00
Canara Bank	5.16	80.00
Standard Chartered Bank	9.03	140.00
Union Bank of India	6.45	100.00
HSBC	13.87	215.00
Citi Bank	6.45	100.00
Bank of America	1.29	20.00
BNP Paribas	1.94	30.00
Punjab National Bank	6.45	100.00
ICICI Bank	4.84	75.00
IDBI Bank	3.23	50.00
Unallocated		
TOTAL	100.00	1550.00

12.7 Accounts where there is erosion in the value of security / frauds committed by borrowers

Not prudent to follow stages of asset classification. It should be straight-away classified as doubtful or loss asset as appropriate.

- (i) Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straight-away classified under doubtful category and provisioning should be made as applicable to doubtful assets.

- (ii) If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straight-away classified as loss asset. It may be either written off or fully provided for by the bank.

12.8 Advances Against Term Deposits, NSCs, KVPs/ IVPs, etc.

Advances against Term Deposits, NSCs eligible for surrender, KVP/IVP and life policies need not be treated as NPAs, provided adequate margin is available in the accounts.

12.9 Agricultural Advances Affected by Natural Calamities

Master Circular issued by the RBI deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities. Banks may decide on their own relief measures, viz., conversion of the short term production loan into a term loan or re-schedulement of the repayment period and the sanctioning of fresh short term loan, subject to the guidelines contained in RBI's latest Master Circular on Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances. In such cases, the NPA classification would be governed by such rescheduled terms.

12.10 Advances to Staff

Interest-bearing staff advances as a banker should be included as part of advances portfolio of the bank. In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of installment of principal or payment of interest on the respective due dates. The staff advances by a bank as an employer and not as a banker are required to be included under the sub-head 'Others' under the schedule of Other Assets.

12.11 Agricultural Advances

As per the guidelines, Agricultural Advances are of two types:

- (1) Agricultural Advances for "long duration" crops; and
- (2) Agricultural Advances for "short duration" crops.

The "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops.

The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

- A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons; and
- A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.



13. COMPUTATION OF DRAWING POWER

- All accounts should be kept within both the drawing power and the sanctioned limit at all times. The accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head Office regularly.
- Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets. Drawing power is required to be arrived at based on current stock statement. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.
- The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail.
- The audited Annual Report submitted by the borrower should be scrutinized properly. The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.
- It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

- The stock audit should be carried out by the bank for all accounts having funded exposure of more than ₹ 5 crores. Auditors can also advise for stock audit in other cases if the situation warrants the same. Branches should obtain the stock audit reports from lead bank in the cases where the Bank is not leader of the consortium of working capital. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.
- The drawing power needs to be calculated carefully in case of working capital advances to companies engaged in construction business. The valuation of work in progress should be ensured in consistent and proper manner. It also needs to be ensured that mobilization advance received by the contractors is reduced while calculating drawing power.

<u>Particulars of current assets</u>		<u>DP</u>
<u>(A) Stocks:</u>		
Stocks at realizable value	1000	
Less: Unpaid stocks:		
- Sundry creditors	300	
- Acceptances/LCs etc.	300	600
Paid for stocks	400	
Margin @ 25%	100	300
<u>(B) Debtors:</u>		
Total Debtors	1000	
Less: Ineligible debtors	200	
Eligible debtors	800	
Margin @ 40%	320	480
Total DP		780

14 AUDIT OF ADVANCES

Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

- (a) Amounts included in balance sheet in respect of advances which are outstanding at the date of the balance sheet.
- (b) Advances represent amount due to the bank.
- (c) Amounts due to the bank are appropriately supported by loan documents and other documents as applicable to the nature of advances.
- (d) There are no unrecorded advances.
- (e) The stated basis of valuation of advances is appropriate and properly applied and the recoverability of advances is recognised in their valuation.
- (f) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
- (g) Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- examining the validity of the recorded amounts;
- examining loan documentation;
- reviewing the operation of the accounts;
- examining the existence, enforceability and valuation of the security;
- checking compliance with RBI norms including appropriate classification and provisioning; and
- carrying out appropriate analytical procedures.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts, however, need to be examined in detail unless the amount involved is insignificant.

Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc. should generally be included in the auditor's review.

Evaluation of Internal Controls over Advances: The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, *inter alia*, the following:

- The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.
- All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- The compliance with the terms of sanction and end use of funds should be ensured.
- Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
- The accounts should be kept within both the drawing power and the sanctioned limit.
- All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- The operation of each advance account should be reviewed at least once an year and at more frequent intervals in the case of large advances.



15. AUDIT OF REVENUE ITEMS

PROFIT AND LOSS ACCOUNT: Sub-section (1) of Section 29 of the Banking Regulation Act, 1949, requires the preparation of Profit and Loss Account in Form B of Third Schedule to the Act or as near thereto as the circumstances admit.

यथा 31 मार्च, 2016 को समाप्त वर्ष का लाभ व हानि खाता PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH 20			
	अनुसूची Schedule	यथा 31.03.2016 को समाप्त वर्ष For the Year ended 31.03.2016 (₹ '000)	यथा 31.03.2015 को समाप्त वर्ष For the Year ended 31.03.2015 (₹ '000)
I. आय / INCOME			
अर्जित व्याज / INTEREST EARNED	13		
अन्य आय / OTHER INCOME	14		
जोड़ / TOTAL			
II. व्यय / EXPENDITURE			
व्यय किया गया व्याज / INTEREST EXPENDED	15		
परिचालन व्यय / OPERATING EXPENSES	16		
प्रावधान और आकस्मिक व्यय / PROVISIONS AND CONTINGENCIES			
जोड़ / TOTAL			
III. वर्ष का निवल लाभ / NET PROFIT FOR THE YEAR			
IV. विनियोजन / APPROPRIATIONS			
निम्नांकित को अंतरण / TRANSFERS TO			
सांविधिक आरक्षित निधियाँ / STATUTORY RESERVES			
धुनी आरक्षित निधियाँ / CAPITAL RESERVES			
निवेश आरक्षित निधि खाता / INVESTMENT RESERVE ACCOUNT			
राजस्व आरक्षित निधि / REVENUE RESERVE			
विशेष आरक्षित निधियाँ / SPECIAL RESERVE			
अंतरिम लाभांश / INTERIM DIVIDEND			
प्रस्तावित लाभांश / PROPOSED DIVIDEND			
लाभांश कर / DIVIDEND TAX			
जोड़ / TOTAL			
लेखांकन नीतियाँ / ACCOUNTING POLICIES	17		
लेखा संबंधी टिप्पणियाँ / NOTES ON ACCOUNTS	18		
प्रति शेयर अर्जन (मूल व तनुकृत) / EARNINGS PER SHARE (BASIC AND DILUTED) (₹ में / in ₹)			

15.1 Income

The following items are included under this head:

Interest Earned	Other Income
● Interest/ Discount on Advances/ Bills: ● Interest Income on Investments: ● Interest on Balances with RBI and Other Inter-bank Funds: ● Others: This includes any other interest/discount income not included in the above heads	● Commission, Exchange and Brokerage: This item comprises of the following: (a) Commission on bills for collection. (b) Commission/exchange on remittances and transfers, e.g. demand drafts, NEFT, RTGS, etc. (c) Commission on letters of credit and guarantees, letter of comforts. (d) Loan processing, arranger and syndication fees. (e) Mobile banking fees. (f) Credit/Debit card fee income including annual fee income, merchant acquiring income, interchange fees, etc. (g) Rent from letting out of lockers (h) Commission on Government business. (i) Commission on other permitted agency business including consultancy and other services. (j) Brokerage on securities. (k) Fee on insurance referral. (l) Commission on referral of mutual fund clients. (m) Service/transaction banking charges including charges levied for transaction at other branches. (n) Income from rendering other services like custodian, demat, investment advisory, cash

	management and other fee based services. ● Profit on Sale of Investments ● Profit/Loss on Revaluation of Investments ● Profit on sale of Land, Buildings and Other Assets: ● Profit/Loss on Revaluation of Fixed Assets ● Profit on exchange transactions: This includes revaluation gains/losses on forward exchange contracts and other derivative contracts, premium income/expenses on options, etc. ● Income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India. ● Miscellaneous income.

15.1.1 Audit Approach and Procedures

- In carrying out audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertained to the bank, there is no unrecorded income and the income is recorded at appropriate amount.
- RBI has advised that in respect of any income which exceeds one percent of the total income of the bank if the income is reckoned on a gross basis or one percent of the net profit before taxes if the income is reckoned net of costs, should be considered on accrual as per Accounting Standard 9.
- If any item of income is not considered to be material as per the above norms, it may be recognised when received and the auditors need not qualify their report in that situation.
- Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In modern day

banking, the entries for interest income on advances are automatically generated through a batch process in the CBS system.

- In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also.
- Interest on advances against Term Deposits, National Savings Certificates (NSCs), Indira Vikas Patras (IVPs), Kisan Vikas Patras (KVPs) and Life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.
- In the case of bills purchased outstanding at the close of the year the discount received thereon should be properly apportioned between the two years. [The Unexpired discount/ rebate on bills discounted i.e., where part of receipt comprising discount charges on bills purchased relate to the period beyond the year-end, should be recorded as "Other Liabilities"]. Interest (discount) component paid by Bank/Branch on rediscount of bills from other financial institutions, is not to be netted off from the discount earned on bills discounted.
- In the case of bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected. The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its agents, etc. This procedure is in consonance with the nature of obligations of the bank in respect of bills for collection. The commission of the branch becomes due only when the bill has been collected.
- Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit. Test check the interest earned by the banks for the sample selected.
- Test check the fees and commissions earned by the banks made for commission on bills for collection, letters of credit and bank guarantees.

Customer Code 280000000000 Customer Name ABCD Account No 015000000000367

Date From	Date To	No Of Days	Rate Of Interest	Amount Base	Total Product	Interest Amount	Applied On
02-06-20XX	03-06-20XX	2	6.86	39.9621376	79.9242751	1.50.214	02-07-2015
04-06-20XX	29-06-20XX	26	6.86	39.9623192	10.39.02.02.983	19.52.789	02-07-2015
30-06-20XX	01-07-20XX	2	6.86	39.94.70.852	79.89.41.705	1.50.137	02-07-2015
						22.53.160	02-07-2015
02-07-20XX	06-07-20XX	5	6.86	39.9621010	1.99.81.05.046	3.75.534	02-08-2015
07-07-20XX	30-07-20XX	24	6.86	39.9623192	9.99.09.98.600	18.02.574	02-08-2015
31-07-20XX	01-08-20XX	2	6.86	40.18.01.300	80.36.02.600	1.51.033	02-08-2015
						23.29.142	02-08-2015
02-08-20XX	02-08-20XX	1	6.86	40.19.52.334	40.19.52.334	75.545	02-09-2015
03-08-20XX	05-08-20XX	3	6.86	39.9621813	1.19.88.65.438	2.25.321	02-09-2015
06-08-20XX	30-08-20XX	25	6.86	39.9623192	9.99.05.79.791	18.77.682	02-09-2015
31-08-20XX	31-08-20XX	1	6.86	40.18.01.739	40.18.01.739	75.517	02-09-2015
01-09-20XX	01-09-20XX	1	6.86	39.94.70.343	39.94.70.343	75.079	02-09-2015
						23.29.143	02-09-2015
02-09-20XX	06-09-20XX	5	6.86	39.9620939	1.99.81.04.693	3.75.534	02-10-2015
07-09-20XX	29-09-20XX	23	6.86	39.9622317	9.19.13.13.283	17.27.463	02-10-2015
30-09-20XX	30-09-20XX	1	6.86	40.17.25.314	40.17.25.314	75.502	02-10-2015
01-10-20XX	01-10-20XX	1	6.86	39.94.69.972	39.94.69.972	75.078	02-10-2015
						22.53.578	02-10-2015

Reversal of Income:

If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).

Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

On leased assets: The component of finance income (as defined in AS 19 – Leases) on the leased asset which was accrued and credited to the income account before the asset became non-performing and remaining unrealised, should be reversed or provided for in the current accounting period.

On Take-out finance: In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognize income unless realised from the borrower/taking-over institution (if the arrangement so provides).

On Partial Recoveries in NPAs:

In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner. The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted.

Interest partly/fully realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

Memorandum Account: On an account turning NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account and stop further application of interest. However, banks may continue to record such accrued interest in a Memorandum account in their books for control purposes. For the purpose of computing Gross Advances, interest recorded in the Memorandum account should not be taken into account.

Income from Investments

Interest Income on Investments: This includes all income derived from Government securities, bonds and debentures of corporates and other investments by way of interest and dividend, except income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India. Broken period interest paid on securities purchased and amortisation of premium on SLR investments is net off from the interest income on investments.

Profit on Sale of Investments: Investments are dealt in the course of banking activity and hence the net profit or loss on sale of investments is taken to profit and loss account.

Profit/Loss on Revaluation of Investments: In terms of guidelines issued by the RBI, investments are to be valued at periodical intervals and depreciation or appreciation in valuation should be recognised and taken to profit and loss account.

15.2 EXPENSES

Expenditure is to be shown under three broad heads:

- (1) Interest expense
- (2) Operating expense
- (3) Provisions and contingencies.

The following items are included under this head:

Interest Expense	Operating Expenses	Provisions and Contingencies
♦ Interest on Deposits	♦ Payments to and Provisions for Employees	♦ Provisions made in respect of the Non-performing assets.
♦ Interest on Reserve Bank of India/Inter-Bank	♦ Rent, Taxes and Lighting ♦ Printing and	♦ Provisions for Taxation

Borrowings	Stationery	
◆ Others	◆ Advertisement and Publicity	◆ Provisions for Diminution in the value of investments
	◆ Depreciation on Bank's Property	◆ Provisions for contingencies
	◆ Directors' Fees, Allowances and Expenses	
	◆ Auditors' Fees and Expenses	
	◆ Legal expenses	
	◆ Postage, Telegrams, Telephones, etc.	
	◆ Repairs and Maintenance	
	◆ Insurance	
	◆ Marketing Expenses	
	◆ Other Expenses	

15.2.1 Audit Approach and Procedures

- In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense by analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. In modern day banking, the entries for interest expenses are automatically generated through a batch process in the CBS system.
- The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.
- The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and

analyse any material differences. The auditor should obtain general ledger break-up for the interest expense incurred on deposits (savings and term deposits) and borrowing each month/quarter. The auditor should analyse month on month (or quarter on quarter) cost analysis and document the reasons for the variances as per the benchmark stated. He should examine whether the interest expense considered in the cost analysis agrees with the general ledger. The auditor should understand the process of computation of the average balance and re-compute the same on sample basis.

- The auditor should, on a test check basis, verify the calculation of interest and ensure that:
 - (a) Interest has been provided on all deposits upto the date of the balance sheet;
 - (b) Interest rates are in accordance with the bank's internal regulations, the RBI directives and agreements with the respective deposit holder;
 - (c) Interest on savings accounts are in accordance with the rules framed by the bank/RBI in this behalf.
 - (d) Interest on inter-branch balances has been provided at the rates prescribed by the head office/RBI.

The auditor should ascertain whether there are any changes in interest rate on saving accounts and term deposits during the period. The auditor should obtain the interest rate card for various types of deposits and analyse the interest cost for the period accordingly. The auditor should examine the completeness that interest has been accrued on the entire borrowing portfolio and the same should agree with the general ledgers. The auditor should re-compute the interest accrual i.e., by referring to the parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc from the term sheet, deal ticket, agreements, etc and ensure that the recomputed amount is tallying with the amount as per books of accounts without any significant difference.

For audit of operating expenses, the auditor should study and evaluate the system of internal control relating to expenses, including authorization procedures in order to determine the nature, timing and extent of his other audit procedures. The auditor should examine whether there are any divergent trends in respect of major items of expenses. The auditor should perform substantive analytical procedures (proforma given below for reference) in respect of these expenses. eg. assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years. The

auditor should also verify expenses with reference to supporting documents and check the calculations wherever required.

For audit of Provisions and contingencies, the auditor should ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled. The auditor should obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. The auditor may verify the loan classification on a sample basis.

The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger. The auditor should obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation. The other provisions for expenses should be examined vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

Proforma for Analytical Procedure:

Analytical - Profit & Loss items						
Particulars	Balances as at				Variation	
	31-03-13	31-03-14	30-09-13	31-12-13	March 13 to March 14	%
Interest Expended	4,43,09,708	4,73,74,798	2,40,11,555	3,50,58,870	30,65,092	7%
General Charges	1,18,02,373	1,11,87,055	58,70,073	82,78,307	-4,15,318	-4%
Interest Collected	3,82,89,39,758	3,42,34,94,482	1,73,51,72,054	2,53,33,51,198	-20,34,45,294	-8%
Commission, Exchange, Brokerage & Other Income	6,87,76,134	6,61,28,900	3,35,16,929	4,89,34,716	-26,47,234	-4%
Net Profit	3,63,98,03,811	3,43,10,61,509	1,73,90,07,354	2,53,89,50,737		

15.3 Disclosure of the prior period items

Since the format of the profit and loss accounts of banks prescribed in Form B under Third Schedule to the Banking Regulation Act, 1949 does not specifically provide for disclosure of the impact of prior period items on the current year's profit and loss, such disclosures, wherever warranted, may be given.

SUMMARY

Banking sector is the backbone of any economy as it is essential for sustainable socio- economic growth and financial stability in the economy. There are different types of banking institutions prevailing in India. Commercial banks are the most wide spread banking institutions in India. Two of its main functions are accepting deposits and granting advances. The functioning of banking industry in India is regulated by the RBI which acts as the Central Bank of our country. There is a sea change in banking as use of technology and its continuous evolution has enabled banks to provide its customers comfort of anytime-anywhere-banking. The auditor should not assume that the system generated information is correct and can be relied upon without evidence.

A bank audit can be divided into following stages:

- ✓ Initial consideration by the statutory auditor
- ✓ Identifying and Assessing the Risks of Material Misstatements
- ✓ Understanding the Bank and Its Environment including Internal Control
- ✓ Understand the Bank's Accounting Process
- ✓ Understanding the Risk Management Process
- ✓ Engagement Team Discussions
- ✓ Establish the Overall Audit Strategy
- ✓ Develop the Audit Plan
- ✓ Audit Planning Memorandum
- ✓ Assess of audit materiality
- ✓ Consider Going Concern
- ✓ Assess the Risk of Fraud including Money Laundering
- ✓ Assess Specific Risks, Risk Associated with Outsourcing of Activities
- ✓ Response to the Assessed Risks
- ✓ Stress Testing
- ✓ BASEL III framework
- ✓ Reliance on / review of other reports
- ✓ Execution
- ✓ Conclusion and reporting.

TEST YOUR KNOWLEDGE

MCQs

1. Regulating body in case of banks is :
 - (a) SEBI
 - (b) IRDA
 - (c) RBI
 - (d) ICAI
2. Which of the following is fund based advance :
 - (a) Term loans
 - (b) Cash credits,
 - (c) Demand Loans
 - (d) All of the above
3. Which of the following is not classification of NPA-
 - (a) Impaired
 - (b) sub standard
 - (c) doubtful
 - (d) Loss

Correct/Incorrect

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

- (1) RBI has been entrusted with the responsibility of regulating the activities of commercial banks only.
- (2) In the computerised environment, the auditor need not be familiar with latest applicable RBI guidelines that have bearing on the classification/ provisions and income recognition.
- (3) The auditor can assume that the system generated information is correct and relied upon without evidence that demonstrates that the system driven information is based on validation of the required parameters for the time being in force and applicable.

- (4) Collateral security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank.
- (5) Registered mortgage is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof
- (6) Any amount due to the bank under any credit facility is 'overdue' if it is not paid within 90 days of becoming due.
- (7) An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

Theoretical Questions

1. The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country. Explain
2. "The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference". Explain
3. Write a short note on reversal of income under bank audit.

ANSWERS/SOLUTIONS

MCQs

1. (c) 2. (d) 3. (a)

Correct/Incorrect

- (1) **Incorrect.** RBI has been entrusted with the responsibility of regulating the activities of commercial and other banks.
- (2) **Incorrect.** In the Computerised environment, it is imperative that the auditor is familiar with, and is satisfied that, all the norms/parameters as per the latest applicable RBI guidelines are incorporated and built into the system that generates information/data having a bearing on the classification/ provisions and income recognition.
- (3) **Incorrect.** The auditor should not go by the assumption that the system generated information is correct and can be relied upon without evidence that demonstrates that the system driven information is based on validation of the required parameters for the time being in force and applicable.

- (4) **Incorrect.** Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.
- (5) **Incorrect.** Equitable mortgage, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.
- (6) **Incorrect.** Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.
- (7) **Correct.** An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

Answers to Theoretical Questions

1. Refer Introduction paragraph
2. Refer Para 2
3. Refer Para 15.1

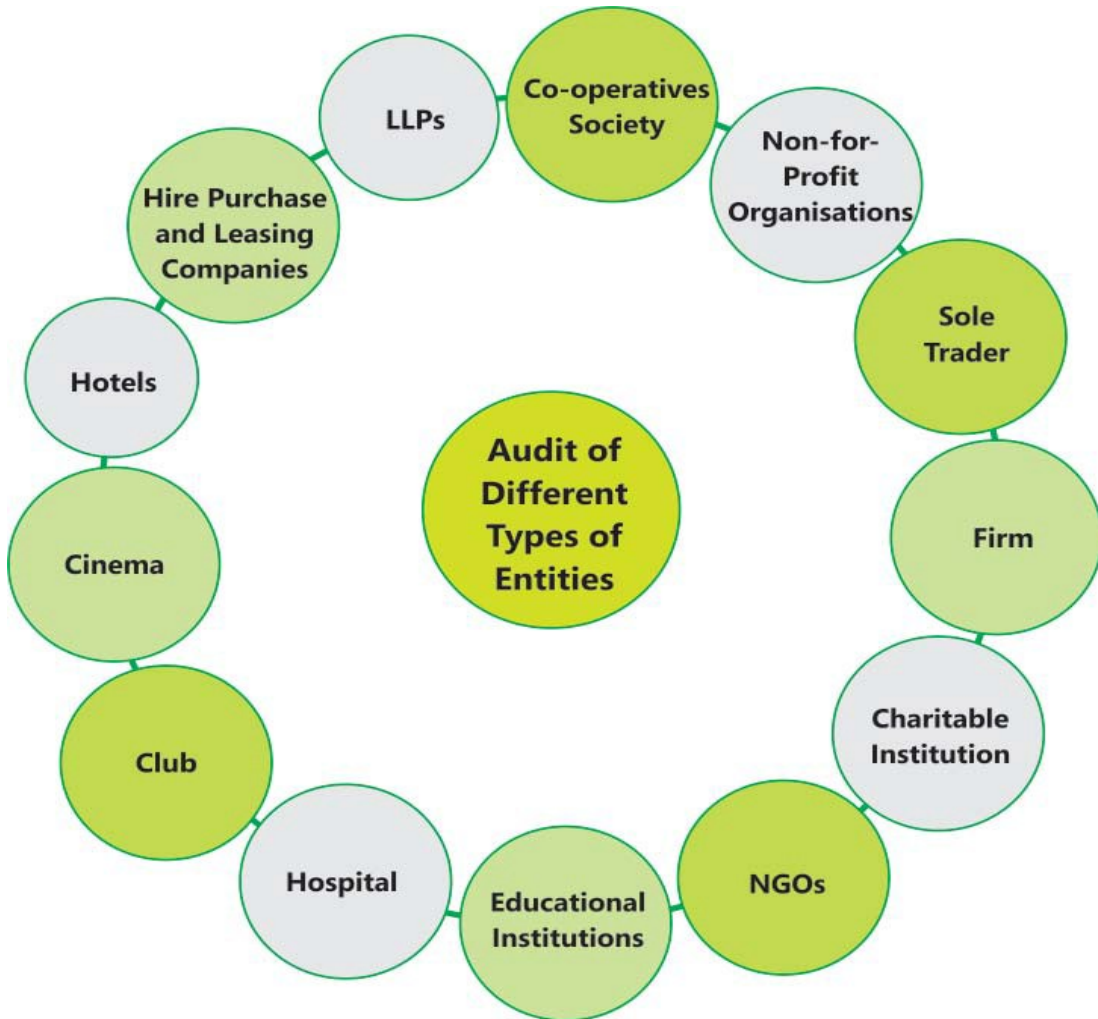
AUDIT OF DIFFERENT TYPES OF ENTITIES



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Understand the procedures to be adopted for auditing of Not-for-profit Organizations (NGOs), Charitable Institutions.
- ❑ Gain knowledge of auditing procedure of sole trader, firm, educational institutions, hospitals, clubs, cinema, hotels, etc.
- ❑ Learn the audit procedure of hire purchase and leasing company accounts.
- ❑ Identify the audit procedures of Government, Local Bodies, Co-operative Societies, LLPs.

CHAPTER OVERVIEW**1. GOVERNMENT AUDIT****1.1 Background**

Government Audit is as old as organised governments and has fairly long pedigree even in developing countries. The concept, content and scope of government audit have developed in tune with the political, social and economic development of the countries. It has also responded to the needs of the administration. It aims to ensure accountability of the executive in respect of public revenue and expenditure. Primarily, the Parliament and in case of States, the State legislatures control all

government expenditure through insistence upon demand for grants. The main idea underlying this control is that no expenditure can be incurred unless it has been voted upon by the Parliament or State Legislatures and funds for every such expenditure must be provided from out of the Consolidated Fund of India or of the State. After the expenditure has been incurred and the accounts are closed, the Appropriation Accounts are prepared which are scrutinised by the Public Accounts Committee. Thus, Parliamentary or Legislative control is exercised before spending and after the expenditure is actually incurred.

Since independence there has been a tremendous spurt in governmental activities with the attendant increase in expenditure, revenue and capital, and in receipts and borrowings to match the expenditure. Government has entered the business field and government in business is not the same as government administering law and order and attending to regulatory functions. Independent India witnessed a steady growth of state commercial enterprise. The change in the character of government and the complex nature of its activities, including regulatory functions in an international environment, called for a change in the nature and scope of audit. Audit has evolved from accountancy and regularity check to evaluation of the end results of the operations of government.

Initially, government auditing in India as elsewhere was primarily expenditure-oriented. Gradually, audit of receipts-tax and non-tax was taken up. With the rapid growth of public enterprises, another major area of specialisation, i.e., commercial audit, came into being. There are also a large number of non-commercial autonomous bodies financed by government in diverse fields of development and of academic study and scientific or social research which are also required to be audited from the viewpoint of public accountability.

Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession. The U.N. Handbook on Government Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:

Government auditing is the objective, systematic, professional and independent examination of financial, administrative and other operations of a public entity made subsequently to their execution for the purpose of evaluating and verifying them, presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions by the responsible officials and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

Government audit serves as a mechanism or process for public accounting of government funds. It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them. Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.

Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration. However, criticism of administrative actions wherever warranted is inherent in auditorial function. This has to be understood and appreciated in a proper spirit, as the criticism is made in a constructive spirit.

In India, the function of Government Audit is discharged by the independent statutory authority of the Comptroller and Auditor General through the agency of the Indian Audit and Accounts Department. Audit is a necessary function to ensure accountability of the executive to Parliament, and within the executives of the spending agencies to the sanctioning or controlling authorities. The purpose or objectives of audit need to be tested at the touchstone of public accountability. The Comptroller and Auditor General (C&AG), in the discharge of his functions, watches that the various authorities act in regard to financial matters in accordance with the Constitution and the laws made by Parliament, and conform to the rules or orders made thereunder.

1.2 Legal Framework and Comptroller & Auditor General

The Constitution of India contains specific provisions regarding the appointment, salary and duties and powers of the C&AG. The constitution guarantees the independence of the C&AG of India by prescribing that he shall be appointed by the President of India and shall not be removed from office except on the ground of proven mis-behaviour or incapacity. As in the case of a Judge of the Supreme Court, he can be removed only when each House of Parliament decides to do so by a majority of not less than 2/3rd of the members of the House present and voting. The Parliament is competent to make laws to determine salary and other conditions of service and they cannot be varied to his disadvantage after his appointment. The Constitution further provides that the conditions of service of person serving in the Indian Audit and Accounts Department and the administrative powers of the C&AG shall be determined by the President after consultation with him.

The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act,

1971 passed in pursuance of the provisions of the Constitution lays down a fixed tenure of the office prescribing that he shall be paid a salary which is equal to the salary of the Judge of the Supreme Court thereby further strengthening his independence.

Article 149 states that the C&AG shall perform such duties and exercise such powers in relation to the accounts of the Union and of the States and of any other authority or body as may be prescribed by or under any law made by the Parliament. The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 defines these functions and powers in detail.

Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.

Article 151 requires that the reports of the C&AG relating to the accounts of the Union/State shall be submitted to the President/Governor who shall cause them to be laid before House of Parliament/State Legislature.

1.3 Comptroller and Auditor General's — Duties and Powers

The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 defines functions and powers in detail. The relevant provisions are discussed hereunder—

Duties of the C&AG:

- (i) **Compile and submit Accounts of Union and States** - The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. The Comptroller and Auditor General shall, from the accounts compiled by him or [by the Government or any other person responsible in that behalf] prepare in each accounts (including, in the case of accounts compiled by him, appropriation accounts) showing under the respective heads the annual receipts and disbursements for the purpose of the Union, of each State and of each Union Territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of the Union Territory having a Legislative Assembly, as the case may be, on or before such dates as he may, with the concurrence of the Government concerned, determine.

The C&AG Act of 1971 has provisions for relieving him of this responsibility to give information and render assistance to the Union and States: The Comptroller and Auditor General shall, in so far as the accounts, for the compilation or keeping of which he is responsible, enable him so to do, give to the Union Government, to the State Government or to the Governments of Union Territories having Legislative Assemblies, as the case may be, such information as they may, from time to time, require and render such assistance in the preparation of the annual financial statements as they may reasonably ask for.

(ii) General Provisions Relating to Audit - It shall be the duty of the Comptroller and Auditor General—

- (a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;
- (b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;
- (c) to audit and report on all trading, manufacturing and profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

(iii) Audit of Receipts and Expenditure - Where anybody or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

Where the grant or loan to a body or authority from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly in a financial year is not less than rupees twenty-five lakhs and the amount of such grant or loan is not less than seventy-five per cent of the total expenditure of that body or authority, such body or authority shall be deemed, for this purpose to be substantially financed by such grants or loans as the case may be.

- (iv) **Audit of Grants or Loans** - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.
- (v) **Audit of Receipts of Union or States** - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make for this purpose such examination of the accounts as he thinks fit and report thereon.
- (vi) **Audit of Accounts of Stores and Inventory** - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.
- (vii) **Audit of Government Companies and Corporations** - The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The Comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

Powers of C&AG

The C&AG Act gives the following powers to the C&AG in connection with the performance of his duties-

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

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

1.4 Expenditure Audit

The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision funds authorised by competent authority fixing the limits within which expenditure can be incurred. These standards are—

- (i) that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the audit against 'rules and orders'.
- (ii) that there is sanction, either special or general, accorded by competent authority authorising the expenditure. Such an audit is called as the audit of sanctions.
- (iii) that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority. Such an audit is called as audit against provision of funds.
- (iv) that the expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called as propriety audit.
- (v) that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Such an audit is termed as the performance audit.

Each of the above audits is discussed in detail in the following paragraphs.

(1) Audit against Rules & Orders - Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority. These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:

- (i) Rules and orders regulating the powers to incur and sanction expenditure from the Consolidated Fund of India or of a State (and the Contingency Fund of India or of a State);
- (ii) Rules and orders dealing with the mode of presentation of claims against government, withdrawing moneys from the Consolidated Fund, Contingency Fund and Public Accounts of the Government of the India and of the States, and in general the financial rules prescribing the detailed procedure to be followed by government servants in dealing with government transactions; and
- (iii) Rules and orders regulating the conditions of service, pay and allowances, and pensions of government servants.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

- (a) they are not inconsistent with any provisions of the Constitution or any laws made thereunder;
- (b) they are consistent with the essential requirements of audit and accounts as determined by the C&AG;
- (c) they do not come in conflict with the orders of, or rules made by, any higher authority; and
- (d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

Audit of expenditure against regularity is of a quasi-judicial type of work performed by the audit authorities. It involves interpretation of the Constitution, statutes, rules, regulations and orders. The final power of interpretation of these, however, does not vest with the C&AG.

(2) Audit of sanctions - The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority. The audit of sanctions is directed both in respect of ensuring that the expenditure is properly covered by a sanction, and also to satisfy that the authority sanctioning it is competent for the purpose by virtue of the powers vested in it by the provisions of the Constitution and of the law, rules or orders made thereunder, or by the rules of delegation of financial powers made by an authority competent to do so.

(3) Audit against provision of funds - Audit against provision of funds aims at ascertaining that the expenditure incurred has been on the purpose for which the grant and appropriation had been provided and that the amount of such expenditure does not exceed the appropriation made.

(4) Propriety audit - According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. With the passage of time, it was felt that regularity audit alone was not sufficient to protect properly the public interest in the spending of money by the executive authorities. A transaction may satisfy all the requirements of regularity audit insofar as the various formalities regarding rules and regulations are concerned, but may still be highly wasteful. A building may be constructed for installing a telephone exchange but may not be used for the same purpose resulting in infructuous expenditure or a school building may be constructed but used after five years of its completion is a case of avoidable expenditure.

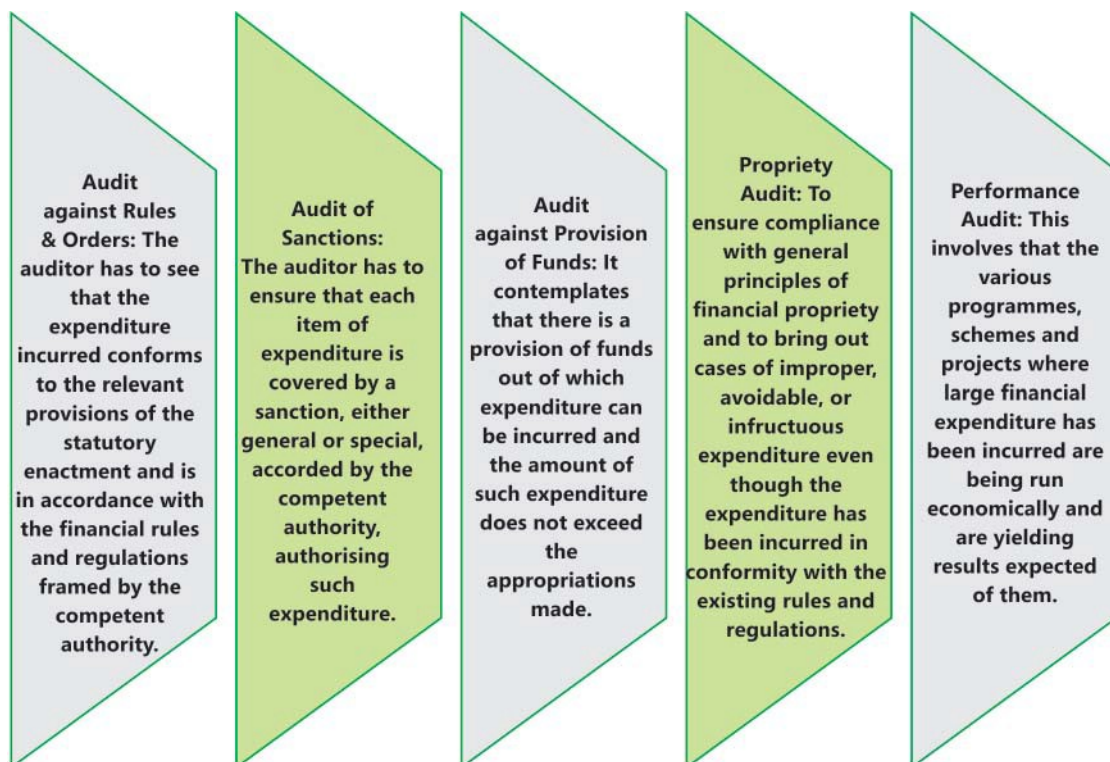
Audit should, therefore, try to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions. These considerations have led to the evolution of audit against propriety which is now being combined by the audit authorities with their routine function of regularity audit. It is hard to frame any precise rules for regulating the course of audit against propriety. Such an objective of audit depends for its acceptance on its appeal to the common sense and straight logic of the auditors and of those whose financial transactions are subjected to propriety audit. However, some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

- (a) The expenditure should not be *prima facie* more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of

expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

- (b) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
- (c) Public moneys should not be utilised for the benefit of a particular person or section of the community unless:
 - (i) the amount of expenditure involved is insignificant; or
 - (ii) a claim for the amount could be enforced in a Court of law; or
 - (iii) the expenditure is in pursuance of a recognised policy or custom; and
 - (iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

It may be stated that it is the responsibility of the executive departments to enforce economy in public expenditure. The function of audit is to bring to the notice of the proper authorities of wastefulness in public administration and cases of improper, avoidable and infructuous expenditure



(5) Performance audit - The scope of audit has been extended to cover efficiency, economy and effectiveness audit or performance audit, or full scope audit. Efficiency audit looks into whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results expected of them, *i.e.*, the relationship between goods and services produced and resources used to produce them; and examination aimed to find out the extent to which operations are carried out in an economical and efficient manner. Economy audit looks into whether government have acquired the financial, human and physical resources in an economical manner, and whether the sanctioning and spending authorities have observed economy. Effectiveness audit is an appraisal of the performance of programmes, schemes, projects with reference to the overall targeted objectives as well as efficiency of the means adopted for the attainment of the objectives. Efficiency- cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness. The procedure for conducting performance audit covers identification of topic, preliminary study, planning and execution of audit, and reporting. While the trend towards a comprehensive approach for conducting performance of full scope audit is visible, the coverage and depth of evaluation vary according to the statutory limitations, and the organisational constraints of C&AG.

1.5 Audit of Receipts

The audit of receipts is neither all pervasive or as old as audit of expenditure but has come to stay in some countries. Such an audit provides for checking;

- (i) whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities;
- (ii) whether adequate regulations and procedures have been framed by the department/agency concerned to secure an effective check on assessment, collection and proper allocation of cases;
- (iii) whether such regulations and procedures are actually being carried out;
- (iv) whether adequate checks are imposed to ensure the prompt detection and investigation of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud or willful omission or negligence to levy or collect taxes or to issue refunds; and

- (v) review of systems and procedures to see that the internal procedures adequately secure correct and regular accounting of demands collection and refunds and pursuant of dues up to final settlement and to suggest improvement. The basic principle of audit of receipts is that it is more important to look at the general than on the particular, though individual cases of assessment, demand, collection, refund, etc. are important within the area of test check. A review of the judicial decisions taken by tax authorities is done to judge the effectiveness of the assessment procedure.
- (vi) The extent and quantum of audit required to be done under each category of audit are determined by the C&AG. These are neither negotiable nor questioned. The prescribed extent and quantum of audit are structured in accordance with the design of test check, random sampling, general review, in-depth study of specified areas, etc. as may be warranted by the nature of transactions, its importance in the scheme of activities of a department and the totality of its transactions, the frequency of check and total plan of audit to be executed during a period. Institutional mechanism provides for primary check by the auditor, test check by the supervisor and control and direction by the group leader. Planning, executing and reporting of work is directed and monitored at middle and top levels of the audit hierarchy. There are built-in arrangements within the C&AG to ensure that the work assigned to each employee is carried out as prescribed. The audit is conducted both centrally where accounts and original vouchers are kept and locally where the drawing and disbursing functions are performed depending on the organisational and institutional arrangements obtaining.

1.6 Audit of Stores and Inventories

Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG. Audit is conducted to ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out. The aim is also to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control. The audit of purchase of stores is conducted in the same manner as audit of expenditure, namely, that these are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority. The auditor has to ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable

to defective or inferior quality of stores are specifically brought by the audit. Accounts of receipts, issues and balances are checked regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding. Any excess or idle inventory is specifically mentioned in the report and periodical verification of inventory is also conducted to ensure their existence. When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time. The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

1.7 Audit of Commercial Accounts

Public enterprises are required to maintain commercial accounts and are generally classified under three categories—

- (a) departmental enterprises engaged in commercial and trading operations, which are subject to the same laws, financial and other regulations as other government departments and agencies;
- (b) statutory bodies, corporations, created by specific statutes mostly financed by government in the form of loans, grants, etc.; and
- (c) government companies set up under the Companies Act, 2013.

The audit of departmental concerns is undertaken in the same manner as any department of government where commercial accounts are kept. Audit of statutory bodies or corporations depends on the nature and type of the statute governing the bodies or corporations. Both financial and accounts audit are conducted by the C&AG, and where compilation of accounts is vested with the C&AG, functions, norms and standards of works usually followed by the professional auditors are adopted *mutatis mutandis*. Government companies have their own auditors under the statute appointed by C&AG. In addition, the C&AG conducts a supplementary test audit of the accounts, as well as periodical financial audit and appraisal of performance. The C&AG also issues direction to the company auditors for reporting on specific aspects of their audit work. These are reviewed, and condensed in the audit reports to the government/legislatures. C&AG has adopted the mechanism of an Audit Board-comprising of representatives of the audit and nominees of government including functional specialists to process reviews or appraisals on performance.

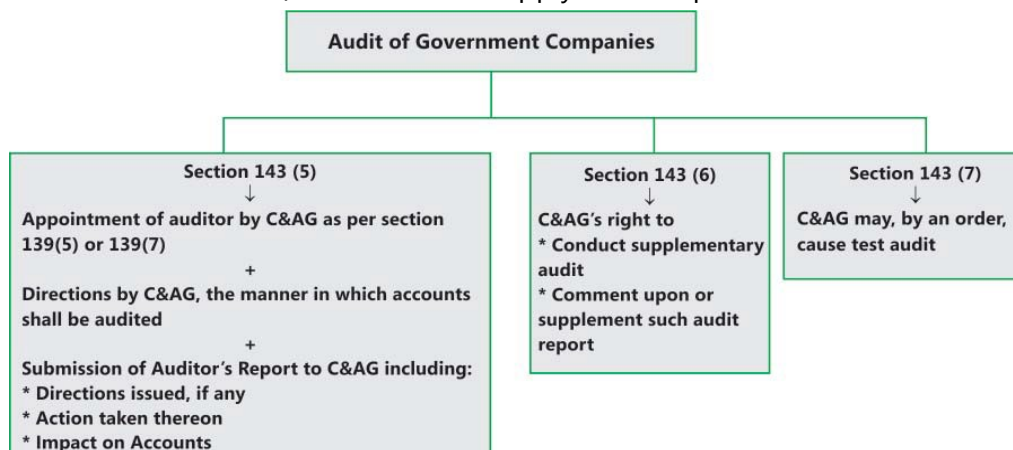
Role of C&AG is prescribed under sub section (5), (6) and (7) of section 143 of the Companies Act, 2013.

Section 143(5) of the Act states 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 comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report have a right to,

- (a) conduct a **supplementary audit under section 143(6)(a)**, of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and
- (b) **comment upon or supplement such audit report under section 143(6)(b)**. Any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

Test Audit under section 143(6)(b): Further, without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor- General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor- General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.



As stated above, in the case of a government company, audit is conducted by professional auditors appointed on the advice of the C&AG and the later is authorised under section 143 of the Companies Act, 2013 to conduct supplementary or test audit.

The C&AG shall direct the manner in which the company's accounts shall be audited by the statutory auditors and give such auditors instructions in regard to any matter relating to the performance of his functions as such. The directions under section 143(6) broadly covers the system of book-keeping and accounts, internal control etc.

The C&AG has power to conduct a supplementary or test audit of the company's accounts by such person as he may authorise in this behalf and for the purposes of such audit require information or additional information to be furnished to any person or persons so authorised on such matters by such person or persons and in such form as the C&AG may by general or special order, direct.

The statutory auditors shall submit a copy of their audit report to the C&AG who shall have a right to comment upon or supplement the audit report submitted by the statutory auditors in such manner as he may think fit. Section 134(3) of the Companies Act, 2013 imposes a duty on the board of directors of

a company to give an explanation or comments on every reservation, or adverse remarks or disclaimer contained in the auditors' report and secretarial audit report of the Company Secretary in practice. In the absence of similar provisions requiring the company to give reply on the reservation made by the C&AG, the board of directors of such a company is not bound to give information or explanation in respect of such comments.

The general standards, principles, techniques and procedures for audit adopted by the C&AG are a mixture of government audit and commercial audit as known and practiced by professional auditors. The concepts of autonomy and accountability of the institution / bodies / corporations / companies have influenced the nature and scope of audit in applying the conventional audit from the angle of economy, efficiency and effectiveness.

1.8 Reporting Procedures

The effectiveness of an audit depends on reporting results to the proper authority so that appropriate action may be taken to rectify the irregularities or impropriety where possible or to prevent re-occurrence. The right as also the obligation to report on the results of audit findings is inherent to the institution of the Auditor General and is usually safeguarded in the Constitution and related enactments. Article 151 of the Indian Constitution enjoins that the C&AG shall report on the accounts of the Union and of each of the States to the President or the Governor concern and the letter shall cause the report to be laid before the legislatures. The reports should not only be presented to the legislatures but thereafter also publicised adequately in order to create a proper climate of public opinion for taking remedial action where necessary, on the findings of the Auditor General. This may also constitute a more effective safeguard in the future.

In India, the reporting is factual and the conclusions are left to be drawn by the reader. This is presumably to ensure total objectivity. Nothing debar C&AG from making recommendations in the audit report but traditionally this has been left to be done by the Public Accounts Committee. The overall Indian position regarding reporting standards is contained in instructions issued by the C&AG on the subject. Experience and professional judgment ultimately determines what is to be included in the audit reports. The auditor has to be a thorough professional and the audit reports have to be prepared with great skill for both the presentation and contents should compel readership.



2. AUDIT OF LOCAL BODIES

2.1 Background

A municipality can be defined as a unit of local self-government in an urban area. By the term 'local self-government' is ordinarily understood the administration of a locality – a village, a town, a city or any other area smaller than a state – by a body representing the local inhabitants, possessing fairly large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services. The discussion in following paragraphs is based on an article "Audit of Municipal Administration" by R. Chandrasekharan.

By 1947, the year of independence of India, most of the urban and semi-urban areas had been constituted into municipalities of one kind or another. Among them were the premier corporations of Mumbai, Chennai and Kolkata each with a special kind of constitutional structure, better financial resources and subject to less state control than other municipal bodies. The service which the local bodies had to render was restricted to education, public health, sanitation, medical relief, roads and a few public works. This was so because these bodies were considered to be inefficient and they lacked adequate financial resources. These bodies derived their revenues from a number of sources – taxes on property, taxes on trade, taxes on persons; fees and licences, non- tax resources such as rent of land, houses, income from commercial undertakings; government grants, etc.

Municipal government in India covers five distinct types of urban local authorities, viz., the municipal corporations, the municipal councils, the notified area committees, the town area committees and the cantonment committees. The taxation powers of the corporations are confined to a few items and are of a generally compulsive nature; on the other hand, the tax powers of other types of urban local authorities cover a wider range, optional in nature and subject to a procedure for their imposition requiring the final sanction of the state governments. Municipal authorities are endowed with specific local functions covering (a) regulatory, (b) maintenance and (c) development activities.

Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads: (a) general administration and revenue collection, (b) public health, (c) public safety, (d) education, (e) public works, and (f) others such as interest payments, etc.

Property taxes and octroi are the major sources of revenue of the municipal authorities; other municipal taxes are profession tax, non-mechanised vehicles tax,

taxes on advertisements, taxes on animals and boats, tolls, show-tax, etc. Local bodies may receive different types of grants from the state administration as well. Broadly, the revenue grants are of three categories:

- (a) **General purpose grants:** These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.
- (b) **Specific purpose grants:** These grants which are tied to the provision of certain services or performance of certain tasks.
- (c) **Statutory and compensatory grants:** These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

2.2 Financial Administration

It would be imminent on the part of the auditor to understand financial administration of local bodies before embarking upon the audit. Some of the aspects are as under:

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

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

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

committee. This leaves the system of external audit by state government as the only instrument of controlling municipal expenditure.

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

2.3 Objective of Audit of Local Bodies

The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. The municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit. The important objectives of audit are:

- (a) reporting on the fairness of the content and presentation of financial statements;
- (b) reporting upon the strengths and weaknesses of systems of financial control;
- (c) reporting on the adherence to legal and/or administrative requirements;
- (d) reporting upon whether value is being fully received on money spent; and
- (e) detection and prevention of error, fraud and misuse of resources.

Audit is another method of financial control on local governments. This provision is coupled with the privilege of *ultra vires*. An action of the local authority if it is beyond legal authority can result in 'surcharge' by audit. This procedure is a legacy of colonial days and even in England it is being resorted to less and less. This may well be because of the increasing competence of the local government authorities.

In addition to the external audit, it is also opined by the learned author that there should be a system of internal audit in all municipal institutions. Internal audit should be provided by the institutions' own staff. It should be performed on a continuous basis according to a well-defined programme. The external auditor should be able to rely upon the work of the internal audit as forming part of a complete system of internal financial control. Where there is no internal audit, as may happen in the case of small or poorly staffed municipalities, the external auditor himself has to do detailed checking. As described under government audit above, increasing attention is being given, to what is described as 'value for money' audit. This kind of audit focuses upon assessment of whether urban institutions are fulfilling their responsibilities with efficiency, economy and effectiveness (sometimes known as 'the three Es').

2.4 Audit Programme for Local Bodies

- (i) The Local Fund Audit Wing of the State Govt. is generally in-charge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc have power to appoint their own auditors for regular external audit. So the auditor should ensure his appointment.
- (ii) The auditor while auditing the local bodies should report on the fairness of the contents and presentation of financial statements, the strengths and weaknesses of system of financial control, the adherence to legal and/or administrative requirements; whether value is being fully received on money spent. His objective should be to detect errors and fraud and misuse of resources.
- (iii) The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.
- (iv) He should ensure that all types of sanctions, either special or general, accorded by the competent authority.
- (v) He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.
- (vi) The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.



3. AUDIT OF NON-GOVERNMENTAL ORGANISATION (NGO'S)

3.1 Background

NGOs can be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives like imparting education, providing medical facilities, economic assistance to poor, managing disasters and emergent situations.



Source of image: crossbarriers.org

Therefore, this definition of NGO would include religious organisations, voluntary health and welfare agencies, **charitable organisations, hospitals, old age homes, research foundations etc.** The scope of services rendered by NGOs is extremely wide and as such cannot be covered in a small definition. Some examples of NGOs operating in India include Child Relief and You (CRY), NORAD, UNICEF, Godhuli, Vidya, Concern India Foundation., etc.

Non-Governmental Organisations are generally incorporated as societies under the Societies Registration Act, 1860 or as a trust under the India Trust Act, 1882, or under any other law corresponding to these Laws enforced in any part of India. NGOs can also be incorporated as a company under section 8 of the Companies Act, 2013. None of the above mentioned Act warrant a mandatory registration under them for an NGO. But if an NGO is created as a trust and trust relates to immovable property worth more than one hundred rupees, the provision of Section 17(1) of the Registration Act, 1908 read with Section 123 of the Transfer of Property Act, 1882 must be complied with and the registration of trust becomes mandatory. In some states, such as the states of Maharashtra and Gujarat, where Public Trusts Acts have been passed, such as the Bombay Public Trusts Act 1950, all charitable trusts have to be registered under these specific Public Trusts Acts. Registration under the Income Tax Act, 1961 and the Foreign Contribution (Regulation) Act, 1976 would also be invoked in many cases.

NGOs registered under the Companies Act, 2013 must maintain their books of account under the accrual basis as required by the provisions of section 128 of the said Act. If the accounts are not maintained on accrual basis, it would amount to non-compliance of the provision of the Companies Act, 2013. The NGOs which are not registered under the Companies Act, 2013 are allowed to maintain accounts either an accrual basis or cash basis.

3.2 Sources and Applications of Funds

The main sources of funds include grants and donations, fund raising programmes, advertisements, fees from the members, technical assistance fees / fee for services rendered, subscriptions, gifts, sale of produce or publications, etc.

Donations and grants received in the nature of promoter's contribution are in the nature of capital receipts and shown as liabilities in the Balance Sheet of NGO. These may either be in the form of corpus contribution or a contribution towards revolving fund. A contribution made towards the capital or the corpus of an NGO is known as corpus contribution. The donors are generally required to specify whether the donation/grant given by him shall form part of the corpus of the NGO. Such contributions are generally given with reference to the total funds required by an NGO. Section 11(1)(d) of the Income Tax Act 1961 also states that income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution shall not be included in the computation of total income. The objective of a contribution or grant towards a Revolving Fund is to rotate the amount by giving temporary loans from the fund to other NGO or beneficiaries for their projects and then recover the loan so as to give temporary loans again and so on. However, any interest earned from the beneficiary on such temporary loans from the revolving fund could be either added back to the fund or credited to the Income and Expenditure Account depending on restrictions laid down by the authority providing the contribution (for the revolving fund) or by the rules and regulations laid down by the concerned NGO in this regard.

Donations and grants received for acquisition of specific fixed assets are those grants whose primary condition is that an NGO accepting them should purchase, construct or otherwise acquire the assets for which the grant is given.

Many a times NGOs receive contributions in kind. These contributions include assets such as land, buildings, vehicles, office equipment, etc. and articles related to programmes / projects such as food, books, building materials, clothes, beds, and raw material for training purposes, e.g., Wool, reeds, cloth, etc.

The areas of application of funds for an NGO include Establishment Costs, Office and Administrative Expenses, Maintenance Expenses, Programme / Project Expenses, Charity, Donations and Contributions given, etc.

3.3 Provisions Relating to Audit

The auditors of an NGO registered under the Societies Registration Act, 1860 (or under any law corresponding to this Act, in force in any part of India) or the Indian

Trusts Act 1882 are normally appointed by the Management of the Society or Trust. **The auditors of NGO registered under section 8 of the Companies Act, 2013 are appointed by the members of the company.** Some of the statutes such as the Companies Act, 2013, Foreign Contribution (Regulation) Act 1976, Income Tax Act 1961 required that the accounts of the NGO be audited and submitted to the prescribed authorities and failure to do so could lead to forfeiture of certain exemptions and benefits. In the case of NGO/PDA's different statutes have specified certain audit reports. The Foreign Contribution (Regulation) Act 1976 has prescribed the format and requires that the same be furnished to the Ministry of Home Affairs within 60 days from the close of the financial year i.e. by May 30 each year.

While planning the audit, the auditor may concentrate on the following:

- (i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.
- (ii) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 1976, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.
- (iii) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.
- (iv) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.
- (v) Examination of minutes of the Board/Managing Committee/Governing Body/Management and Committees thereof to ascertain the impact of any decisions on the financial records.
- (vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.
- (vii) Setting of materiality levels for audit purposes.
- (viii) The nature and timing of reports or other communications.
- (ix) The involvement of experts and their reports.
- (x) Review the previous year's Audit Report.

The **audit programme** should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted.

- (i) **Corpus Fund:** The contributions / grants received towards corpus be vouched with special reference to the letters from the donor(s). The interest income be checked with Investment Register and Physical Investments in hand.
- (ii) **Reserves:** Vouch transfers from projects / programmes with donors letters and board resolutions of NGO. Also check transfer of gross value of asset sold from capital reserve to general reserve and adjustments during the year.
- (iii) **Ear-marked Funds:** Check requirements of donors institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.
- (iv) **Project / Agency Balances:** Vouch disbursements and expenditure as per agreements with donors for each of the balances.
- (v) **Loans:** Vouch loans with loan agreements, counterfoil of receipt issued.
- (vi) **Fixed Assets:** Vouch all acquisitions / sale or disposal of assets including depreciation and the authorisations for the same. Also check donor's letters/ agreements for the grant. In the case of immovable property check title, etc.
- (vii) **Investments:** Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis- investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.
- (viii) **Cash in Hand:** Physically verify the cash in hand and imprest balances, at the close of the year and whether it tallies with the books of account.
- (ix) **Bank Balance:** Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.
- (x) **Inventory:** Verify inventory in hand and obtain certificate from the management for the quantities and valuation of the same.
- (xi) **Programme and Project Expenses:** Verify agreement with donor/contributor(s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.
- (xii) **Establishment Expenses:** Verify that provident fund, life insurance premium, employees state insurance and their administrative charges are deducted,

contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

The receipt of income of NGO may be checked on the following lines:

- (i) **Contributions and Grants for projects and programmes:** Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.
- (ii) **Receipts from fund raising programmes:** Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.
- (iii) **Membership Fees:** Check fees received with Membership Register. Ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.
- (iv) **Subscriptions:** Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine / circulars / periodicals. Check the receipts with subscription rate schedule.
- (v) **Interest and Dividends:** Check the interest and dividends received and receivable with investments held during the year.

Appointment of Auditors (Other Than Government Company)

Appointment of AUDITOR at Annual General Meeting (AGM):

- Every company shall at First AGM, appoint an individual Chartered Accountant in practice or a firm of Chartered Accountants as an Auditor to hold office from the conclusion of that meeting till the conclusion of the sixth (6th) Annual General Meeting (AGM).
- The duration of appointment of auditor of company will be restricted to term of consecutive five (5) years each for Individual and two terms of consecutive five (5) years in case of Audit Firm. However, the restriction of 5 years and 10 years does not apply to One Person Company and Small Companies as per Rule-5- The Companies (Audit and Auditor) Rules, 2014.

Ratification at Every Annual General Meeting (AGM) [First Proviso of Section-139 (1)]

Although the duration of auditors' office is Five (5) years and Ten (10) years, the company is required to place the matter for ratification at every AGM.

DRAFT LANGUAGE OF NOTICE OF AGM (ORDINARY BUSINESS):

Resolved that pursuant to the provisions of Section 139, 141 and other applicable provisions, if any, of the Companies Act, 2013 and the Rules framed thereunder, as amended from time to time, and pursuant to the recommendations of the Audit Committee, the appointment of M/s XYZ, Chartered Accountants, Gurgaon (ICAI Firm registration No. 123456), as Auditors of the Company to hold office from the conclusion of this Annual General Meeting (AGM) till the conclusion of the sixth AGM of the Company to be held in the year 2022 be and is hereby ratified at such remuneration plus service tax and out-of-pocket expenses as may be mutually agreed between the Board of Directors of the Company and the Auditors.

Resolved further that the Board of Directors of the Company be and is hereby authorized to do all such necessary acts and take all such steps as may be necessary, proper or expedient to give effect to this resolution”

Consent and Certificate from Auditor [Second Proviso of Section-139 (1)]

Following documents are required from Auditor before his Appointment in the AGM:

Written consent of auditor for such appointment;

Certificate from auditor for such appointment.

Under Rule 4 of Chapter-X, Auditor shall state in said certificate that he satisfies the following conditions [Third Proviso of Section 139(1)]:

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 Act'), the Chartered Accountants Act, 1949 and the rules or regulations made there under;

The proposed appointment is as per the term provided under the Act;

The proposed appointment is within the limits laid down by or under the authority of the Act;

The list of proceedings against the 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.

(Detailed discussion on appointment of auditors in case of Companies has been discussed in Chapter 10- Company Audit)

**4. AUDIT OF SOLE TRADER**

A sole trader is under no legal obligation to have his accounts audited. However, many such individuals get their financial statement audited due to regulatory

requirements, such as inventory brokers or on a specific instructions of the bank for approval of loans, etc.

Appointment of Auditor: Auditors of sole- proprietary concern shall be appointed by the sole proprietor himself. In case of change of auditor, it would be duty of incoming auditor to communicate with the previous auditor. As such, sole proprietor can determine the scope of the audit as well as the conditions under which it will be carried out.

Example

He can stipulate that only a partial audit shall be carried out, that certain parts of the accounts shall not be checked or that the auditor also shall prepare the final statements of account. He can also decide whether the audit shall be carried out continuously or at the end of the year.

On these considerations, it is desirable that the contract of appointment of auditor in such a case should be in writing; also that it should clearly define the scope of the work which the auditor is expected to carry out. This helps to prevent misunderstanding. If the appointment of the auditor is not in writing, the auditor should write to his client explaining the scope of his duties. While doing so, he should state the limitations, if any, placed upon his work to obtain the client's confirmation.

The advantages and audit procedure discussed in following paragraphs of audit in case of partnership firm would be similar in case of proprietorship.



5. AUDIT OF FIRM

Appointment of Auditors: The auditor to a firm is usually appointed by the partners either on the basis of a decision taken by them or to comply with a condition in the partnership agreement. His remuneration is also fixed by the partners. It is important that the letter of appointment should clearly state the nature and scope of audit which is to be carried out and particulars of limitations, if any, under which he would have to function. In case of change of auditor, it would be duty of incoming auditor to communicate with the previous auditor.

The auditor may, particularly, ensure application of accounting standards prescribed by the Institute. In case the firm is required to get its accounts audited under the requirements of any statute, the auditor will have to qualify the report in case of non-compliance with the accounting standards. Alternatively, only disclosure of non- compliance with the accounting standards, would be sufficient without making it a subject matter of qualification.

Matters to be considered before starting audit: Also, before starting the audit, he should examine the partnership agreement and note the provisions therein as regards the following matters:

1. The name and style under which the business shall be conducted.
2. The duration of the partnership, if any, that has been agreed upon.
3. The amount of capital that shall be contributed by each partner—whether it will be fixed or could be varied from year to year.
4. The period at the end of which the accounts of the partnership will be closed periodically and the proportions in which the profit shall be divided among the partners or losses shall have to be contributed by them; whether the losses shall be borne by the partners or whether any of the partners will not be required to do so.
5. The provisions as regards maintenance of books of account and the matters which must be taken into account for determining the profits of the firm available for division among the partners *e.g.*, creation of reserves, provision for depreciation, etc. also the period within which accounts can be reopened for correcting a manifest error.
6. Borrowing capacity of the partnership (when it is not implied as in the case of non-trading firms).
7. The rate at which interest will be allowed on the capitals and loans provided by partners and the rate at which it will be charged on their drawings and current accounts.
8. Whether any salaries are payable to the partners or withdrawals are permitted against shares of profits and, if so, to what extent?
9. Duties of the partners as regards the management of business of the firm; also, the partners who shall act as managing partners.
10. Who shall operate the bank account of the firm? How will the surplus funds of the partnership be invested?
11. Limitations and restrictions that have been agreed upon, the rights and powers of partners and on their implied authority to pledge the firm's credit or to render it liable.

Advantages of Audit of a Partnership Firm - On broad considerations, the advantages of audit of accounts of a partnership could be stated as follows:

- (1) Audited accounts provide a convenient and reliable means of settling accounts between the partners and, thereby, the possibility of occurrence of a dispute among them is mitigated. On this consideration, it is usually provided in and accepted by the partners, shall be binding upon them, unless some manifest error is brought to light within a specified period subsequent to the accounts having been signed.
- (2) On the retirement or death of a partner, audited accounts, which have been accepted by the partners, constitute a reliable evidence for computing the amounts due to the retiring partner or to the representative of the deceased partner in respect of his share of capital, profits and goodwill.
- (3) Audited statement of accounts are relied upon by the banks when advancing loans, as well as by prospective purchasers of the business, as evidence of the profitability of the concern and its financial position.
- (4) Audited statements of account can be helpful in the negotiations to admit a person as a partner, especially when they are available for a number of past years.
- (5) An audit is an effective safeguard against any undue advantage being taken by a working partner or partners especially in the case of those partners who are not actively associated with the working of the firm.

Matters which should be specially considered in the audit of accounts of a partnership:

- (i) Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.
- (ii) Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans; purchase of assets, extraordinary contracts entered into and other such matters as are not of a routine nature.
- (iii) Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.

- (iv) Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.
- (v) Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreements.
- (vi) Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.
- (vii) Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

From the foregoing steps involved in the audit of a partnership it would be observed that like the audit of every other commercial undertaking, it culminates in the verification of the Balance Sheet and the Statement of Profit and Loss to ensure that these exhibit a true and fair state of affairs of the firm.

The object of examining the partnership agreement, which is an important feature of such an audit, is that the auditor may be able to report to the partners if the interest of any partner has been prejudicially affected, on account of the firm having engaged itself in an activity which it was not authorised to do or violation of any provision of the partnership agreement.

5.1 Basics of Limited Liability Partnerships (LLP) Audit

An LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. A "Statement of Accounts and Solvency" in prescribed form shall be filed by every LLP with the Registrar every year.

The accounts of every LLP shall be audited in accordance with Rule 24 of LLP, Rules 2009. Such rules, inter-alia, provides that any LLP, whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty five lakh rupees, is not required to get its accounts audited. However, if the partners of such limited liability partnership decide to get the accounts of such LLP audited, the accounts shall be audited only in accordance with such rule.

No mandatory insurance has been proposed in the Act. It would be difficult to assess insurance requirements of different types and sizes of LLPs. This would depend upon the nature of commercial risk attached with work or assignment handled by each. Applying common insurance requirements across a class of LLPs

would result in increasing their costs of operation. Therefore, the underlying concern as to the credit worthiness of the LLP in the event of a contractual default is being addressed through statutory provisions for solvency declaration, disclosure of financial information and audit.

Every LLP would be required to file annual return in Form 11 with ROC within 60 days of closer of financial year. The annual return will be available for public inspection on payment of prescribed fees to Registrar.

Every LLP is also required to submit Statement of Account and Solvency in Form 8 which shall be filed within a period of thirty days from the end of six months the financial year to which the Statement of Account and Solvency relates.

Registrar would have power to obtain such information which he may consider necessary for the purposes of carrying out the provisions of the Act, from any designated partner, partner or employee of the LLP. He would also have power to summon any designated partner, partner or employee of any LLP before him for any such purpose, in case the information has not been furnished to him or in case the Registrar is not satisfied with the information furnished to him.

The following documents/information will be available for inspection by any person:-

- ◆ Incorporation document
- ◆ Names of partners and changes, if any, made therein
- ◆ Statement of Account and Solvency
- ◆ Annual Return

The fees for such inspection of an LLP is Rs 50/- and fees for certified copy or extract of any document u/s 36 shall Rs. 5/- per page.

The provisions of the Act require LLPs to file the documents like Statement of Account and Solvency (SAS) and Annual Return (AR) and notices in respect of changes among partners etc. within the time specifically indicated in relevant provisions. The Act contains provisions for allowing LLPs to file such documents after their due dates on payment of additional fees. It has been provided that in case LLPs file relevant documents after their due dates with additional fees upto 300 days, no action for prosecution will be taken against them. In case there is delay of 300 days or more, the LLPs will be required to pay normal filing fees, additional fee and shall also be liable to be prosecuted.

The Act also contains provisions for compounding of offences which are punishable with fine only.

Appointment of Auditor: The auditor may be appointed by the designated partners of the LLP –

1. At any time for the first financial year but before the end of first financial year,
2. At least thirty days prior to the end of each financial year (other than the first financial year),
3. To fill the causal vacancy in the office of auditor,
4. To fill the casual vacancy caused by removal of auditor.

The partners may appoint the auditors if the designated partners have failed to appoint them.

LLP's are required to maintain books of accounts which shall contain-

1. Particulars of all sums of money received and expended by the LLP and the matters in respect of which the receipt and expenditure takes place,
2. A record of the assets and liabilities of the LLP,
3. Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold,
4. Any other particulars which the partners may decide.

Advantages / Purpose / Need of Audit

1. Auditing the accounts of a LLP helps in detecting errors & frauds & verification of financial statements.
2. Disputes, if any between any partners in the matter of accounts can be settled with the help of audited accounts.
3. Banks & financial institutions lend money to the firms only on the basis of audited accounts.
4. Periodical visits & suggestions by the auditor will be helpful in improving the management of the LLP.
5. For settling accounts between partners at the time of admission, death, retirement, insolvency, insanity, etc audited accounts are accepted by those concerned who have dealings with the LLP.

Auditor's Duty Regarding Audit of LLP

1. The auditor should get definite instructions in writing as to the work to be performed by him.

2. The auditor should mention
 - (a) Whether the records of the firm appear to be correct & reliable.
 - (b) Whether he was able to obtain all information & explanation necessary for his work.
 - (c) Whether any restriction was imposed upon him.
3. The auditor should read the LLP agreement & note the following provisions
 - (a) Nature of the business of the LLP.
 - (b) Amount of capital contributed by each partner.
 - (c) Interest – in respect of additional capital contributed.
 - (d) Duration of partnership.
 - (e) Drawings allowed to the partners.
 - (f) Salaries, commission etc payable to partners.
 - (g) Borrowing powers of the LLP.
 - (h) Rights & duties of partners.
 - (i) Method of settlement of accounts between partners at the time of admission, retirement, admission etc.
 - (j) Any loans advanced by the partners.
 - (k) Profit sharing ratio
4. If partners maintain minute book he shall refer it for any resolution passed regarding the accounts

(Source: <http://www.mca.gov.in/MinistryV2/disclosureauditandfilingrequirements.html>)



6. AUDIT OF CHARITABLE INSTITUTION

In the case of audit of a charitable institution, attention should be paid to the following matters-

(1) General

- (i) Studying the constitution under which the charitable institution has been set up.
- (ii) Verifying whether the institution is being managed in the manner contemplated by the law under which it has been set up.

- (iii) Examining the system of internal check, especially as regards accounting of amounts collected.
- (iv) Verifying in detail the income and confirming that the amounts received have been deposited in the bank regularly and promptly.

(2) Subscriptions and donations

- (i) Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year.
- (ii) Whether official receipts are issued;
 - (a) confirming that adequate control is imposed over unused receipt books;
 - (b) obtaining all receipt books covering the period under review;
 - (c) test checking the counterfoils with the cash book; any cancelled receipts being specially looked into;
 - (d) obtaining the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;
 - (e) examining the system of internal check regarding moneys received from box collections, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued; paying special attention to the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and
 - (f) verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.

(3) Legacies - Verifying the amounts received by reference to correspondence with any figures and other available information.

(4) Grants

- (i) Vouching the amount received with the relevant correspondence, receipts and minute books.
- (ii) Obtaining a certificate from a responsible official showing the amount of grants received.

(5) Investments Income

- (i) Vouching the amounts received with the dividend and interest counterfoils.
- (ii) Checking the calculations of interest received on securities bearing fixed rates of interest.
- (iii) Checking that the appropriate dividend has been received where any investment has been sold ex-dividend or purchased cum-dividend.
- (iv) Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.

(6) Rent

- (i) Examining the rent roll and inspecting tenancy agreements, noting in each case:
 - (a) the amounts of the rent, and
 - (b) the due dates.
- (ii) Vouching the rent on to the rent roll from the counterfoils of receipt books and checking the totals of the cash book.

(7) Special function, etc. - Vouching gross receipts and outgoings in respect of any special functions, *e.g.* concerts, dramatic performance, etc., held in aid of the charity with such vouchers and cash statements as are necessary. In particular, verifying that the proceeds of all tickets issued have been accounted for, after making the allowance for returns.

(8) Income Tax Refunds - Where income-tax has been deducted from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax. This involves:

- (i) vouching the Income-tax refund with the correspondence with the Income- tax Department; and
- (ii) checking the calculation of the repayment of claims.

(9) Expenditure

- (i) Vouching payment of grants, also verifying that the grants have been paid only for a charitable purpose or purposes falling within the purview of the objects for which the charitable institution has been set up and

that no trustee, director or member of the Managing Committee has benefited there from either directly or indirectly.

- (ii) Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test- basis.
- (iii) Verifying the cash and bank balances.
- (iv) Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.

7. AUDIT OF EDUCATIONAL INSTITUTIONS (SCHOOL, COLLEGE OR UNIVERSITY)

The special steps involved in their audit are the following-

- (1) Examine the Trust Deed or Regulations, in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulation framed thereunder.



Source of image: www.aspiringminds.in

- (2) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.
- (3) Check names entered in the Students Fee Register for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.

- (4) Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
- (5) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
- (6) Check admission fees with admission slips signed by the head of the institution and confirm that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.
- (7) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the Rules prepared by the Managing Committee.
- (8) Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.
- (9) Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.
- (10) Verify rental income from landed property with the rent rolls, etc.
- (11) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.
- (12) Verify any Government or local authority grant with the memo of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons thereof.
- (13) Report any old heavy arrears on account of fees, dormitory rents, etc. to the Managing Committee.
- (14) Confirm that caution money and other deposits paid by students on admission, have been shown as liability in the balance sheet not transferred to revenue, unless they are not refundable.
- (15) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.
- (16) Verify that the Provident Fund money of the staff has been invested in appropriate securities.

- (17) Vouch donations, if any with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.
- (18) Vouch, all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.
- (19) Vouch, in the usual manner, all establishment expenses and enquire into any unduly heavy expenditure under any head. If there was any annual budget prepared, see that any excess under any head over the budgeted amount was duly sanctioned by the Managing Committee. If not, bring it to the Committee's notice in your report.
- (20) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.
- (21) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
- (22) Verify the inventories of furniture, stationery, clothing, provision and all equipment etc. These should be checked by reference to Inventory Register or corresponding inventories of the previous year and values applied to various items should be test checked.
- (23) Confirm that the refund of taxes deducted from the income from investment (interest on securities etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.
- (24) Finally, verify the annual statements of account and, while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of staff, etc.

8. AUDIT OF HOSPITAL

The special steps involved in such an audit are stated below-



1. **Register of Patients:** 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.
2. **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.
3. **Income from Investments, Rent etc:** 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 have been collected.
4. **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
5. **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).
6. **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.
7. **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.
8. **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.
9. **Internal Check:** Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.
10. **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.

11. **Registers:** Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.
12. **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.
13. **Management Representation and Certificate:** Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.



9. AUDIT OF CLUB

The special steps involved in such an audit are stated below-

- (1) Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes of the Managing Committee.
- (2) Vouch members' subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.
- (3) Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance have been correctly adjusted.
- (4) Check totals of various columns of the Register of members and tally them across.
- (5) 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 should be mentioned in the Audit Report.
- (6) 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 services rendered, such as billiards, tennis, etc.
- (7) 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.

- (8) Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective inventory registers.
- (9) Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. The inventory of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.
- (10) 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.
- (11) 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.
- (12) Examine the financial powers of the secretary and, if these have been exceeded, report specific case for confirmation by the Managing Committee.



10. AUDIT OF CINEMA

The special steps involved in its audit are stated below-

- (1) Verify the internal control mechanism-
 - (a) that entrance to the cinema-hall during show is only through printed tickets;
 - (b) that they are serially numbered and bound into books;
 - (c) that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;
 - (d) that for advance booking a separate series of tickets is issued; and
 - (e) that the inventory of tickets is kept in the custody of a responsible official.
- (2) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.
- (3) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.

- (4) Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class and vouch and verify the entertainment tax returns filed each month.
- (5) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.
- (6) Verify the charges collected for advertisement slides and shorts by reference to the Register of Slides and Shorts Exhibited kept at the cinema as well with the agreements, entered into with advertisers in this regard.
- (7) Vouch the expenditure incurred on advertisement, repairs and maintenance. No part of such expenditure should be capitalized.
- (8) Confirm that depreciation on machinery and furniture has been charged at an appropriate rate.
- (9) Vouch payments on account of film hire with bills of distributors and in the process, the agreements concerned should be referred to.
- (10) Examine unadjusted balance out of advance paid to the distributors against film hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquired as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.
- (11) The arrangement for collection of the share in the restaurant income should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually. In case the restaurant is run by the Cinema, its accounts should be checked. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cold drink, etc. as in the case of club.



11. AUDIT OF HIRE PURCHASE AND LEASING COMPANIES

Generally speaking, hire-purchase agreement means an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which-

- (i) possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical instalments,
- (ii) the property in the goods is to pass to such person on the payment of the last of such instalments, and
- (iii) such person has a right to terminate the agreement at any time before the property so passes.

Thus, hirer means the person who obtains or has obtained possession of goods from an owner under a hire- purchase agreement and owner means the person who lets or has let, delivers or has delivered possession of goods to a hirer under a hire- purchase agreement in order to complete the purchase of, or the acquisition of property in the goods of which the agreement relates; and includes any sum so payable by the hirer under the hire- purchase agreement by way of a deposit or other initial payment.

While checking the hire- purchase transaction, the auditor may examine the following:

- (i) Hire purchase agreement is in writing and is signed by all parties.
- (ii) Hire purchase agreement specifies clearly-
 - (a) The hire-purchase price of the goods to which the agreement relates;
 - (b) The cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash;
 - (c) The date on which the agreement shall be deemed to have commenced;
 - (d) The number of instalments by which the hire- purchase price is to be paid, the amount of each of those instalments, and the date, or the mode of determining the date, upon which it is payable, and the person to whom and the place where it is payable; and
 - (e) The goods to which the agreement relates, in a manner sufficient to identify them.
- (iii) Ensure that instalment payments are being received regularly as per the agreement.

In a lease agreement, a party (called 'lessee') acquires the right to use an asset for an agreed period of time in consideration of payment of rent to another party (called 'lessor'). In certain lease agreements, the legal ownership of the asset remains with the lessor (the leasing company), but in substance, all the risks and rewards of

ownership of the asset are transferred to the lessee. In other words, the lease is, in effect, a financing arrangement. Such leases are termed as finance leases. An operating lease, on the other hand, is a simple arrangement where, in return for rent, the lessor allows the lessee to use the asset for a certain period.

A normal financial lease transaction usually goes through the following modality:

The lessee will select the equipment, and satisfy himself about its functional fitness and specifications, the lessor has no participation at this stage.

Having chosen the equipment, the lessee approaches a lessor, either directly or through a lease-broking agency.

The lease agreement is broadly negotiated and the rates are finalised. The lessor places an order on the manufacturer as chosen by the lessee.

The manufacturer delivers the equipment at the site of the lessee, and the latter gives notice of acceptance to the lessor.

The lease agreement giving detailed terms of contract is signed between the parties. Leases will normally be full pay-out, with term varying as per requirements.

During the lease period, the lessee:

- ◆ Will pay rentals regularly at periods agreed-upon, which are usually each calendar month;
- ◆ Will keep the equipment in good repair and working condition, etc.
- ◆ Will be entitled to any manufacturer's warranties or after-sales services.

At the end of the lease period, the equipment shall retreat to the lessor. The lessee may, however, be given a renewal right, or may be allowed to participate in purchase of the equipment when the lessor intends to sell it. No purchase option shall be given to the lessee in the lease agreement itself.

In respect of leasing transaction entered into by the leasing company, the following procedures may be adopted by the auditor:

- (1) The object clause of leasing company to see that the goods like capital goods, consumer durables etc. in respect of which the company can undertake such activities. Further, to ensure that whether company can undertake financing activities or not.
- (2) Whether there exists a procedure to ascertain the credit analysis of lessee like lessee's ability to meet the commitment under lease, past credit record, capital strength, availability of collateral security, etc.

- (3) The lease agreement should be examined and the following points may be noted:
- (i) the description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).
 - (ii) the amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.
 - (iii) whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.
 - (iv) whether the agreement prohibits the lessee from assigning the subletting the equipment and authorises the lessor to do so.
- (4) Examine the lease proposal form submitted by the lessee requesting the lessor to provide him the equipment on lease.
- (5) Ensure that the invoice is retained safely as the lease is a long-term contract.
- (6) Examine the acceptance letter obtained from the lessee indicating that the equipment has been received in order and is acceptable to the lessee.
- (7) See the Board resolution authorising a particular director to execute the lease agreement has been passed by the lessee.
- (8) See that the copies of the insurance policies have been obtained by the lessor for his records.

Students need to pay attention that AS-19/ Ind-AS 17 define that lease arrangements could be of 2 types i.e. 1 Finance Lease and 2 Operating Lease.

Finance Lease: An arrangement with the following attributes qualifies as a Finance Lease:

The lease arrangement transfers ownership of the asset to the lessee at the end of the lease term;

- ◆ The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
- ◆ The lease term is for the major part of the economic life of the asset even if title is not transferred;

- ♦ At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- ♦ the leased assets are of such a specialized nature that only the lessee can use them without major modifications

Operating Lease

An arrangement that does not transfer substantially all the risks and rewards incidental to ownership qualifies as an Operating Lease. In other words, an operating lease is a lease arrangement "Other than finance lease".

The below table captures the broad differences under both the above said types of lease arrangements:

	Operating Lease	Financial Lease
Common examples	Lease of Projector, Computers, Laptops, Coffee Dispensers etc	Lease of Plant and Machinery, Land, Office Building etc
Ownership	Ownership of the asset remains with the lessor for the entire period of lease.	Ownership transfer option at the end of the lease period is with the lessee. Title may or may not be eventually transferred.
Accounting treatment	Operating lease is generally treated like a renting arrangement. That means, the lease payments are treated as operating expenses and the asset does not appear as an asset on lessee's balance sheet.	Financial lease is treated like loan arrangement. Hence, the asset ownership is considered of that of the lessee and thus appears on the balance sheet of the lessee.
Purchase Option	Under operating lease, the lessee does not have any option to buy the asset during the lease period.	Financial lease allows the lessee to have a purchase option at less than the fair market value of the asset.

Lease Term	Lease term generally extends to less than 75% of the projected useful life of the leased asset.	Lease term is generally more than or equal to estimated economic life of the asset under the lease arrangement.
Operating/ running expenses	Lessee pays only the monthly lease payments. No running or administration costs are to be borne for example: registration, repairs etc. since it gives only right to use the asset.	Lessee generally bears insurance, maintenance and taxes.
Tax benefit	Since operating lease is as good as renting, lease payment is considered as expense. No depreciation can be claimed by the lessee.	Lessee can claim both interest and depreciation expense as financial lease is treated like a loan.

12. AUDIT OF HOTELS

There are many problems involved in any hotel audit, some of which are peculiar to the hotel industry such as control of cash assumes greater proportions.

Almost all sales points in a hotel make both cash and credit sales. The auditor should reconcile the total sales reported with the total of the bills issued by the sales point; this total may take the form of a bill roll or a series of numerically controlled bills. This numerical control must be checked to ensure that all bills are included in the total. The cash element of the sales must then be checked to the cash records and the credit sales in total and detail to the guest's bills.

The special considerations in a hotel audit can be summarised as follows:

(1) Internal Controls - Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. It is the responsibility of management to introduce controls which will minimise the leakage as far as possible. Evidence of their success is provided by the preparation of regular perhaps weekly, trading accounts for each sales point and a detailed scrutiny of the resulting profit percentages, with any deviation from the anticipated form being

investigated. The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.

If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor. As a result of the transient nature of many of his clients' records, the auditor must rely to a very large extent on the gross margin shown by the accounts. As a result, the scope of his audit tests will necessarily be increased and, in the event of a material margin discrepancy being unexplained, he will have to consider qualifying his audit report.

(2) Room Sales - The charge for room sales is normally posted to guest bills by the receptionist/ front office or in the case of large hotels by the night auditor. The source of these entries is invariably the guest register and audit tests should be carried out to ensure that the correct numbers of guests are charged for the correct period. Any difference between the charged rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorised.

In many hotels, the housekeeper prepares a daily report of the rooms which were occupied the previous night and the number of beds kept in each room. This report tends not to be permanently retained and the auditor should ensure that a sufficient number of reports are available for him to test both with the guest register and with the individual guest's bill.

(3) Inventories - The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores areas and sales point. The auditor should carry out tests to ensure that all such documentation is accurately processed.

Areas where large quantities of inventory are held should be kept locked, the key being retained by the departmental manager. The key should be released only to trusted personnel and unauthorised persons should not be permitted in the stores areas except under constant supervision. In particular, any movement of goods in or out of the stores should be checked. Many hotels use specialised professional valuers to take and value the inventories on a continuous basis throughout the year. Such a valuation is then almost invariably used as the basis of the balance sheet inventory figure at the year end. Although such valuers are independent of the audit client, it is important that the auditor satisfies himself that the amounts included for such inventories are reasonable. In order to satisfy himself of this, the auditor

should consider attending the physical inventory taking and carrying out certain pricing and calculation tests. The extent of such tests could well be limited since the figures will have been prepared independently of the hotel.

(4) Fixed Assets - The accounting policies for fixed assets of individual hotels are likely to differ. However, many hotels account for certain quasi-fixed assets such as silver and cutlery on inventory basis. This can lead to confusion between each inventory items and similar assets which are accounted for on a more normal fixed assets basis. In such cases, it is important that very detailed definitions of inventory items exist and the auditor should carry out tests to ensure that the definitions have been closely followed.

(5) Casual Labour - The hotel trade operates to very large extent on casual labour. The records maintained of such wage payments are frequently inadequate. The auditor should ensure that defalcation on this account does not take place by suggesting proper controls to the management.

(6) Other points -

- (i) For ledgers coming through travel agents or other booking agencies the bills are usually made on the travel agents or booking agencies. The auditor should ensure that money are recovered from the travel agents or booking agencies as per the terms of credit allowed.
- (ii) Commission, if any, paid to travel agents or booking agents should be checked by reference to the agreement on that behalf.
- (iii) The auditor should ensure that proper records re-maintained for booking of halls and other premises for special parties and recovered on the basis of the tariff.
- (iv) The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic record. This would enable the auditor to ensure that controls regarding revenue cycle are in order.
- (v) The auditor should see that costs of repairs and minor renovation and redecoration are treated as revenue expenditure, where as costs of major alterations and additions to the hotel building and facilities capitalised.
- (vi) The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts.

- (vii) The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities.



13. AUDIT OF CO-OPERATIVE SOCIETIES

13.1 Background

The Co-operative Societies Act, 1912, a Central Act, contains the fundamental law regarding the formation and working of the co-operative societies in India and is applicable in many states with or without amendments. In many states, viz., Maharashtra, West Bengal, Orissa, the co-operative societies are governed by specific state Acts. An auditor of a co-operative society should be familiar with the provisions of the particular Act governing the society under audit.

Co-operative society is a business organisation with a special mode of doing business, by pulling together all the means of production co-operatively, elimination of middlemen and exploitation from outside forces.

A chartered accountant has to play a significant role in the development of co-operative organisations on scientific lines. In this Unit, it is proposed to give a few guidelines in the matter of audits of co-operative societies.

Apart from audit, some other professional services could be rendered by chartered accountants such as-

- (1) guidance in accounts writing,
- (2) installation of accounting system,
- (3) internal audit,
- (4) management accounting services,
- (5) taxation etc.

However, the main focus is to give some guidelines about the audit of co-operative societies in general. The special features of audit applicable to all societies will be considered first, and subsequently a few special points with reference to audit programmes of specific types of societies will be considered.

13.2 Audit as per Section 17 of the Co-Operative Societies Act, 1912

- (1) The Registrar shall audit or cause to be audited by some person authorised by him by general or special order in writing in this behalf the accounts of every registered society once at least in every year.

- (2) The audit under sub-section (1) shall include an examination of overdue debts, if any, and a valuation of the assets and liabilities of the society.
- (3) The Registrar, the Collector or any person authorised by general or special order in writing in this behalf by the Registrar shall at all times have access to all the books, accounts, papers and securities of a society, and every officer of the society shall furnish such information in regard to the transactions and working of the society as the person making such inspection may require.

"Registrar" means a person appointed to perform the duties of a Registrar of Co-operative Societies under this Act.

The following points should be kept in mind in connection with the audit of a co-operative society:

1. Qualifications of Auditors - Apart from a chartered accountant within the meaning of the Chartered Accountants Act, 1949, some of the State Co-operative Acts have permitted persons holding a government diploma in co-operative accounts or in co-operation and accountancy and also a person who has served as an auditor in the co-operative department of a government to act as an auditor.

2. Appointment of the Auditor - An auditor of a co-operative society is appointed by the Registrar of Co-operative Societies and the auditor so appointed conducts the audit on behalf of the Registrar and submits his report to him as also to the society. The audit fees are paid by the society on the basis of statutory scale of fees prescribed by the Registrar, according to the category of the society audited.

3. Books, Accounts and other records of Co-operative Societies - Under section 43(h) of the Central Act, a state government can frame rules prescribing the books and accounts to be kept by a co-operative society.

For example, in Maharashtra, the co-operative societies are required to maintain books of account in terms of the instructions of the Registrar as following:

- (i) All sums of money received and expended by the society and the matters in respect of which receipts and expenditure take place.
- (ii) All sales and purchases of goods by the society.
- (iii) Assets and liabilities of the society.

In order to maintain proper financial accounting records so as to disclose full financial results of working of the society, the statutory or mandatory provisions provide a directive, but they are not conclusive. The society is at liberty to maintain such additional records according to its convenience and which it thinks more

useful for clarity and detailed explanation. Ultimately the financial transactions and the results thereof must be presented very clearly and in the best possible manner.

Depending upon the nature and object of the society, different kinds of books and registers will be maintained, so as to disclose a proper and fair picture of financial transactions. In case of large scale co-operative organisation, different subsidiary books and registers shall be maintained and the daily summary totals will be transferred to main Cash Book. For example:

- (a) Daily cash sales summary register.
- (b) A register of collection from debtors if credit sales are allowed by bye-laws of society.
- (c) A register of recovery of loans from salaries and directly by receipts from members in case of credit society.
- (d) Loan disbursement register in case of credit society.
- (e) Any other columnar subsidiaries depending upon the nature and functions of society.

1. Restrictions on share holdings - According to section 5 of the Central Act, in the case of a society where the liability of a member of the society is limited, no member of a society other than a registered society can hold such portion of the share capital of the society as would exceed a maximum of twenty percent of the total number of shares or of the value of shareholding to ₹ 1,000/-. The auditor of a co-operative society will be concerned with this provision so as to watch any breach relating to holding of shares. One should also watch whether any provision in the bye-laws of the society is not contrary to this statutory position. The State Acts may provide limits as to the shareholding, other than that provided in the Central Act.

2. Restrictions on loans - Section 29 of the Central Act puts restriction on loan. It states that a registered society shall not make a loan to any person other than a member. However, with the special sanction of the Registrar, a registered society may make a loan to another registered society.

The State Government may further put such restrictions as it thinks fit on the loaning powers of the society to its members or to other societies in the interest of the society concerned and its members.

3. Restrictions on borrowings - Section 30 of the Central Act further puts restriction on borrowings. According to this section, a registered society shall accept loans and deposits from persons who are not members subject to the

restrictions and limits of the bye-laws of the society. The auditor will have to examine the bye-laws in this respect.

4. Investment of funds - According to section 32 of the Central Act, a society may invest its funds in any one or more of the following:

- (a) In the Central or State Co-operative Bank.
- (b) In any of the securities specified in section 20 of the Indian Trusts Act, 1882.
- (c) In the shares, securities, bonds or debentures of any other society with limited liability.
- (d) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.
- (e) In any other moneys permitted by the Central or State Government.

In the principal provision relating to the investments of funds of a co-operative society, the Central as well as State Acts does not mention anything about the investment of reserve fund outside the business specifically.

5. Appropriation of profits - According to section 33 of the Central Act, a prescribed percentage of the profits should be transferred to Reserve Fund, before distribution as dividends or bonus to members.

6. Contributions to Charitable Purposes - According to section 34, a registered society may, with the sanction of the Registrar, contribute an amount not exceeding 10% of the net profits remaining after the compulsory transfer to the reserve fund for any charitable purpose as defined in section 2 of the Charitable Endowments Act, 1890.

7. Investment of Reserve Fund outside the business or utilisation as working capital - Some of the State Acts provide that a society may use the Reserve Fund:

- (a) in the business of a society, as working capital (subject to the rules made in this behalf).
- (b) may invest as per provisions of the Act.
- (c) may be used for some public purposes likely to promote the object of the society. The auditor should ensure strict compliance with the State Act and Rules in this regard.

8. Contribution to Education Fund - Some of the State Acts provide that every society shall contribute annually towards the Education Fund of the State

Federal Society, at the appropriate rate as per the class of the society. Contribution to Education Fund is a charge on profits and not an appropriation.

Apart from statutory provisions relating to Reserve Fund, the auditor may have regard to the provisions in bye-laws and Rules and Regulations of the society regarding the appropriation of profits. Transfers to other reserves, dividends to members etc. are the other appropriations. Appropriations of profits must be approved by the General Body of the society, which is the supreme authority in the co-operative management. Further, it may be noted that necessary accounting entries for the appropriation of profits must be passed after the date of approval by the General Body. Here there is a departure from corporate accounting practice, where entries are passed for proposed appropriations, subject to approval of Annual General Meeting.

According to certain State Acts, transfers to Dividend Equalization Reserve and Share Capital Redemption Fund are stated as charges against profits. According to the generally accepted principles of accountancy these items are not charges, but appropriation of profits. The auditor should point out such spots where statutory provisions of any law are in contradiction with the generally accepted accounting principles.

13.3 Special Features of Co-Operative Audit

The general processes of auditing involved in audit work such as checking of posting, ascertainment of arithmetical accuracy, vouching, verification of assets and liabilities and final scrutiny of Balance Sheet are well known to the students, and the same are to be applied in co-operative audit as well. It need not be discussed in detail.

However, the special features of co-operative audit, to be borne in mind in general while conducting the audit are as follows:



1. Examination of overdue debts - Overdue debts for a period from 6 months to 5 years and more than 5 years will have to be classified and shall have to be reported by an auditor. Overdue debts have far reaching consequences on the working of a credit society. It affects its working capital position. A further analysis of these overdue debts from the viewpoint of chances of recovery will have to be made, and they will have to be classified as good or bad. The auditor will have to ascertain whether proper provisions for doubtful debts are made and whether the same is satisfactory.

2. Overdue Interest - Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.

3. Certification of Bad Debts - A peculiar feature regarding the writing off of the bad debts as per Maharashtra State Co-operative Rules, 1961, is very interesting to note. As per the said rules, bad debts can be written off only when they are certified as bad by the auditor. Bad debts and irrecoverable losses before being written off against Bad Debts Funds, Reserve Fund etc. should be certified as bad debts or irrecoverable losses by the auditor where the law so requires. Where no such requirement exists, the managing committee of the society must authorise the write-off.

4. Valuation of Assets and Liabilities - Regarding valuation of assets there are no specific provisions or instructions under the Act and Rules and as such due regard shall be had to the general principles of accounting and auditing conventions and standards adopted. The auditor will have to ascertain existence, ownership and valuation of assets. Fixed assets should be valued at cost less adequate provision for depreciation. The incidental expenses incurred in the acquisition and the installation expenses of assets should be properly capitalised. If the difference in the original cost of acquisition and the present market price is of far reaching significance, a note regarding the present market value may be appended; so as to have a proper disclosure in the light of present inflatory conditions. The current assets be valued at cost or market price, whichever is lower. Regarding the liabilities, the auditor should see that all the known liabilities are brought into the account, and the contingent liabilities are stated by way of a note.

5. Adherence to Co-operative Principles - The auditor will have to ascertain in general, how far the objects, for which the co-operative organisation is set up, have been achieved in the course of its working. The assessment is not necessarily

in terms of profits, but in terms of extending of benefits to members who have formed the society. Considered from the viewpoint of social benefits it may be looked into that how far the sales could be affected at lower prices. For the achievement of these activities, cost accounting methods, store control methods, techniques of standard costing, budgetary control etc. should be adopted. However, these modern techniques are mostly not in application and as such in practice a wide gap is found in the goals to be achieved and the actual achievements. While auditing the expenses, the auditor should see that they are economically incurred and there is no wastage of funds. Middlemen commissions are, as far as possible, avoided and the purchases are made by the committee members directly from the wholesalers. The principles of propriety audit should be followed for the purpose.

6. Observations of the Provisions of the Act and Rules - An auditor of a co-operative society is required to point out the infringement with the provisions of Co-operative Societies Act and Rules and bye-laws. The financial implications of such infringements should be properly assessed by the auditor and they should be reported. Some of the State Acts contain restrictions on payment of dividends, which should be noted by the auditor.

7. Verification of Members' Register and examination of their pass books

- Examination of entries in members pass books regarding the loan given and its repayments, and confirmation of loan balances in person is very much important in a co-operative organisation to assure that the entries in the books of accounts are free from manipulation. Specifically in the rural and agricultural credit societies, members are not literate and as such this is a good safeguard on their part. Of course this checking will be resorted to on a test basis, which is a matter of judgement of the auditor.

8. Special report to the Registrar - During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society he may report these special matters to the Registrar, drawing his specific attention to the points. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance, a special report may become necessary:

- (i) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.
- (ii) Detection of fraud relating to expenses, purchases, property and stores of the society.

- (iii) Specific examples of mis-management. Decisions of management against co-operative principles.
- (iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

9. Audit classification of society - After a judgement of an overall performance of the society, the auditor has to award a class to the society. This judgement is to be based on the criteria specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.

10. Discussion of draft audit report with managing committee - On conclusion of the audit, the auditor should ask the Secretary of the society to convene the managing committee meeting to discuss the audit draft report. The audit report should never be finalised without discussion with the managing committee. Minor irregularities may be got settled and rectified. Matters of policy should be discussed in detail.

13.4 Rights and Duties of Co-Operative Auditors

Section 17 of the Co-operative Societies Act, 1912 contains audit provision as under:

- (i) The Registrar shall audit or cause to be audited by some person authorised by him by general or special order in writing in this behalf the accounts of every registered society once at least in every year.
- (ii) The audit under sub-section (1) shall include an examination of overdue debts, if any, and a valuation of the assets and liabilities of the society.
- (iii) The Registrar, the Collector or any person authorised by general or special order in writing in this behalf by the Registrar shall at all times have access to all the books, accounts, papers and securities of a society, and every officer of the society shall furnish such information in regard to the transactions and working of the society as the person making such inspection may require.

On completion of audit, the auditor has to submit his audit report to the society, and copies thereof to the respective authorities such as District

Special Auditor, District Deputy Registrar etc. The audit report has to be submitted in the prescribed form specified by the Registrar or as given in the related Rules. According to the present prescribed form in some of the States, the auditor has to state:

- (a) Whether he has obtained all the necessary information and explanations which to the best of his knowledge and belief were necessary for the purpose of audit.
- (b) Whether in his opinion and to the best of his information and according to the explanations given to him, the said accounts give all the information required by the Act.
- (c) Whether the Profit and Loss Account of the society gives a true and fair view of the Profit and Loss made by the society.
- (d) Whether the Balance Sheet drawn up as at the end of the year gives a true and fair view of the state of affairs of the society as on the given date.
- (e) Whether in his opinion, proper books of account as required by the Act, the Rules and the bye-laws of the society have been properly maintained.
- (f) Whether the Balance Sheet and the Profit and Loss Account examined by him are in agreement with the books of account and returns of the society.

The auditor will have to give qualifying observations, if any of the answers to the above mentioned matters are negative.

13.5 Form of Audit Report

The form of the audit report to be submitted by the auditor, as prescribed in various states, contains a number of matters which the auditor has to state or comment upon. For example, the Rules formed under the Maharashtra State Co-operative Societies Act requires the auditor to make the usual affirmation pertaining to proper maintenance of books of accounts, true and fair nature of financial statements, etc. In addition to the above, the auditor will have to attach schedules to the report regarding the following information:

- (1) All transactions which appear to be contrary to the provisions of the Act, the rules and bye-laws of the society.

- (2) All sums, which ought to have been, but have not been brought into account by the society.
- (3) Any material, or property belonging to society which appears to the auditor to be bad or doubtful of recovery.
- (4) Any material irregularity or impropriety in expenditure or in the realisation or monies due to society.
- (5) Any other matters specified by the Registrar in this behalf.

In the case of Nil report in any of the above matters, the auditor will have to give a Nil report.

Further in addition to the audit certificate in the prescribed form and various schedules stated above, the auditor of co-operative society in the applicable State has to answer two sets of questionnaires called as audit memos. The first set of audit memo or questionnaire is of general nature and is applicable to all types of societies such as urban banks, consumers' stores, credit societies etc. The second set of questionnaire is specific for a particular type of society. These questionnaires are drafted in detail and serve the practical purpose of audit programme.

The audit report in a narrative form is also required to be submitted by the auditor addressed to the Chairman of the society. Generally the narrative audit report as per convention is divided into two parts styled as part I and part II. Part I of the report is very important which throws a light on comparative financial position, capital structure, solvency position and the profitability or otherwise of the society. It may contain comments on the working of the society and the suggestions for future improvements. It must be suitably divided into paragraphs. Part II of the report points out the observations of routine nature, which are the finished products of the routine vouch and post audit such as missing vouchers, loan bonds, inadequacies of documents, mistakes of principles in accounting etc. However, mistakes having an impact on the profitability of society should be pointed out in Part I as it has got a consequential effect on the financial position of society.

13.6 Audit, Inquiry and Inspection of Multi-State Co-Operative Societies

The Multi-State Co-operative Societies Act, 2002, which came into force in August, 2002 applies to co-operative societies whose objects are not confined to one State. The Act contains detailed provisions regarding registration, membership and management of such societies.

The funds of a Multi-State co-operative society cannot be utilised for any political

purpose. The Act contains detailed provisions regarding the investment of funds and restrictions on loans, borrowings, etc.

Books of Accounts - As per Multi-State Co-operative Society Rules 2002, every Multi- State Co-operative society shall keep books of account with respect to-

- a. all sum of money received and expended and matters in respect of which the receipt and expenditure take place;
- b. all sale and purchase of goods;
- c. the assets and liabilities;
- d. in the case of a Multi-State Co-operative society engaged in production, processing and manufacturing, particulars relating to utilization of materials or labour or other items of cost as may be specified in the bye-hours of such a society.

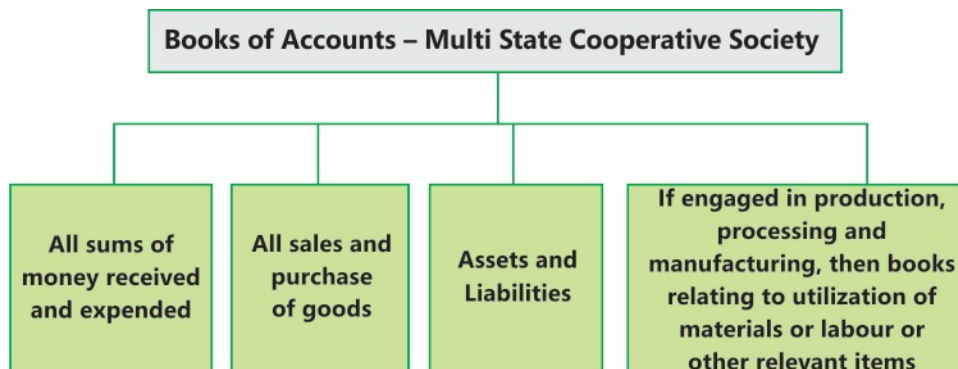


Diagram showing the Books of Accounts to be maintained by Multi State Co-operative Society

13.6.1 Audit of Multi-State Co-operative Society –

1. Qualification of Auditors - Section 72 of the Multi-State Co-operative Societies Act, 2002 states that a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can only be appointed as auditor of Multi-State co-operative society.

However the following persons are not eligible for appointment as auditors of a Multi- State co-operative society-

- (a) A body corporate.
- (b) An officer or employee of the Multi-State co-operative society.

- (c) A person who is a member or who is in the employment, of an officer or employee of the Multi-State co-operative society.
- (d) A person who is indebted to the Multi-State co-operative society or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the Multi-State co-operative society for an amount exceeding one thousand rupees.

If an auditor becomes subject, after his appointment, to any, of the disqualifications specified above, he shall be deemed to have vacated his office as such.

2. Appointment of Auditors - Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration of such society and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails to exercise its powers under this sub-section, the Multi-State co-operative society in the general meeting may appoint the first auditor or auditors.

The subsequent auditor or auditors are appointed by Multi-State co-operative society, at each annual general meeting. The auditor or auditors so appointed shall hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

3. Power and duties of Auditors – Section 73 of the Multi-State Co-operative Societies Act, 2002 discusses the powers and duties of auditors. According to this, every auditor of a Multi-State co-operative society shall have a right of access at all times to the books accounts and vouchers of the Multi-State co-operative society, whether kept at the head office of the Multi-State co-operative society or elsewhere, and shall be entitled to require from the officers or other employees of the Multi- State co-operative society such information and explanation as the auditor may think necessary for the performance of his duties as an auditor.

As per section 73(2), the auditor shall make following inquiries:

- (a) Whether loans and advances made by the Multi-State co-operative society on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the Multi-State co- operative society or its members,
- (b) Whether transactions of the Multi-State co-operative society which are represented merely by book entries are not prejudicial to the interests of the Multi-State co-operative society,

- (c) Whether personal expenses have been charged to revenue account, and
- (d) Where it is Stated in the books and papers of the Multi-State co-operative society that any shares have been allotted for cash, whether cash has actually, been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet as correct regular and not misleading.

4. Content of Auditor's Report - As per sub-section (3) & (4) of section 73 of Multi- state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co-operative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, and give a true and fair view:

- (a) In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and
- (b) In the case of the profit and loss account, of the profit or loss for its financial year. The auditor's report shall also state:
 - (i) Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.
 - (ii) Whether, in his opinion, proper books of account have been kept by the Multi- State co-operative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from branches or offices of the Multi-State co-operative society not visited by him.
 - (iii) Whether the report on the accounts of any branch office audited by a person other than the Multi-State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.
 - (iv) Whether the Multi-State co-operative society's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and return.

Where any of the matters referred to in sub-section (3) or (4) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

5. Power of Central Government to direct special audit in certain cases -

Under section 77 of the Multi-State Co-operative Societies Act, 2002, where the Central Government is of the opinion:

- (a) that the affairs of any Multi-State co-operative society are not being managed in accordance with self-help and mutual deed and co-operative principles or prudent commercial practices or with sound business principles; or
- (b) that any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains; or
- (c) that the financial position of any Multi-State co-operative society is such as to endanger its solvency.



Diagram showing Power of Central Government to Direct Special Audit

The Central Government may at any time by order direct that a special audit of the Multi-State co-operative society's accounts for such period or periods as may be specified in the order, shall be conducted and appoint either a chartered accountant or the Multi-State co-operative society's auditor himself to conduct the special audit.

However, Central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty-one percent or more of the paid-up share capital in such Multi-State co-operative society.

The special auditor shall have the same powers and duties in relation to the special

audit as an auditor of a Multi-State co-operative society has under section 73. However the special auditor shall instead of making his report to the members of the Multi-State co-operative society make the report to the Central Government. The report of the special auditor shall, include all the matters required to be included in the auditor's report under section 73 and any other matter as directed by the Central Government.

On receipts of the report of the special auditor the Central Government may take such action on the report as it considers necessary in accordance with the provision of the Act or any law for the time being in force.

However, if the Central Government does not take any action on the report within four months from the date of its receipt, that Government shall send to the Multi-State Co-operative society either a copy of, or relevant extract from, the report with its comments thereon and require the Multi-State Co-operative society either to circulate that copy or those extracts to the members or to have such copy or extracts read before the Multi-State Co-operative society at its next general meeting.

The expenses of, and incidental to, any special audit under this section (including the remuneration of the special auditor) shall be determined by the Central Government which determination shall be final and paid by the Multi-State Co-operative society and in default of such payment, shall be recoverable from the Multi-State Co-operative society as an arrear of land revenue.

13.6.2 Inquiry by Central Registrar under Section 78

The Central Registrar may, on a request from a federal co-operative to which a Multi-State Co-operative society is affiliated or a creditor or not less than one-third of the members of the board or not less than one-fifth of the total number of members of a Multi-state co-operative society, hold an inquiry or direct some person authorized by him by order in writing in his behalf to hold an inquiry into the constitutions, working and financial condition of a Multi-State Co-operative society. However, before holding such inquiry fifteen days notice must be given to the Multi-State co-operative society.

The Central Registrar or the person authorized by him shall have the following powers, namely:

- (a) he shall at all reasonable times have free access to the books, accounts, documents, securities, cash and other properties belonging to or in the custody of the Multi-State co-operative society and may summon any person in possession or responsible for the custody of any such books, accounts,

documents securities, cash or other properties to produce the same at any place specified by him.

- (b) he may, notwithstanding any bye-law specifying the period of notice for a general meeting of the Multi-State co-operative society, require the officers of the society to call a general meeting of the society by giving notice of not less than seven days at such time and place at the head quarters of the society to consider such matters as may be directed to him, and where the officers of the society refuse or fail to call such a meeting, he shall have power to call it himself.
- (c) he may summon any person who is reasonably believed by him to have any knowledge of the affairs of the Multi-State co-operative society to appear before him at any place at the headquarters of the society or any branch thereof and may examine such person on oath.

The Central Registrar shall, within a period of three months of the date of receipt of the report, communicate the report of inquiry to the Multi-State co-operative society, the financial institutions, if any, to which the society is affiliated, and to the person or authority, if any at whose instance the inquiry is needed.

13.6.3 Inspection of Multi-State Co-operative societies under Section 79

The Central Registrar may, on a request from federal co-operative to which a Multi-State Co-operative society is affiliated or a creditor or not less than one-third of the members of the board or not less than one-fifth of the total number of members of a Multi-State co-operative society by general or special order in writing in this behalf inspect or direct any person authorized by him by order in writing in this behalf to make an inspection into the constitution, working and financial condition of a Multi- State co-operative society.

However, no inspection shall be made unless a notice of not less than fifteen days has been given to the multi-state co-operative society.

The Central Registrar or the person authorized by him shall have the following powers:

- (a) He shall at all times have access to all books, accounts, papers, vouchers, securities, stock and other property of that society and may, in the event of serious irregularities discovered during inspection, take them into custody and shall have power to verify the cash balance of the society and subject to the general or special order of the central registrar to call a meeting of the society where such general meeting is, in his opinion necessary.

- (b) Every officer or member of a Multi-State Co-operative society shall furnish such information with regard to the working of the society as the central registrar or the person making such inspection may require.

A copy of the report of inspection under this section shall be communicated to the Multi-State Co-operative society within a period of three months from the date of completion of such inspection.



14. AUDIT REPORT IN RESPECT OF DIFFERENT ENTITIES

In respect of Report on the Audit of Financial Statements of the Companies, students are advised to refer Chapter 10 – “The Company Audit” and Chapter 11 – “Audit Report” and regarding other entities, refer Chapter 11- “Audit Report”.

SUMMARY

Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of government transactions but has also added new concepts, techniques and procedures to the audit profession. Government auditing is the objective, systematic, professional and independent examination of financial, administrative and other operations of a public entity. Government audit serves as a mechanism or process for public accounting of government funds. In India, the function of audit of Government accounts is discharged by the independent statutory authority of the Comptroller and Auditor General of India. The C&AG shall direct the manner in which the company's accounts shall be audited by the statutory auditors. The C&AG has power to conduct a supplementary or test audit of the company's accounts.

NGOs are non-profit making organisations which raise funds from members, donors or contributors for achieving their social objectives. The auditors of an NGO registered under the Societies Registration Act, 1860 (or under any law corresponding to this Act, in force in any part of India) or the Indian Trusts Act 1882 are normally appointed by the Management of the Society or Trust. The auditors of NGO registered under section 8 of the Companies Act, 2013 are appointed by the members of the company.

The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts.

A sole trader is under no legal obligation to have his accounts audited. However, many such individuals get their financial statement audited due to regulatory

requirements. Auditors of sole- proprietary concern shall be appointed by the sole proprietor himself. The auditors of a firm are usually appointed by the partners. The object of examining the partnership agreement, which is an important feature of such an audit, is that the auditor may be able to report to the partners if the interest of any partner has been prejudicially affected. The accounts of every LLP shall be audited in accordance with LLP Rules 2009. Such rules provide that any LLP, whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty five lakh rupees, is not required to get its accounts audited.

TEST YOUR KNOWLEDGE

MCQs

1. While auditing a cinema hall, the auditor needs to verify that-
 - (a) entrance to the cinema-hall during show is only through printed tickets
 - (b) tickets are serially numbered and bound into books
 - (c) that for advance booking a separate series of tickets is issued
 - (d) All of the above
2. Article 151 requires that the reports of the C&AG relating to the accounts of the Union/State shall be submitted to the ----- who shall cause them to be laid before House of Parliament/State Legislature
 - (a) President/Governor
 - (b) Prime Minister/ Chief Minister
 - (c) Union Finance Minister/State Finance Minister
 - (d) All of the above
3. The C&AG Act gives which of the following power to the C&AG in connection with the performance of his duties-
 - (a) To inspect any office of accounts under the control of the Union or a State Government including office responsible for the creation of the initial or subsidiary accounts.
 - (b) To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.

- (c) To put such questions or make such observations as he may consider necessary to the person in charge of the office and to call for such information as he may require for the preparation of any account or report which is his duty to prepare.
- (d) All of the above
4. _____ aims at ascertaining that the expenditure incurred has been on the purpose for which the grant and appropriation had been provided and that the amount of such expenditure does not exceed the appropriation made.
- (a) Audit against provision of funds
- (b) Propriety audit
- (c) Audit of sanctions
- (d) Audit against rules and orders

Correct/Incorrect

State with reasons (in short) whether the following statement is correct or incorrect:

1. Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the Finance Minister may on the advice of the C&AG prescribe.
2. According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.
3. Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads: (a) general administration and revenue collection, (b) public health, (c) public safety, (d) education, (e) public works, and (f) others such as interest payments.
4. The external control of municipal expenditure is exercised by the Central Government through the appointment of auditors to examine municipal accounts.
5. NGOs may be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives.

Theoretical Questions

1. You have been appointed as an auditor of an NGO, briefly state the points on which you would concentrate while planning the audit of such an organisation?
2. The general transactions of a hospital include patient treatment, collection of receipts, donations, capital expenditures. You are required to mention special points of consideration while auditing such transactions of a hospital?
3. Mention the special points to be examined by the auditor in the audit of a charitable institution running hostel for students pursuing the Chartered Accountancy Course and which charges only ₹ 500 per month from a student for his lodging/boarding.
4. Explain in detail the duties of Comptroller and Auditor General of India
5. 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.

ANSWERS/SOLUTIONS

Answers to MCQs

1. (d) 2. (d) 3. (d) 4. (a)

Answers to Correct/Incorrect

1. **Incorrect.** Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.
2. **Correct.** According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.
3. **Correct .** Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads: (a) general administration and

revenue collection, (b) public health, (c) public safety, (d) education, (e) public works, and (f) others such as interest payments, etc.

4. **Incorrect.** The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts.
5. **Correct.** NGOs can be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives like imparting education, providing medical facilities, economic assistance to poor, managing disasters and emergent situations.

Answer to Theoretical Questions

1. While planning the audit of an NGO, the auditor may concentrate on the following:
 - (i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.
 - (ii) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions related to the statutes.
 - (iii) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.
 - (iv) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.
 - (v) Examination of minutes of the Board/Managing Committee/Governing Body/Management and Committees thereof to ascertain the impact of any decisions on the financial records.
 - (vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.
 - (vii) Setting of materiality levels for audit purposes.
 - (viii) The nature and timing of reports or other communications.
 - (ix) The involvement of experts and their reports.
 - (x) Review the previous year's Audit Report.

2. Special points of consideration while auditing certain transactions of a hospital are stated below-

- (i) **Register of Patients:** 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) **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
- (iv) **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).
- (v) **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.

3. 1. **General**

- (i) Study the constitution under which the charitable institution has been set up whether under the Society Registration Act, as a trust or as a company limited by guarantee. Verify whether it is managed as contemplated by the law and rules and regulations made thereunder.
- (ii) Examine the internal control structure particularly with reference to admission to hostel, expenses incurred on different kinds of activities.
- (ii) Verify the broad nature of expenses likely to be incurred with reference to the previous year's annual audited accounts.

2. Verification of the receipts

- (i) Check the amounts received on account of, monthly rentals, etc., and receipts issued for the same.
- (ii) Ascertain that there is adequate internal control over the issue of official receipts, custody of unused receipt books, printing of receipt books, etc.
- (iii) Cross - tally the rent received along with the number of students (from the student register) staying in the hostel during the year.
- (iv) Check the amounts received from additional services rendered like guest fees, receipts for breakage, fines, penalties, etc.

3. Verification of expenses

- (i) Check the day-to-day administration expenses incurred along with the necessary vouchers, supporting for the same like salary registers, repairs register, etc.
 - (ii) Verify whether the expenses incurred are in conformity with the budgets prepared internally or filed with the relevant authorities.
 - (iii) Check the amount spent on provisions of hostel facilities with reference to bills, etc.
 - (iv) See that whenever heavy expenditure has been incurred on renovation of the hostel, computer centre, etc. the same is accounted for properly (if such facilities are being provided by the hostel).
- 4.** Verify investments made from surplus funds as well as existing investments by physically verifying the same and that they are in the name of the institution and that there is no charge/pledge against the same.
- 5.** Verify all capital expenditure and expenditure on repairs, etc., incurred with the vouchers and also whether proper tenders, etc., were invited for the same. See that all furniture, glass, cutlery, kitchen utensils, liner, etc. are adequately depreciated.
- 6.** Library Facilities: See that proper library register are maintained. The system regarding issue and receipt of books is in order. Late fee fines and money received on account of lost book is accounted for properly. Obsolete books are written off only after proper authorisation.

Expenses incurred on newspapers and weekly magazines as compared to Journals and periodicals have been accounted for properly.

7. Check the provision of other additional facilities like computer facilities, etc. Ensure that proper registers are maintained for charging fees, based on monthly or hourly basis. In case such facility is extended to each room, whether the charges are payable on lump-sum basis or on actual usage basis. Also ensure that amounts spent have been allocated properly.
 8. Verify whether the institution is eligible for income tax exemption and if not, whether provision for taxation has been made.
4. **Duties of C&AG:** The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C&AG as under-
- (i) **Compile and submit Accounts of Union and States** - The C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account.
 - (ii) **General Provisions Relating to Audit - It shall be the duty of the C&AG –**
 - (a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;
 - (b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;
 - (c) to audit and report on all trading, manufacturing profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.
 - (iii) **Audit of Receipts and Expenditure** - Where any body or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body

or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

- (iv) **Audit of Grants or Loans** - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.
- (v) **Audit of Receipts of Union or States** - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.
- (vi) **Audit of Accounts of Stores and Inventory** - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.
- (vii) **Audit of Government Companies and Corporations** - The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

5. 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.

INTERMEDIATE COURSE STUDY MATERIAL

AUDITING PRONOUNCEMENTS



**BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA**

The objective of this material is to provide teaching material to the students to enable them to obtain knowledge and skills in the subject. In case students need any clarifications or have any suggestions to make for further improvement of the material contained herein, they may write to the Director of Studies.

All care has been taken to provide interpretations and discussions in a manner useful for the students. However, this material has not been specifically discussed by the Council of the Institute or any of its Committees and the views expressed herein may not be taken to necessarily represent the views of the Council or any of its Committees.

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Revised Edition : July, 2019

Website : www.icaai.org

Department/
Committee : Board of Studies

E-mail : bos@icaai.in

ISBN No. :

Price : ₹

Published by : The Publication Department on behalf of The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi-110 002, India.

Typeset and designed at Board of Studies.

Printed by : Sahitya Bhawan Publications, Hospital Road, Agra- 282 003

A WORD ABOUT AUDITING PRONOUNCEMENTS

The audit of financial statements add credibility to financial statements prepared by the management of the entity and ensure that the financial statements are prepared in accordance with the legal and regulatory requirements applicable to the entity and are free from any material misstatement.

For ensuring quality in audits, it is essential to have auditing standards for auditors which are at par with globally accepted auditing standards. The Engagement and Quality Control Standards developed by the Auditing and Assurance Standards Board of the ICAI and issued under the authority of the Council of the ICAI are harmonized with the globally recognized International Standards issued by the International Auditing and Assurance Standards Board (IAASB).

In respect of audit engagements, these Standards cover the important aspects such as planning, documentation, risk assessment, fraud considerations, evidence, reporting, etc. Separate Standards deal with other assurance engagements, review engagements and related services. These Standards are principle based and mandatory in nature.

Keeping all this in view, it has been decided to publish a separate book namely Auditing Pronouncements for the students. This book is quite handy and will be highly useful for the students since they will get all the relevant auditing pronouncements at one place for easy reference.

This handbook contains the Authority and Preface, Glossary of Terms, Standards on Quality Control, Framework for Assurance engagements along with SAs for the convenience of the students.

It is pertinent to note that necessary references have also been given in line with the Companies Act, 2013 at the appropriate places in this book for better understanding of students.

Happy Reading and Best Wishes!

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Announcements of the Council Regarding Status of Various Documents Issued by the Institute of Chartered Accountants of India

A. Clarification regarding Authority Attached to Documents Issued by the Institute¹

1. The Institute has, from time to time, issued 'Guidance Notes' and 'Statements' on a number of matters. With the formation of the Accounting Standards Board and the Auditing Practices Committee², 'Accounting Standards' and 'Statements on Standard Auditing Practices'³ are also being issued.
2. Members have sought guidance regarding the level of authority attached to the various documents issued by the Institute and the degree of compliance required in respect thereof. This note is being issued to provide this guidance.
3. The 'Statements' have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. 'Statements' therefore are mandatory. Accordingly, while discharging their attest function, it will be the duty of the members of the Institute:
 - (a) to examine whether 'Statements' relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the 'Statements', it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations; and
 - (b) to ensure that the 'Statements' relating to auditing matters are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with such 'Statements', his report should draw attention to the material departures therefrom.
4. A list of 'Statements' issued by the Institute and currently in force is given at the end of this note.⁴
5. 'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in

¹ Published in the December, 1985 issue of the 'The Chartered Accountant'.

² The Auditing Practices Committee of the Institute of Chartered Accountants of India was established in 1982 with, *inter alia*, the objectives of preparing the Statements on Standard Auditing Practices (SAPs), Guidance Notes on matters related to auditing, etc. At its 226th meeting held on July 2, 2002 at New Delhi, the Council of the Institute of Chartered Accountants of India approved the recommendations of the Auditing Practices Committee to strengthen the role being played by it in the growth and development of the profession of chartered accountancy in India. The Council also approved renaming of the Committee as, "Auditing and Assurance Standards Board" (AASB) with immediate effect to better reflect the activities being undertaken by the Committee. Apart from changes designed to strengthen the process for establishing auditing and assurance standards, such a move would bring about greater transparency in the working of the Auditing Practices Committee now known as the Auditing and Assurance Standards Board (AASB).

The Council also approved the renaming of the Statements on Standard Auditing Practices (SAPs) as, "Auditing and Assurance Standards" (AASs). The ICAI in 2007 issued the 'Revised Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services'. Pursuant to issuance of Revised Preface, the Auditing and Assurance Standards (AAS) have been renamed as 'Engagement and Quality Control Standards'. The Engagement Standards comprise:

- *Standards on Auditing (SAs)* - To be applied in the audit of historical financial information.
- *Standards on Review Engagements (SREs)* - To be applied in the review of historical financial information.
- *Standards on Assurance Engagements (SAEs)* - To be applied in assurance engagements, other than audits and reviews of historical financial information.
- *Standards on Related Services (SRSs)* - To be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

³ *ibid.*

⁴ An updated list of mandatory statements on auditing is included in the 'List of Mandatory Statements and Standards' given after this clarification. It may also be noted that besides statements on accounting and auditing, the Institute has issued statements on other aspects also, namely, Statement on Peer Review and Statement on Continuing Professional Education.

2 Auditing Pronouncements

the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

6. There are however a few guidance notes in case of which the Council has specifically stated that they should be considered as mandatory on members while discharging their attest function. A list of these guidance notes is given below:

- (i) Guidance Note on Treatment of Interest on Deferred Payments read along with the pronouncement of the Council, published in 'The Chartered Accountant', March 1984.⁵
- (ii) Provision for Depreciation in respect of Extra or Multiple Shift Allowance, published in 'The Chartered Accountant', May 1984.⁶

7. The 'Accounting Standards' and 'Statements on Standard Auditing Practices'⁷ issued by the Accounting Standards Board and the Auditing Practices Committee⁸, respectively, establish standards which have to be complied with to ensure that financial statements are prepared in accordance with generally accepted accounting standards and that auditors carry out their audits in accordance with the generally accepted auditing practices. They become mandatory on the dates specified either in the respective document or by notification issued by the Council.⁹

8. There can be situations in which certain matters are covered both by a 'Statement' and by an 'Accounting Standard'/'Statement on Standard Auditing Practices'¹⁰. In such a situation, the 'Statement' shall prevail till the time the relevant 'Accounting Standard'/'Statement on Standard Auditing Practices'¹¹ becomes mandatory. It

⁵ The nomenclature of this document was changed by the Council of the Institute at its 133rd meeting held in April, 1988. The new nomenclature was 'Statement on Treatment of Interest on Deferred Payments'. In view of para 8 of this 'Clarification', with Accounting Standard (AS) 10 on 'Accounting for Fixed Assets', becoming mandatory (see Announcement II) in respect of accounts for periods commencing on or after 1.4.1991, the 'Statement on Treatment of Interest on Deferred Payments' stands automatically withdrawn except in the case of certain specified non-corporate entities where it stands withdrawn in respect of accounts for periods commencing on or after 1.4.1993 (see Announcements III, V and VI in this regard). It may be noted that pursuant to the issuance of Accounting Standard (AS) 16 on 'Borrowing Costs', which came into effect in respect of accounting periods commencing on or after 1-4-2000, paragraph 9.2 and paragraph 20 (except the first sentence) of AS 10, relating to treatment of finance costs including interest, stand withdrawn from that date.

⁶ The nomenclature of this document was changed by the Council of the Institute at its 133rd meeting held in April, 1988. The new nomenclature was 'Statement on Provision for Depreciation in respect of Extra or Multiple Shift Allowance'. This statement has been withdrawn in respect of accounting periods commencing on or after 1.4.1989, as per the Guidance Note on Accounting for Depreciation in Companies, issued in pursuance of amendments in the Companies Act, 1956, through Companies (Amendment) Act, 1988.

⁷ Refer footnote 2. 'Statements on Standard Auditing Practices' have been renamed as 'Engagement and Quality Control Standards'.

⁸ Refer footnote 2. The 'Auditing Practices Committee' has been renamed as 'Auditing and Assurance Standards Board'.

⁹ Subsequent to the publication of this Clarification, the Council has made various Accounting Standards mandatory. The Announcements made by the Council in this regard are reproduced hereafter.

¹⁰ Refer footnote 2. 'Statements on Standard Auditing Practices' have been renamed as 'Engagement and Quality Control Standards'.

¹¹ *ibid.*

is clarified that once an 'Accounting Standard'/'Statement on Standard Auditing Practices'¹² becomes mandatory, the concerned 'Statement' or the relevant part thereof shall automatically stand withdrawn.

9. List of statements issued by the Institute and which are mandatory in nature.
1. Statement on Companies (Auditor's Report) Order, 2003 (Revised 2005)
2. Statement on Reporting under Section 227(1A) of the Companies Act, 1956.

B. Use of Bold Type Face/ Normal Type Face in Auditing and Assurance Standards

- I. As the members are aware, the Institute of Chartered Accountants of India has till date issued 35 (thirty five) Auditing and Assurance Standards (AASs). It may be reiterated that all the Standards are mandatory in nature. This means that while carrying out an attest function, it will be the duty of the members of the Institute to ensure that these AASs are followed in the audit of financial information covered by their audit reports. If for any reason a member has not been able to perform an audit in accordance with the AASs, his report should draw attention to the material departures therefrom.
- II. Further, it might have been noted by the members that in case of AAS 1 to AAS 15, the entire text of the Standards appears in normal type face, except for the headings and sub headings therein. On the other hand, in case of AAS 16 to AAS 35, certain text in the Standards is appearing in **bold type** face and certain portion of the text appearing in normal type face. Normally, in these Standards, the **bold type** face has been used to facilitate distinction between the principles *vis-a-vis* the application/ procedural aspects, which have been written in normal type face. In any case, however, the entire text of the Standard is mandatory, irrespective of the fact whether such distinction is made in the Standard or not.

The New Format (applicable from 1st April, 2008)¹³

- III. Members may also note that recently, the Council of the Institute of Chartered Accountants of India has approved the **Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services**. The said Preface introduces a totally new format of writing Standards, in line with that adopted by the International Auditing and Assurance Standards Board pursuant to its Clarity Project. According to the new format the Standards on Auditing (SAs) would now contain two distinct sections, one, the Requirements section and, two, the Application Guidance section.
- IV. The fundamental principles of the Standard are contained in the Requirements section and represented by use of "shall". Hitherto, the word, "should" was used in the Standards, for this purpose. Further, this format also does away with the need to present the principles laid down by the Standard in bold text. The application and other explanatory material contained in a Standard on Auditing (SA) is an integral part of the SA as it provides further explanation of, and guidance for carrying out, the requirements of an SA, along with the background information on the matters addressed in the SA. It may include examples of procedures, some of which the auditor may judge to be appropriate in the circumstances. Such guidance is, however, not intended to impose a requirement. In view of this format of writing, the **standard portion or principles enunciated in a Standard would no longer be given in bold face**.

¹² *ibid*.

¹³ The "Preface to Standards on Quality control, auditing, Review, Other Assurance and Related Services" and the document containing the reclassification and renumbering of the Auditing and Assurance Standards issued by the Institute have been published in July 2007 issue of the Journal.

- V. The new presentation format has, however, not as yet being followed in drafting the Standards on Quality Control and other Standards.
- VI. **There is no change in the authority attached to the Standards, i.e., they are mandatory in nature, notwithstanding the new format of writing the Standards.**

C. Announcements/ Clarifications

1. Clarification on the Auditors' Rights Where Clients and Other Auditors Seek Access to their Audit Working Papers*

- I. Auditing and Assurance Standard (AAS) 1¹⁴, "Basic Principles Governing An Audit", states in para 6, "The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose". Auditing and Assurance Standard (AAS) 3¹⁵, "Documentation" (Paragraph 13), states, "Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client." AAS 3 further requires (paragraph 14), *inter alia*, that the "auditor should adopt reasonable procedures for custody and confidentiality of his working papers."
- II. Part I of the Second Schedule to the Chartered Accountants Act, 1949 provides that "A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he –
"Discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force."
- III. Requests are sometimes received by the members of the Institute, who have/had been performing the duties as the auditors of an enterprise, to provide access to their audit working papers. The requests may be made by the clients or other auditors of the enterprise or its related enterprise such as a parent enterprise.
- IV. It is hereby clarified that except to the extent stated in para 5 below, an auditor is not required to provide the client or the other auditors of the same enterprise or its related enterprise such as a parent or a subsidiary, access to his audit working papers. The main auditors of an enterprise do not have right of access to the audit working papers of the branch auditors. In the case of a company, the statutory auditor has to consider the report of the branch auditor and has a right to seek clarifications and/or to visit the branch if he deems it necessary to do so for the performance of the duties as auditor. An auditor can rely on the work of another auditor, without having any right of access to the audit working papers of the other auditor¹⁶. For this purpose, the term 'auditor' includes 'internal auditor'.
- V. As stated in para 4, the client does not have a right to access the working papers of the auditor. However, the auditor may, at his discretion, in cases considered appropriate by him, make portions of or extracts from his working papers available to the client.

* Published in May, 2000 issue of "The Chartered Accountant".

¹⁴ Now known as Standard on Auditing (SA) 200.

¹⁵ Now known as Standard on Auditing (SA) 230.

¹⁶ Reference in this regard may be made to Standard on Auditing (SA) 600, "Using the Work of Another Auditor" and Standard on Auditing (SA) 610, "Relying on the Work of Internal Auditor."

2. Format of Review Report under Clause 41 of the Listing Agreement**

- I. As the members are aware, the Institute had in March 2005, issued Auditing and Assurance Standard (AAS) 33¹⁷, Engagements to Review Financial Statements, applicable to all review engagements relating to accounting periods beginning on or after April 1, 2005. Appendix 3 to the said AAS contains an illustrative format of review report in respect of balance sheet. The illustrative format given in the AAS is different from the format of the review report required to be given under clause 41 of the Listing Agreement in that it is in respect of review of financial results and not a balance sheet.
- II. In view of the above, the members are requested to note that in so far as review carried out in terms of clause 41 of the Listing Agreement is concerned, the members are expected to submit their review report in accordance with the format prescribed by the Securities and Exchange Board of India in clause 41 of the Listing Agreement.

3. Audit in Situations of Missing or Incomplete Records***

- I. Members of the Institute while carrying out audit assignments might come across a situation where the records of the client are incomplete or destroyed (partially or completely) on account of a natural calamity or otherwise. While guidance on reporting responsibilities of the members in such cases has been provided to the members by way of publications such as Auditing and Assurance Standard (AAS) 28¹⁸, The Auditor's Report on Financial Statements, the Statement on Qualifications in Auditor's Report, opinions of the Expert Advisory Committee, and a publication titled, "Study on Audit and Certification in Case of Missing Records", issued by the Institute, the Council, for the benefit of the members, wishes to reiterate the guidance in the following paragraphs.
- II. The auditor should, first, obtain a representation from the management that the original accounts are not available for audit. The letter should also include the fact whether the accounts of the entity have been reconstructed by the management. If yes, the extent thereof (partial or complete) and the details of the items of financial statements that have been reconstructed should also be specified in the said letter. In case the accounts have been reconstructed, the members must consider the limitation of scope in audit imposed by the circumstances. Limitation on scope of audit can be of two types, firstly, inability of the management to reconstruct some or all of the items of the financial statements either for the whole financial year or for a certain period during the financial year and secondly, lack of corroborative evidence to support certain or all the entries in the reconstructed accounts. In case of completely reconstructed accounts, the lack of supporting evidence will pose a greater risk of limitation on scope, whereas, for partially reconstructed accounts, both types of limitations, i.e., inability of the management to reconstruct accounts and lack of supporting evidence, can be material. While auditing the reconstructed accounts (partial as well as complete), the auditor should analyse the limitation imposed on application of audit procedures required to be applied in the given situation and use his professional judgment to determine whether to issue an unqualified opinion, qualified opinion or disclaimer of opinion. Further, the fact of scope limitation must clearly be mentioned in the scope paragraph of the audit report. The AAS 28, "The Auditor's Report on Financial Statements", in its paragraphs

** Issued in July, 2005.

¹⁷ Now known as Standard on Review Engagements (SRE) 2400.

*** Issued in October, 2006.

¹⁸ Now known as Standard on Auditing (SA) 700.

43 and 44 reproduced below, provides the guidance for the auditor in case of a scope limitation:

“43. A scope limitation may be imposed by circumstances, for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories. It may also arise when, in the opinion of the auditor, **the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion.** (emphasis added)

44. When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.”

- III. Guidance in respect of the matter discussed in the two paragraphs above has been explained in paragraph 45 of the AAS 28 by way of illustrative examples of the scope paragraphs in the audit reports in the cases of qualified opinion and disclaimer of opinion:

In situations of Qualified Opinion

“We have audited

Except as discussed in the following paragraph, we conducted our audit in accordance with

We did not observe the counting of the physical inventories as at 31st March 2XXX since that date was prior to the time we were appointed as auditors of(Name of the entity). Owing to the nature of the entity's records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures.”

In situations of Disclaimer of Opinion

“The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances. (emphasis added)

(Add a paragraph discussing the scope limitation as follows:)

We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the entity.”

- IV. Paragraph 10 of AAS 13¹⁹, “Audit Materiality”, reproduced below, states that the auditor while auditing the reconstructed accounts must consider the concept of materiality and the audit risk involved with specific account balances and classes of transactions:

“10. There is an inverse relationship between materiality and the degree of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low, but the risk that it could be misstated by an extremely small amount might be very high. The auditor takes the inverse relationship between materiality and audit risk into account when determining the nature, timing and extent of audit procedures. For example, if, after planning for specific audit procedures, the auditor determines that the acceptable materiality level is lower,

¹⁹ Now known as Standard on Auditing (SA) 320.

audit risk is increased. The auditor would compensate for this by either:

- (a) reducing the assessed degree of control risk, where this is possible, and supporting the reduced degree by carrying out extended or additional tests of control; or*
- (b) reducing detection risk by modifying the nature, timing and extent of planned substantive procedures."*

- V. While auditing the reconstructed accounts, since the auditor would normally find it difficult to obtain internally generated corroborative evidences supporting the reconstructed accounts, the auditor should apply alternative audit procedures such as inquiry and external confirmation as outlined in paragraphs 14 and 15 of the AAS 5²⁰, "Audit Evidence", reproduced below:

"Inquiry and Confirmation

- 14. *Inquiry consists of seeking appropriate information from knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information which he did not previously possess or may provide him with corroborative evidence.*
- 15. *Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. For example, the auditor requests confirmation of receivables by direct communication with debtors."*

For assessing the reliability of the evidence obtained by the auditor from various sources, the auditor is guided by the principles enunciated in paragraph 7 of AAS 5.

- VI. The auditor, if he himself was not the auditor in the immediately preceding financial year, must apply the principles laid down in AAS 22²¹, "Initial Engagements - Opening Balances" while verifying the figures of opening balances.
- VII. Paragraph 4 of the AAS 28, "The Auditor's Report on Financial Statements", provides that the auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole. An unqualified opinion can be expressed only if the auditor is able to satisfy himself, by way of application of sufficient appropriate compliance and substantive procedures, that the financial statements give a true and fair view. The scope limitation imposed by lack of supporting evidence implies a particular emphasis on obtaining alternative corroborative evidence. However, if the auditor concludes that an unqualified opinion can not be expressed but the limitation on scope is not so material and pervasive as to require a disclaimer of opinion, a qualified opinion should be expressed. Further, a disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and is, accordingly, unable to express an opinion on the financial statements. Paragraph 45 of AAS 28 illustrates the principles enunciated here above. Having regard to the above, two illustrative formats of reporting by the auditor are given in the paragraphs 8 and 10 below for guidance of the members.

- VIII. Illustrative audit report where the auditor decides to express a qualified opinion about the true

²⁰ Now known as Standard on Auditing (SA) 500.

²¹ Now known as Standard on Auditing (SA) 510.

and fair view of the financial statements:

I. (Where accounts have been reconstructed for some or all of the items for the whole financial year)

"We have audited the attached Balance Sheet of (name of the client), as at 31st March 2XXX, and also the Profit and Loss Account and the cash flow statement for the year ended on that date annexed thereto. We have been informed by the management that because of _____ (give reason) _____ the original accounts are not available for audit and hence these financial statements have been prepared from the reconstructed accounts prepared by the management. The accounts as well as the financial statements are the responsibility of the management. Our responsibility is to express an opinion on these financial statements based on our audit of the accounts.

We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We have not been able to obtain corroborative audit evidence supporting following items of the financial statements while auditing the accounts of the entity:

(State the areas for which the corroborative evidences were not available along with their quantification, to the extent possible and also their resultant effect on the financial statements.)

Subject to the above, the financial statements give a true and fair view:

- (i) in the case of the balance sheet, of the state of the _____ (name of the client) affairs as at the end of its financial year;
- (ii) in the case of the profit and loss account, of the profit or loss for its financial year; and
- (iii) In the case of the cash flow statement, of the cash flows for the year ended on that date."

(ii) (where accounts have been reconstructed only for certain period during the year)

"We have audited the attached Balance Sheet of (name of the client), as at 31st March 2XXX, and also the Profit and Loss Account and the cash flow statement for the year ended on that date annexed thereto. We have been informed by the management that because of _____ (give reason) _____ the original accounts are not available for audit and hence these financial statements have been prepared from the reconstructed accounts prepared by the management for the period from _____ to _____ during the financial year. The accounts as well as the financial statements are the responsibility of the management. Our responsibility is to express an opinion on these financial statements based on our audit of the accounts.

(Other paragraphs shall be same as in the format given in Part I above.)

- IX. If the auditor is satisfied after obtaining a representation letter from the management and considering the results of sufficient appropriate audit procedures that the reconstruction of the accounts of the entity is not possible, he has no other option but to issue a disclaimer of

opinion. The auditor should issue a report to the shareholders mentioning therein that it is not possible for him to express any opinion. The format of audit report to express disclaimer of opinion has been suggested in the following paragraph for guidance of the members.

- X. Illustrative audit report in situations where the reconstruction of the accounts is not possible:

"We were engaged to audit the Balance Sheet of (name of the client), as at 31st March 2XXX, and also the Profit and Loss Account and the cash flow statement for the year ended on that date. The financial statements are the responsibility of the company's management. The management of (name of the client) has informed us that owing to (state the reason for unavailability of records), the books of account and/ or other related records and documents of the (name of the client) have been completely destroyed. The management has also informed us that the reconstruction of the accounts is also not possible. Since we have not been able to examine the books of account as well as the financial statements of (name of the client), we are unable to form any opinion on the financial statements."

- XI. Members' attention is also invited to the opinion given by the Expert Advisory Committee in September 1988 in situation of an audit where the records etc., had been seized by the income tax authorities and released after four years and records were reconstructed for the interregnum. The Committee, apart from the opinion on the type of the opinion to be expressed by the auditor in such cases, has also opined that the auditor should not normally rely on the management's certificate as to the opening balances unless the information therein can be corroborated by other supporting document.

4. Amendment to SQC 1 - Retention Period for Engagement Documentation* (Working Papers)

Paragraph 83 of the 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*, states as follows:

"83. The needs of the firm for retention

.....

.....

*In the specific case of audit engagements, the retention period ordinarily is **no shorter than ten years** from the date of the auditor's report, or, if later, the date of the group auditor's report.*" (emphasis added)

The Council of the Institute of Chartered Accountants of India, at its 289th meeting held on August 19, 2009 at New Delhi, pursuant to the provisions of Rule 12 of the Chartered Accountants (Procedures of Investigations of Professional and Other Misconduct and Conduct of Cases) Rules, 2007, has decided to amend paragraph 83 of the SQC 1 as follows:

"83. The needs of the firm for retention

.....

.....

* Issued in August, 2009.

*In the specific case of audit engagements, the retention period 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."* (emphasis added)

5. Requirement to include the registration number of the firm as allotted by ICAI, in the audit reports signed by members of the ICAI*

The Council of the Institute of Chartered Accountants of India (ICAI), at its 292nd meeting held on January 13, 2010 has decided to require the members of the Institute of Chartered Accountants of India to:

- Include, in addition to the other requirements relating to signature on the audit report, as prescribed under the relevant Standard on Auditing, the registration number of the firm as allotted by ICAI, in the audit reports signed by them ; and
- Ensure that the resolution passed by the company regarding appointment of the statutory auditor of the company under section 224 of the Companies Act, 1956, also contain the registration number of the firm of the auditor(s) with the ICAI.
- These requirements would come into effect from April 1, 2010.

6. Amendment to SA 230- Retention Period for Engagement Documentation (Working Papers)**

Consequential Amendment to Audit Documentation Retention Period in Standard on Auditing (SA) 230, Audit Documentation

The Council of the Institute of Chartered Accountants of India had in August 2009, pursuant to the provisions of Rule 12 of the Chartered Accountants (Procedures of Investigations of Professional and Other Misconduct and Cases) Rules, 2007 had amended the audit documentation retention period appearing as ten years in paragraph 83 of Standard on Quality Control 1 to seven years.

As a consequence of the above decision of the Council, with the issuance of this announcement by the Auditing and Assurance Standards Board, the audit documentation retention period appearing as ten years in paragraph A23 of the Standard on Auditing (SA) 230, Audit Documentation, issued in January 2009, shall also stand amended to seven years.

7. Requirement to mention the firm registration number allotted by ICAI in all reports issued, including certificates, by members of the ICAI***

Attention of the members is invited to the announcement regarding requirement relating to mentioning the firm registration number in the audit reports and resolution passed by the company for appointment of statutory auditors, published on page 1312 of the February 2010 issue of the Journal.

The Council of the Institute of Chartered Accountants of India, in terms of the decision taken at the 296th meeting held in June 2010 has decided to extend the requirement to mention the firm registration number to all reports issued pursuant to any attestation engagement, including certificates, issued by the members as proprietor of/ partner in the said firm. The requirement shall apply where such firm registration number has been allotted by the Institute of Chartered Accountants of India.

The Council further decided to make this requirement effective for all attestation reports/ certificates issued on or after 1st October, 2010.

* Issued in January, 2010.

** Issued in May, 2010.

*** Issued in August, 2010.

8. Manner of Reporting by the Auditors on Prudential Regulatory Treatment Prescribed by RBI In Respect of Pension and Gratuity Liability of Public Sector Banks*

1. As the members are aware, the Reserve Bank of India on 9th February 2011 had issued a circular (no. DBOD.BP.BC.80/21.04.018/2010-11) on *Re-opening of Pension Option to Employees of Public Sector Banks and Enhancement in Gratuity Limits – Prudential Regulatory Treatment*. In terms of the said circular, “the banks may take the following course of action in the matter:
 - a. The expenditure, as indicated in paragraph 2 above, may, if not fully charged to the Profit and Loss Account during the financial year 2010-11, be amortised over a period of five years {subject to (b) and (c) below} beginning with the financial year ending March 31, 2011 subject to a minimum of 1/5th of the total amount involved every year.
 - b. Consequent upon the introduction of International Financial Reporting Standards (IFRS) from April 1, 2013 for the banking industry as scheduled, the opening balance of reserves of banks will be reduced to the extent of the unamortised carry forward expenditure.
 - c. The unamortised expenditure carried forward as aforementioned shall not include any amounts relating to separated/retired employees.
 - d. Appropriate disclosures of the accounting policy followed in this regard may be made in the Notes to Accounts to the financial statements.
.....”
2. The Council of the Institute of Chartered Accountants of India at its 304th meeting held on 23rd March 2011 considered the prudential regulatory treatment prescribed by the Reserve Bank of India vide its above mentioned circular *vis a vis* the impact thereof on the auditor’s report since the said treatment is a departure from the requirements of the Accounting Standard (AS) 15, *Employee Benefits*.
3. On a consideration of the matter, the Council of the Institute decided that since the accounting treatment for such expenditure is prescribed under the prudential regulatory framework of the Regulator, the auditors need not qualify their audit report on account of this. The matter should, however, be brought out by the auditors in the audit report by way of an “Emphasis of Matter Paragraph” in accordance with the Standard on Audit (SA) 706, “*Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report*”, provided the matter of departure from the requirements of AS 15 pursuant to the aforesaid circular of RBI is appropriately disclosed, with quantification, by the bank by way of the notes to the accounts in the financial statements.
4. An illustrative Emphasis of Matter Paragraph in the audit report is as follows:

“Emphasis of Matter

Without qualifying our opinion, we draw attention to Note X to the financial statements, which describes deferment of pension and gratuity liability of the bank to the extent of Rs. YYY pursuant to the exemption granted by the Reserve Bank of India to the public sector banks from of application of the provisions of Accounting Standard (AS) 15, *Employee Benefits* vide its circular no. DBOD.

* Issued in April, 2011.

BP.BC/80/21.04.018/2010-11 on Re-opening of Pension Option to Employees of Public Sector Banks and Enhancement in Gratuity Limits – Prudential Regulatory Treatment.”

5. Members may note that the aforesaid disclosure in the Notes to the Accounts would normally include:

- Quantification of the actual amount of pension liability arising on account of exercise of the pension option by the employees of the bank who had not opted for pension earlier;
- Quantification of the actual amount of additional liability arising on account of the amendment to the Payment of Gratuity Act, 1972; and
- Impact on the financial statements of application of the provisions of AS 15 in the given circumstances had such circular not been issued by RBI.

An illustrative Note to Accounts in this regard is as follows:

“During the year, the Bank reopened the pension option for such of its employees who had not opted for the pension scheme earlier. As a result of exercise of which by BBB (number of employees), the bank has incurred a liability of Rs. XXX. Further, during the year, the limit of gratuity payable to the employees of the banks was also enhanced pursuant to the amendment to the Payment of Gratuity Act, 1972. As a result the gratuity liability of the Bank has increased by Rs. ZZZ.

In terms of the requirements of the Accounting Standard (AS) 15, Employee Benefits, the entire amount of Rs. AAA (ie. Rs. XXX + Rs. ZZZ) is required to be charged to the Profit and Loss Account. However, the Reserve Bank of India has issued a circular no. DBOD.BP.BC.80/21.04.018/2010-11) on Re-opening of Pension Option to Employees of Public Sector Banks and Enhancement in Gratuity Limits – Prudential Regulatory Treatment, dated 9th February 2011. In accordance with the provisions of the said Circular, the Bank would amortise the amount of Rs. AAA over a period of five years. Accordingly, Rs. CCC (representing one-fifth²² of Rs. AAA) has been charged to the Profit and Loss Account. In terms of the requirements of the aforesaid RBI circular, the balance amount carried forward, ie., Rs. YYY (Rs. AAA – Rs. CCC) does not include any employees relating to separated/ retired employees.

Had such a circular not been issued by the RBI, the profit of the bank would have been lower by Rs. YYY pursuant to application of the requirements of AS 15.”

9. Compliance with Paragraphs 61 and 62 of the Standard on Review Engagements (SRE) 2410*

1. The Council of the Institute of Chartered Accountants of India, at its 308th meeting, considered an issue relating to difficulties being faced by the members of the Institute in compliance with paragraphs 61 and 62 of the SRE 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*, raised by the Auditing and Assurance Standards Board of the Institute.

²² The said RBI circular requires that the amount of amortisation should be at least one-fifth of the total amount involved every year.

* Issued in October, 2011.

2. The Council noted that paragraphs 61 and 62 of SRE 2410 require as under:

“61. The terms of the engagement include management’s agreement that where any document containing interim financial information indicates that such information has been reviewed by the entity’s auditor, the review report will also be included in the document. If management has not included the review report in the document, the auditor considers seeking legal advice to assist in determining the appropriate course of action in the circumstances.

62. If the auditor has issued a modified review report and management issues the interim financial information without including the modified review report in the document containing the interim financial information, the auditor considers seeking legal advice to assist in determining the appropriate course of action in the circumstances, and the possibility of resigning from the appointment to audit the annual financial statements.”
 3. The Council noted that a number of entities were publishing interim financial results with a declaration that the “results have been approved by the Board of Directors at its meeting held on xxxxx and have been subjected to limited review by the statutory auditors.” The companies, however, were not publishing the review report along with such published results. Accordingly, it was either that the auditors had not obtained an agreement with the management that they would publish the review report along with the reviewed results or that despite the said agreement, the management had not complied therewith. The Council noted that in the latter cases, the auditor would be penalised under the requirements of SRE 2410 even when the default/ breach had been committed by the management.
 4. The Council was of the view that it is not practically feasible for the auditor to ensure that every document released by the management containing the interim financial information indicating that such information has been reviewed by the entity’s auditor, the review report has been included in the said document.
 5. On a consideration of the matter, the Council is of the opinion that paragraphs 61 and 62 did not envisage the auditor to take steps to ensure that on every occasion when the review results were published by the management, it also published the review report therewith. The responsibility of the auditor was upto issuance of the review report on the results, at most till the time the interim results, along with the review report, were filed by the company with the concerned stock exchange. Further, since such filing led to the concerned interim results and the review report thereon becoming available in the public domain, the same would be construed as sufficient compliance by the auditor with the requirements of paragraphs 61 and 62 of SRE 2410.
 6. The Council, however, felt that if, subsequent to the issuance of the review report, the auditor became aware of situations where the management had not published the review report especially where the review report contained auditor’s reservations, he would need to bring the same to the attention of the management and, if considered necessary, take legal advice.
10. **Statutory Auditor’s Reporting Responsibilities in Respect of Depositing of Cess Pursuant to Clause 4(ix)(a) of the Companies (Auditor’s Report) Order, 2003 and Section 227(3)(g) of the**

Companies Act, 1956*

1. The Council of the Institute, at its 312th meeting held on December 25 - 27, 2011, noted that paragraph 4(ix)(a) of the Companies (Auditor's Report) Order, 2003 required the statutory auditor to report on the matter relating to regularity of the company in depositing undisputed statutory dues as follows:

"Is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees' State Insurance, Income-tax, Sales-tax, Wealth Tax, Service Tax, Custom Duty, Excise Duty, Cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at 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 by the auditor.[Paragraph 4(ix)(a)]"

2. The Council also noted that paragraph 63(g) of the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India states as follows:

*It may be noted that at present, no Rules relating to the amount of cess for rehabilitation or revival or protection of assets of sick industrial companies, payable by a company under section 441A of the Act have been notified by the Central Government. Thus, it would not be possible for the auditor to comment on the regularity or otherwise about the cess till the time relevant rules or regulations are issued. **However, till the time such Rules are prescribed, the auditor should also state in his report under this clause that the Government has not notified any Rules under section 441A of the Companies Act, 1956 and, therefore, the auditor is unable to comment on this particular issue.** (emphasis added)*

3. The Council noted that till date the Central Government had not notified the effective date of section 441A of the Companies Act, 1956. Consequently, no Rules thereunder had also been prescribed by the Central Government. Accordingly, there was no question of reporting thereon under the Companies (Auditor's Report) Order, 2003. The Council, therefore, decided that in view of the aforementioned situation, the statutory auditor need not report in respect of cess payable under section 441A of the Companies Act, 1956 as envisaged under paragraph 63(g) of the Statement on the Companies (Auditor's Report) Order, 2003. The Council, therefore, decided to modify paragraph 63(g) of the said Statement as follows:

"It may be noted that at present, no Rules relating to the amount of cess for rehabilitation or revival or protection of assets of sick industrial companies, payable by a company under section 441A of the Act have been notified by the Central Government. Thus, it would not be possible for the auditor to comment on the regularity or otherwise about the cess till the time relevant rules or regulations are issued. ~~However, till the time such Rules are prescribed, the auditor should also state in his report under this clause that the Government has not notified any Rules under section 441A of the Companies Act, 1956 and, therefore, the auditor is unable to comment on this particular issue.~~ However, till the time such Rules are prescribed, the auditor need not make any comment in respect of the Cess under

* Issued in January, 2012.

section 441A of the Companies Act, 1956 in his report under paragraph 4(ix)(a) of CARO 2003."

4. The Council, incidentally, also noted that section 227(3)(g) of the Companies Act, 1956 required the statutory auditor's report to state, "*Whether the cess payable under section 441A has been paid and if not, the details of amount of cess not so paid.*" It was also noted that the operative date of even section 227(3)(g) had not yet been notified by the Central Government.
5. Accordingly, as a corollary to the Council's views on auditor's reporting responsibilities on cess under section 441A of the Companies Act, 1956, pursuant to clause 4(ix)(a) of CARO, 2003, the Council was of the view that the statutory auditor's report need not contain any comment on section 227(3)(g) of the Companies Act, 1956.

11. Important Announcement on revised Effective Date/ Applicability of three Standards on Auditing, namely:*

- **SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements";**
- **SA 705, "Modifications to the Opinion in the Independent Auditor's Report";**
- **SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report"**

During the last few weeks, the President and Vice-President, during their interaction with members especially statutory central and branch auditors of banks, business community and Council Members, have been urged that concerted efforts be made by the Institute by way of regular CPE and other programmes to familiarise the practicing members with the requirements of the following three Standards on Auditing namely:

- SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements";
- SA 705, "Modifications to the Opinion in the Independent Auditor's Report";
- SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report"

which were issued in 2010 to be effective/applicable for audits of financial statements for the periods beginning on or after 1.4.2011 and only after ensuring adequate education, publicity and familiarization, the said standards, be made mandatory.

The above concerns were shared by the President and Vice-President among other Council colleagues and thereafter based on the view emerged, the President directed the office to circulate a proposal, under Regulation 165, among Council Members for taking a decision on postponement by one year of the applicability of aforementioned Standards on Auditing.

Accordingly, a proposal for postponement by one year of the effective date/applicability of the above mentioned three Standards on Auditing was circulated among Council Members for taking a decision in the matter, in accordance with the applicable provisions of Regulation 165 of the Chartered Accountants Regulations 1988. The decision so taken by the Council is as follows:

"The Council, in partial modification of the decision taken by it at its 291st meeting held in December, 2009, decided that the effective date/applicability of the following Standards on Auditing –

* Issued in April, 2012.

- a) SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements";
- b) SA 705, "Modifications to the Opinion in the Independent Auditor's Report";
- c) SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report"

be postponed by one year and consequently the said Standards shall now be effective/applicable for audits of financial statements for periods beginning on or after 1st April, 2012 (instead of audits of financial statements for periods beginning on or after 1st April, 2011 as was earlier decided and referred to above).

The suggestion of some members on issue of suitable clarification in respect of those members who have since issued the audit reports in consonance with the said Standards i.e. under new format, shall be brought before the Council at its next meeting for addressing the same appropriately."

This is for information and compliance of all concerned.

12. Manner of Reporting by the Statutory Auditors on Accounting for Liabilities Arising on Dismantling of Indian Motor Third Party Insurance Pool (IMTPIP) Prescribed by IRDA*

- 1. As the members are aware, the Insurance Regulatory and Development Authority (IRDA) had vide its Order No. IRDA/NL/ORD/MPL/277/12/2011 dated 23rd December 2011 had directed the dismantling of the Indian Motor Third Party Insurance Pool (IMTPIP) with effect from 31st March 2012.
- 2. Subsequently, vide its Order No. IRDA/F&A/ORD/MTPP/070/03-2012 dated 22nd March 2012, in exercise of its powers under section 34 of the Insurance Act, 1938, prescribed, *inter alia*, the following accounting treatment in respect of the "transitional liabilities" relating to the financial years 2009-10, 2010-11 and 2011-12, arising on account of such dismantling as follows:
 - "3. The IMPTPIP liabilities upon estimation/re-estimation of actuarially determined liabilities relating to the financial years (accounting years as the practice is) 2009-10, 2010-11 and 2011-12 following the dismantling of the IMTPIP shall be determined and such determined liabilities (Transitional Liabilities) shall be recognized by insurers by making an irrevocable choice to recognize the said transitional liabilities:
 - a. Immediately in the financial year ending March, 2012; or
 - b. As an expense on a straight-line basis over upto the three years beginning with the financial year ending March, 31, 2012.
 - c. An insurer opting for (b) above, shall:
 - (i) Disclose at the end of each financial year the amount of transitional liabilities that remains unrecognized; and the amount recognized in the financial year; and
 - (ii) Shall ensure that the expense to be recognized in subsequent years shall not be less than the expense that shall fall due on a straight-line basis; and
 - (iii) In case the actual liability in respect of past years i.e. underwriting years until March, 31, 2012 being more than the amount on straight-line basis,

* Issued in May, 2012.

such additional liabilities shall be recognized in full, in addition to the amount falling due for recognition on straight-line basis.”

3. The Council of the Institute of Chartered Accountants of India at its 316th meeting held from 15th to 17th May 2012 considered the accounting treatment prescribed under paragraph 3(b) of the above mentioned Order of IRDA *vis a vis* the impact thereof on the auditor's report since non-recognition of the said liability where an insurer exercises the option under paragraph 3(b) is not in accordance with accounting principles generally accepted in India.
4. On a consideration of the matter, the Council of the Institute noted that the aforesaid accounting treatment has been prescribed by the IRDA in exercise of its powers under section 34 of the Insurance Act, 1938. Accordingly, the statutory auditors need not qualify their audit report on account of such accounting treatment followed by the insurance company. The matter should, however, be brought out by the auditors in the audit report by way of an *“Emphasis of Matter Paragraph”* in accordance with the Standard on Audit (SA) 706, *“Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, provided the non-recognition of the said liability pursuant to the aforesaid order of IRDA is appropriately disclosed, with quantification, by the insurer by way of the notes to the accounts in the financial statements.
5. An illustrative Emphasis of Matter Paragraph in the audit report is as follows:
“Emphasis of Matter Without qualifying our opinion, we draw attention to Note X to the financial statements, which describes deferment of the liability on dismantling of the Indian Motor Third Party Insurance Pool by the Company to the extent of Rs. YYY pursuant to the exercise of the option for the accounting treatment for the same prescribed under paragraph 3(b) of Insurance Regulatory and Development Authority Order no. IRDA/F&A/ORD/MTAP/070/03/2012 dated 22nd March 2012. ”
6. Members may note that the aforesaid disclosure in the Notes to the Accounts would normally include.
 - Quantification of the actual amount of the total liability on dismantling.
 - amount of transitional liabilities that remains unrecognized; and
 - the amount recognized in the financial year;
7. Further, pursuant to dismantling of the IMTPIP by the IRDA, the insurance company's accounting policy for recognition of liability incurred by it in respect of third party risks of specified commercial motor vehicles (specified risks) would also undergo a change. Accordingly, the Company would also need to appropriately disclose such change in accounting policy in its Notes to Accounts. An illustrative disclosure in this respect in this regard is also given below.
8. An illustrative Notes to Accounts in respect of treatment of liability arising on account of dismantling of IMTPIP for the financial years 2007-08 and 2008-09 and the transitional liability in respect of the financial years 2009-10, 2010-11 and 2011-12 is as follows:
“During the year, the Insurance Regulatory and Development Authority vide its Orders No. IRDA/NL/ORD/MPL/277/ 12/2011 dated 23rd December 2011 directed the dismantling of the Indian Motor Third Party Insurance Pool (IMTPIP).
Subsequently, the IRDA vide its Order No. IRDA/F&A/ORD/ MTPP/070/03-2012 dated 22nd March 2012, in exercise of its powers under section 34 of the Insurance

Act, 1938, prescribed, the following accounting treatment in respect of the liability arising on account of the dismantling of the IMTPIP:

“2.The additional IMPTPIP liabilities upon re-estimation of actuarially determined liabilities relating to underwriting years 2007-08 and 2008-09 shall be accounted for and recognized in full in the financial year ending March 31, 2012 itself. The Pool Manager shall quantify the liability in respect of each insurer for this purpose.

3. The IMPTPIP liabilities upon estimation/re-estimation of actuarially determined liabilities relating to the financial years (accounting years as the practice is) 2009-10, 2010-11 and 2011-12 following the dismantling of the IMTPIP shall be determined and such determined liabilities (Transitional Liabilities) shall be recognized by insurers by making an irrevocable choice to recognize the said transitional liabilities;

- (a) Immediately in the financial year ending March, 2012; or
- (b) As an expense on a straight-line basis over upto the three years beginning with the financial year ending March, 31, 2012.”

As a result of dismantling of the IMTPIP, the Company has incurred the following liability:

2007 – 08	:	Rs. DDD	(as quantified by the Pool Manager)
2008 – 09	:	Rs. GGG	(as quantified by the Pool Manager)

Total (A): Rs. JJJ

Transitional Liability

2009-10	:	Rs. PPP
2010-11	:	Rs. QQQ
2011-12	:	Rs. TTT

Total Transitional liability (B): Rs. AAA

TOTAL LIABILITY ON ACCOUNT

OF DISMANTLING (A) + (B) : Rs. HHH

Accordingly, in terms of the requirements of paragraph 2 of IRDA's Order of 22nd March 2012, an amount of Rs. JJJ has been charged to the Profit and Loss Account for the current financial year ended 31st March 2012.

Further, the Company has decided to exercise the option given under paragraph 3(b) of the aforesaid Order of IRDA in respect of the accounting treatment of Transitional Liability amounting to Rs. AAA and, thus, would amortize the amount of Rs. AAA over a period of three years. Accordingly, Rs. CCC (representing one-third of Rs. AAA) has been charged to the Profit and Loss Account for this financial year. Further, in terms of the requirements of paragraphs 3(b) and (c) of the aforesaid Order of IRDA, the balance amount carried forward is Rs. YYY (Rs. AAA – Rs. CCC).

Had the Company chosen to exercise the option given under paragraph 3(a) of the aforesaid Order of the IRDA, the Company would have been required to recognise the entire amount of Transitional Liability of Rs. AAA in its Profit and Loss Account for the year 2011-12. Accordingly, the profit of the company would have been lower

by Rs.YYY pursuant to recognition of the said liability in the year of dismantling of IMTPIP."

9. An illustrative Notes to Account in respect of change in the accounting policy in respect of third party risks of specified commercial motor vehicles is as follows:

"Till the financial year 2010-11, the Company had the following accounting policy in respect of respect of third party risks of specified commercial motor vehicles (specified risks):

(state the policy hitherto being followed by the company)

Pursuant to the dismantling of the IMTPIP by the IRDA with effect from 31st March 2012, with effect from 1st April, 2012, it would not be possible for the Company to transfer the risks incurred by it on account of third party risks of specified commercial motor vehicles by way of reinsurance of same through IMTPIP. Accordingly, the Company would be required to provide for the entire amount of related liability and also recognize the entire amount of other related expenditure in the financial statements of the relevant financial year."

13. Manner of Reporting on Section 227(3)(bb) of the Companies Act, 1956*

- I. Section 227(3)(bb) of the Companies Act, 1956 requires the statutory auditor to report on the following aspect:

"bb. whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by clause (c) of sub-section (3) of that section and how he has dealt with the same in preparing the auditor's report;"

(A similar reporting requirement appears in section 143(3)(c) of the Companies Act, 2013 though the section has not yet been notified by the Central Government**.)

- II. The Council of the Institute, at its 329th (Adjourned) meeting held on 03rd and 04th January 2014 at New Delhi noted that reporting by the statutory auditors of the Company on clause (3)(bb) of section 227 of the Companies Act, 1956 is a legal requirement in cases where the company had appointed separate branch auditor/s. However, the same was inadvertently not appearing under the "Report on Other Legal and Regulatory Requirements" paragraph in the illustrative format of the independent auditor's report for a Company as given in the Appendix to SA 700. The Council accordingly, decided to add the following reporting in the illustrative independent auditor's report formats for a Company (to be reported upon as and where applicable):

"bb. the report on the accounts of the branch offices audited under section 228 by a person other than the company's auditor has been forwarded to us as required by clause (c) of sub-section (3) of section 228 and have been dealt with in preparing our report in the manner considered necessary by us;"

14. Reference to the Accounting Standards Applicable to the Companies in the Auditor's Report and Limited Review Reports and various Engagement Standards*

- I. The Ministry of Corporate Affairs (MCA) has vide its notification dated 12th September 2013 notified 98 sections of the Companies Act 2013 having come into force from that date. One of the sections

* Issued in February, 2014.

** The Section has been notified after the issuance of this announcement.

so notified is Section 133 which empowers the Central Government to prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India (ICAI) in consultation with and after examination of the recommendation by the National Financial Reporting Authority (NFRA).

- II. Subsequently, MCA *vide* its General Clarification No. 15/2013 dated 13th September 2013, has clarified that to facilitate proper administration of the notified sections of the Companies Act 2013, in respect of the aforesaid Section 133, *"Till the Standards of Accounting or any addendum thereto are prescribed by Central Government in consultation and recommendation of the National Financial Reporting Authority, the existing Accounting Standards, notified under the Companies Act, 1956 shall continue to apply."*
- III. Further, *vide* its Circular no. 16/2013 dated 18th September 2013, MCA has further clarified that with effect from 12th September 2013, *"the relevant provisions of the Companies Act, 1956, which correspond to provisions of 98 sections of the Companies Act, 2013 brought into force on 12.09.2013, cease to have effect from that date."* As a result, section 211(3C) of the Companies Act, 1956 corresponding to which section 133 of the Companies Act, 2013 has been notified has ceased to have effect from 12th September, 2013.
- IV. In view of the above, members have sought guidance on the manner of reference to the Accounting Standards applicable to the company in the statutory auditor's report of the company as well as the limited review report in case of a listed company, issued pursuant to clause 41 of the Listing Agreement.
- V. The matter was considered by the Council of the Institute of Chartered Accountants of India at its 329th Adjourned meeting held on 03rd and 04th January 2014 at New Delhi. The Council noted that in so far as the format of the auditor's report for a statutory audit of a company, for example, as given in illustration 1 in Appendix to SA 700, is concerned, reference to the Accounting Standards issued under section 211 (3C) of the Companies Act, 1956 appears at two places. First, under the *"Management's Responsibility for the Financial Statements"* paragraph and second, under the *"Report on Other Legal and Regulatory Requirements"* paragraph.
- VI. The Council noted that, while section 133 of the Companies Act, 2013 had been notified, and accordingly, section 211(3C) of the Companies Act, 1956 had been superceded, section 143 of the Companies Act, 2013, which dealt with the matters to be contained in the auditor's report, had not yet been notified*. Accordingly, the auditor's reporting requirements were still being governed by section 227(3) of the Companies Act, 1956 and that clause 227(3)(d) of the Companies Act, 1956 requires the auditors to report *"whether, in his opinion, the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section (3C) of section 211"* of the Companies Act, 1956.
- VII. The Council is of the view that in the above background, till the time section 143 of the Companies Act, 2013 is made operative, both the following manners of making reference to the Accounting Standards in the independent auditor's report of a Company would be acceptable:

Alternative 1: Refer to section 211(3C) of the Companies Act, 1956 (both in the *"Management's Responsibility for Financial Statements"* and *"Report on Legal and Other Regulatory Matters"* paragraphs *(as currently given in the illustrative format of independent auditor's report for a company given in Appendix to SA 700)*;

* The Section has been notified after the issuance of this announcement.

OR

Alternative 2: Refer to only the Companies Act, 1956 along with the reference to the relevant notifications of MCA *vide* which it had clarified that the Accounting Standards prescribed under the Companies Act, 1956 would continue to apply in respect of section 133 of the Companies Act, 2013.

- VIII. Where the members decide to opt for *Alternative 2* above, the “Management Responsibility for Financial Statements” paragraph and the “Report on Legal and Other Regulatory Matters” paragraph in the independent auditor’s report would need to suitably reworded as follows and such rewording would be construed to be in accordance with that prescribed in the text/ Appendix to the concerned Engagement Standard.

“Management’s Responsibility for the Financial Statements

Management is cash flows of the Company in accordance with the Accounting Standards notified under the Companies Act, 1956 (“the Act”) read with the General Circular 15/2013 dated 13th September 2013 of the Ministry of Corporate Affairs in respect of section 133 of the Companies Act, 2013. This responsibility..... fraud or error.”

“Report on Other Legal and Regulatory Requirements

2. As required by Section 227(3) of the Act, we report that:

(a)
.....

(d) In our opinion, the Balance Sheet, the Statement of Profit and Loss, and the Cash Flow Statement comply with the Accounting Standards notified under the Companies Act, 1956 read with the General Circular 15/2013 dated 13 September 2013 of the Ministry of Corporate Affairs in respect of section 133 of the Companies Act, 2013.

.....

(f)”

- IX. Similarly, in case of limited review reports issued in terms of clause 41 of the Listing Agreement, approach similar to as suggested above may also be adopted while making a reference to the Accounting Standards applicable to the concerned Company in the limited review report/s issued by a practitioner pursuant to the Standard on Review Engagement (SRE) 2400, *Engagements to Review Financial Statements* or the Standard on Review Engagement (SRE) 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*.

15. Amendment to the “Auditor’s Responsibility” Paragraph Included in the Independent Auditor’s Report*

1. The Council of the Institute of Chartered Accountants of India at its 329th Adjourned meeting held on 03rd and 04th January 2014, New Delhi noted that in the context of the “auditor’s responsibility”, paragraph 31(b) of the Standard on Auditing (SA) 700, *Forming An Opinion and Reporting on Financial Statements*, issued by the Institute, required the following to be mentioned in the auditor’s report:

* Issued in February, 2014.

“31. The auditor’s report shall describe an audit by stating that:

- (b) The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor’s consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of internal control; and”

(emphasis added)

2. The Council noted that the “Auditor’s Responsibility” paragraph as given in the illustrative formats of the independent auditor’s report, as given in the Appendix to SA 700 (and as a corollary, in the Appendices to SA 705²³ and SA 706²⁴), however, did not contain such description that the auditor’s risk assessment and procedures were not designed for the purpose of expressing an opinion on the effectiveness of the entity’s internal controls.
3. The Council, accordingly, decided to amend the “Auditor’s Responsibility” paragraph in an independent auditor’s report as follows:

“An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.”

(the amendment is shown in the track changed mode)

16. Use of the Term “Profit and Loss Account” or “Statement of Profit and Loss” in the Statutory Audit Reports of Companies*

- I. The Council of the Institute of Chartered Accountants of India, at its 329th Adjourned meeting, held on 03rd and 04th January, 2014 at New Delhi noted that the illustrative formats of the independent auditor’s report (in respect of a Company) as given in SA 700, SA 705 and SA 706 contain the references to “Profit and Loss Account” at various places. The term was being used since the Schedule VI to the Companies Act, 1956 also used this term.
- II. The Council also noted that though the Revised Schedule VI to the Companies Act, 1956 as also the corresponding Schedule III to the Companies Act, 2013, instead use the term “Statement of

²³ SA 705, Modifications to the Opinion in the Independent Auditors Report.

²⁴ SA 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report.

* Issued in February, 2014.

Profit and Loss", section 227 of the Companies Act, 1956, which continues to be applicable in respect of the statutory auditor's reporting requirements, used the term "Profit and Loss Account".

- III. The Council decided that in view of the above, in the independent auditor's report of a Company, the auditors may choose to use the term "Profit and Loss Account" or "Statement of Profit and Loss".

17. Manner of Reporting In Respect of Such Clauses of the Companies (Auditor's Report) Order, 2003 Which Are Not Applicable to the Auditee Company*

- I. The Council, at its 329th Adjourned meeting held on 03rd and 04th January 2014 at New Delhi noted that the paragraph 80 of the Statement on the Companies (Auditor's Report) Order, 2003 (the Statement) requires that, in such situations, where one or more of the clauses are not applicable, it would be appropriate for the auditor to make a suitable comment in his report bringing out the fact of non-applicability of a particular clause.
- II. The Council considered the requirements of paragraph 80 of the Statement and was of the view that non applicability of one or more clauses of the Companies (Auditor's Report) Order, 2003 (CARO 2003) to the company would not, in any way, impact the auditor's opinion on the financial statements. Thus, the said information did not have much perceivable benefit to the readers of the audit report. Accordingly, the auditor may choose to report on the non-applicability of the individual clause of CARO, 2003, or, alternatively, aggregate/ club the fact of non applicability of different clause(s) of CARO 2003.
- III. The Council, accordingly, decided to amend paragraph 80 of the Statement on CARO, 2003 as follows:

80. There may be situations where one or more of the clauses are not applicable. For example, the requirement regarding internal audit system does not apply in case of all the companies. In such situations, it would be appropriate for the auditor to make a suitable comment in his report bringing out the fact of non-applicability of a particular clause. To illustrate, where the maintenance of cost records has not been prescribed by the Central Government under section 209(1)(d) of the Act, the auditor may state:

"The Central Government has not prescribed maintenance of cost records under section 209(1)(d) of the Companies Act, 1956 for any of the products of the company".

Alternatively, the auditor may aggregate/ club the fact of non applicability of different clauses of CARO, 2003 and report as under:

"Matters specified in clauses.....(relevant clause number of the clause/s not applicable) of paragraph 4 of the CARO 2003 do not apply to the Company."

(note: Amendments to paragraph 80 of the Statement on CARO, 2003 are given in track changed mode).

18. Manner of Disclosure in the Auditor's Report of the Fact of Inclusion of Unaudited Financial Statements/ Information of Component/s in the Financial Statements Audited by the Principal Auditor(s)*

1. An independent auditor of the financial statements of an entity may, at times, need to rely upon work of the other auditors. For example, in an audit of the stand alone financial statements of an entity the independent auditor thereof (the Principal Auditor) may need to rely upon the financial statements of the entity's component/s such as branch/es, division/s, etc., which have been audited by other independent auditor/s. Similarly, in an audit of the consolidated financial statements of a

* Issued in February, 2014.

group, the independent auditor thereof (the Principal Auditor), may need to rely upon the work of the independent auditors of the components of the group such as subsidiary/ies, joint venture/s, associate/s, etc., whose audited financial statements/ information have been included in the consolidated financial statements and have been audited by their respective independent auditors (the Component Auditors).

2. There may also be a situation where the financial statements of one or more components included in the stand alone financial statements of an entity/ consolidated financial statements of a group have not been audited either by the Principal Auditor or the Component Auditor/s.
3. Members have sought guidance on the appropriate manner of disclosure of information in the independent auditor's report of the Principal Auditor about the fact that the financial statements/ information pertaining to certain/ all components, included in the stand alone financial statements of an entity/ consolidated financial statements of a group are unaudited.
4. The Council at its 331st meeting held on 10th February, 2014 considered the above matter and decided as under:

Situation 1 Component/s is/ are unaudited and such component/s is/ are not material to the financial statements of the entity/ consolidated financial statements of the Group

Situation 2 Component/s is/ are audited by auditor/s other than the Principal Auditor and such component/s is/ are not material to the financial statements of the entity/ consolidated financial statements of the Group

Situation 3 Component/s is/ are audited by auditor/s other than the Principal Auditor and such component/s is/ are material to the financial statements of the entity/ consolidated financial statements of the Group

Situation 4 Component/s is/ are unaudited and such component/s is/ are material to the financial statements of the entity/

Disclosures in the Principal Auditor's Report

The principal auditor may or may not disclose the fact of such component/s in the Principal Auditor's report. In case the Principal Auditor decided to make such disclosure, the same would be done under the "Other Matters" paragraph, pursuant to SA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. An illustrative manner of reporting is given in Illustration 2 in the Appendix to SA 706.

The principal auditor would need to disclose the fact of such component/s in the Principal Auditor's report. Such disclosure would be done under the "Other Matters" paragraph, pursuant to SA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. An illustrative manner of reporting is given in Illustration 2 in the Appendix to SA 706.

The Principal Auditor needs to consider its/ their impact on the auditor's opinion on the financial statements of the entity/ consolidated

consolidated financial statements
of the Group

financial statements of the group, in
terms of the principles laid down in SA
705, *Modifications to the Opinion in the
Independent Auditor's Report*.

5. Further, in case of the auditor's reports of the statutory central auditors, the manner of disclosure about the audited/ unaudited components as given in the illustrative formats of the auditor's report in the Guidance Note on Audit of Banks would continue to apply.

19. Applicability of the Companies Act, 2013 to Auditor's Report to FY 2014-15 and Onwards*

The Ministry of Corporate Affairs, on 26th March 2014 notified a majority of the remaining sections of the Companies Act, 2013, including sections 139 to 148, relating to audits and auditors. The Act was stated to be effective from 1st April, 2014.

Accordingly, queries are being raised by a number of members as to whether any auditor's report of a company being signed on or after 01st April, 2014 would be in accordance with the requirements of section 143 of the Companies Act, 2013.

In this context, it may be noted that the Ministry of Corporate Affairs (MCA) has, on 04th April 2014, *vide* its General Circular No. 08/2014, clarified that the financial statements (and documents required to be attached thereto), auditor's report and Board's report in respect of financial years that commenced earlier than 01st April, 2014 shall be governed by the relevant provisions/Schedules/rules of the Companies Act 1956. This MCA Circular can be seen at URL http://www.mca.gov.in/Ministry/pdf/General_Circular_8_2014.pdf.

Therefore, it is clear from MCA's aforesaid General Circular that the auditor's report of a company pertaining to any financial year commencing on or before 31st March 2014, would be in accordance with the requirements of the Companies Act, 1956 even if that financial year ends after 01st April 2014. For example, where the financial year of a company is 01st January 2014 to 31st December 2014, the statutory auditor's report signed therefor would be in accordance with the requirements of the Companies Act, 1956.

As a corollary to MCA's General Circular, it appears that the provisions of the 2013 Act would apply only to the financial years commencing on or after 01st April 2014. Thus, for example, the statutory auditor's report signed in respect of the financial year of the company ended 31st March 2015 would need to be issued in accordance with the provisions of the Companies Act, 2013.

20. Manner of Reporting by the Auditors In Respect of RBI's Circular on Deferred Tax Liability on Special Reserve created under Section 36(1) (viii) of the Income Tax Act, 1961*

1. The Reserve Bank of India, on 20th December 2013, issued Circular No. DBOD. No.BP.BC.77/21.04.018/2013-14 for all commercial banks (excluding Regional Rural Banks) in respect of Deferred Tax Liability on Special Reserve created under Section 36(1) (viii) of the Income Tax Act, 1961.
2. RBI, in its aforesaid Circular has noted that some banks were not creating deferred tax liability (DTL) on Special Reserve as per Accounting Standard 22, 'Accounting for taxes on Income' (AS 22) on the grounds that they do not intend to withdraw from such Reserve in the future. In many cases banks have formalised such intent by having resolutions passed by their Boards or Committees to this effect.

* Issued in April, 2014.

* Issued in April, 2014.

3. RBI, *vide* its aforesaid Circular, has required that as a matter of prudence, banks should create DTL on such Special Reserve. Further, for this purpose, banks may take the following course of action:
 - a) If the expenditure due to the creation of DTL on Special Reserve as at March 31, 2013 has not been fully charged to the Profit and Loss account, banks may adjust the same directly from Reserves. The amount so adjusted may be appropriately disclosed in the Notes to Accounts of the financial statements for the financial year 2013-14.
 - b) DTL for amounts transferred to Special Reserve from the year ending March 31, 2014 onwards should be charged to the Profit and Loss Account of that year.
4. RBI Circular also states that in view of the requirement to create DTL on Special Reserve, banks may reckon the entire Special Reserve for the purpose of computing Tier-I Capital.
5. The Council of ICAI has considered the impact of the accounting dispensation prescribed by RBI with respect to treatment of expenditure on creation of DTL as at 31st March 2013 (as referred to in paragraph 3.a above) on the report of the banks' statutory auditors.
6. On a consideration of the matter, the Council is of the view that any specific accounting treatment prescribed by a regulator, even if at variance with the Accounting Standard/s, was an integral part of the financial reporting framework applicable to the entity falling under the jurisdiction of such regulator and the entity would be required to follow such prescribed accounting treatment. Accordingly, the statutory auditors need not modify their audit opinion in respect of such prescribed accounting treatment. However, the fact may be brought out by the statutory auditors in their audit report by way of an "Emphasis of Matter" paragraph in accordance with the Standard on Audit (SA) 706, *"Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report"*, issued by ICAI, provided the matter of departure from the requirements of the Accounting Standard/s pursuant to the aforesaid regulatory requirement is appropriately disclosed, with quantification, by the entity by way of the notes to the accounts in the financial statements.
7. An illustrative "Emphasis of Matter" paragraph is as follows:

"Emphasis of Matter

We draw attention to Note X to the financial statements, which describes the accounting treatment of the expenditure on creation of Deferred Tax Liability on Special Reserve under section 36(1)(viii) of the Income Tax Act, 1961 as at 31st March 2013, pursuant to RBI's Circular No. DBOD. No.BP.BC.77/21.04.018/2013-14 dated 20th December 2013. Our opinion is not qualified in respect of this matter."
8. The aforesaid disclosure in the Notes to the Accounts would normally include the following information in respect of creation of Deferred Tax Liability (DTL) on Special Reserve for the following:
 - Amount of expenditure due to the creation of DTL on Special Reserve as at March 31, 2013 not fully charged to the Profit and Loss Account as adjusted directly against Reserves
 - Impact on Profit & Loss Account had the amount of hitherto unprovided DTL been charged to the Profit and Loss Account instead of Reserves directly as required by the RBI Circular.
9. An illustrative Note to Accounts in this regard is as follows:

"Pursuant to Reserve Bank of India's (RBI's) Circular No. DBOD. No.BP.BC.77/21.04.018/2013-14 dated 20th December 2013, the Bank has created Deferred Tax Liability on the Special Reserve under section 36(1)(viii) of the Income-

tax Act, 1961. As required by the said RBI Circular, the expenditure, amounting to Rs. XXXX due to the creation of DTL on Special Reserve as at March 31, 2013, not previously charged to the Profit and Loss Account, has now been adjusted directly from the Reserves. Had this amount been charged to the Profit & Loss Account in accordance with the generally accepted accounting principles in India, the amount of Profit for year had been lower/ amount of Loss for the year higher²⁵ by such amount."

21. Applicability of The Provisions of Section 143(3)(i) of The Companies Act 2013 and The Related Rules*

Section 143(3)(i) of the Companies Act 2013 requires the auditors of the companies to report as whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

The Council of the Institute of Chartered Accountants of India, at its adjourned 333rd meeting held on 18th June 2014, considered the issue of applicability of the provisions of sections 143(3)(i) of the Companies Act 2013 and the related Rules to the audits of the periods beginning on or before 31st March 2014.

The Council noted that the sections 143(3)(i) had come into force in respect of financial years beginning on or after 1st April 2014. The Council was of the view that the provisions of sections 143(3)(i) of the Companies Act 2013 applied to the auditors appointed under the Companies Act 2013 to audit the financial statements for the year beginning on or after 1st April 2014. As a corollary, the requirements of these sections and related Rules would not apply to audits of financial statements of the periods beginning on or before 31st March 2014, even if the audits therefor were actually carried out and auditor's report thereon issued on or after 1st April 2014. These would continue to be done as per the requirements of the Companies Act 1956.

The Council also decided that as a corollary, the provisions of section 143(3)(i) of the Companies Act 2013 would apply to the audits of the financial year beginning on or after 1st April 2014.

22. Applicability of The Provisions of Section 143(12) of The Companies Act 2013 and The Related Rules to Periods Beginning on or Before 31st March 2014*

Section 143(12) of the Companies Act 2013 requires the auditors of the companies to report to the Central Government on the frauds committed or being committed against the company.

The Council of the Institute of Chartered Accountants of India, at its adjourned 333rd meeting held on 18th June 2014, considered the issue of applicability of the provisions of sections 143(3)(12) of the Companies Act 2013 and the related Rules to the audits of the periods beginning on or before 31st March 2014.

The Council noted that the sections 143(12) had come into force in respect of financial years beginning on or after 1st April 2014. The Council was of the view that the provisions of sections 143(12) of the Companies Act 2013 applied to the auditors appointed under the Companies Act 2013 to audit the financial statements for the year beginning on or after 1st April 2014. As a corollary, the requirements of these sections and related Rules would not apply to audits of financial statements of the periods beginning on or before 31st March 2014, even if the audits therefor were actually carried out and auditor's report thereon issued on or after 1st April 2014.

²⁵ As the case may be.

* Issued in June, 2014.

23. Applicability of Section 143(12) to Financial Years Beginning on or After 1st April 2014*

The Council of the Institute of Chartered Accountants of India, at its adjourned 333rd meeting held on 18th June 2014, considered the issue of applicability of the provisions of section 143(12) of the Companies Act 2013 to the financial periods beginning on or after 1st April 2014. In other words, whether the statutory auditor would be required to report pursuant to section 143(12) while carrying out audits of financial statements for the interim periods, such as quarterly or half yearly audits.

The Council was of the view that such quarterly/ half yearly audits are not carried out pursuant to the requirements of the Companies Act 2013 (rather to meet the specific requirements of the auditee company, for example, to comply with the listing agreement requirements) as the latter only envisages audit of the annual financial statements.

The Council, accordingly, felt that prima facie, as a corollary, section 143(12) would become applicable only for financial year (and not for a period) 2014-2015 and onwards. The Council is, however, in the process of communicating with the Ministry of Corporate Affairs in this regard.

24. Illustrative Formats of the Engagement Letter for Audit of Financial Statements under the Companies Act, 2013 and the Rules Thereunder@

The Auditing and Assurance Standards Board is issuing the following illustrative formats for engagement letter for audit of Financial Statements under the Companies Act, 2013 and the Rules thereunder. These illustrative formats were approved by the Council of the Institute of Chartered Accountants of India (ICAI) at its meeting held in November 2014. These illustrative formats would be added to the Appendix 1 of Standard on Auditing (SA) 210, 'Agreeing the Terms of Audit Engagements', issued by ICAI.

Illus. 1	Engagement Letter for Audit of Financial Statements under the Companies Act 2013 and the Rules Thereunder (When Reporting u/s 143(3)(i) is Applicable) ²⁶
Illus. 2	Engagement Letter for Audit of Financial Statements under the Companies Act 2013 and the Rules Thereunder (When Reporting u/s 143(3)(i) is not Applicable) ²⁶

25. Illustrative Formats of the Independent Auditor's Report on Standalone Financial Statements under the Companies Act, 2013 and the Rules Thereunder*

The Auditing and Assurance Standards Board is issuing the following illustrative formats of the Independent Auditor's Report on the Standalone Financial Statements under the Companies Act, 2013 and the Rules thereunder. These illustrative formats were approved by the Council of the Institute of Chartered Accountants of India (ICAI) at its meeting held in November 2014. These illustrative formats would be added to the respective Appendices of Standard on Auditing (SA) 700, Forming An Opinion and Reporting On Financial Statements and Standard on Auditing (SA) 705, Modifications to the Opinion in the Independent Auditor's Report, issued by ICAI.

* Issued in June, 2014.

@ Issued in December, 2014.

²⁶ These formats have been included as a part of Appendix 1 to SA 210, "Agreeing the Terms of Audit Engagements", published elsewhere in Volume I.A of the Handbook.

* Issued in December, 2014.

Illus. 1	Unmodified Opinion on Standalone Financial Statements, Emphasis of Matter Paragraphs, Reporting on clause 143(3)(i) regarding internal financial controls is required ²⁷	<i>Will be added to Appendix to SA 700</i>
Illus. 2	Unmodified Opinion on Standalone Financial Statements, Emphasis of Matter Paragraphs, Reporting on clause 143(3)(i) regarding internal financial controls is not required ²⁷	
Illus. 3	Qualified Opinion on Standalone Financial Statements, Qualification is quantifiable, Reporting on clause 143(3)(i) regarding internal financial controls is not required ²⁸	<i>Will be added to Appendix to SA 705</i>
Illus. 4	Qualified Opinion on Standalone Financial Statements, Qualification is not quantifiable, Reporting on clause 143(3)(i) regarding internal financial controls is not required ²⁸	
Illus. 5	Adverse Opinion on Standalone Financial Statements, Reporting on clause 143(3)(i) regarding internal financial controls is not required ²⁸	
Illus. 6	Disclaimer of Opinion on Standalone Financial Statements, Reporting on clause 143(3)(i) regarding internal financial controls is not required ²⁸	

The Board is in consultation with the Ministry of Corporate Affairs with respect to issues pertaining to the independent auditor's report on consolidated financial statements under the Companies Act 2013. Accordingly, the illustrative format of the independent auditor's report on consolidated financial statements under the Companies Act, 2013 will be issued in due course.

26. Announcement on CARO, 2003 and Additional Reporting Under the Companies Act, 2013*

We are receiving queries from the members regarding applicability of CARO, 2003 along with Auditors' Report on financial statements of companies for the financial year 2014-15. The Ministry of Corporate Affairs (MCA) is working on it and has constituted a Committee for this purpose to analyse the contents of the Order to be made under section 143(11) of the Companies Act, 2013 for the Financial Year 2014-15. ICAI is also a member of the said committee. We are given to understand by MCA that an Order being a smaller version of CARO 2003, applicable for the financial year 2014-15, may be notified soon under section 143(11) of the Companies Act, 2013. However, at this juncture, to bring more clarity, this Announcement is released in consultation with the Ministry.

The Companies Act, 1956 has ceased to have effect from 01st April, 2014. As a corollary, the Companies (Auditor's Report) Order, 2003 issued under section 227(4A) of the said Act also ceases to have effect from the said date.

Section 143(11) of the Companies Act, 2013 which came into force from 01st April, 2014 provides that "the Central Government may, in consultation with the National Financial Reporting Authority, by general or special order, direct, in respect of such class or description of companies, as may be specified in the

²⁷ These formats have been included as a part of Appendix to SA 700, "Forming an Opinion and Reporting on Financial Statements", published elsewhere in Volume I.A of the Handbook.

²⁸ These formats have been included as a part of Appendix to SA 705, "Modifications to the Opinion in the Independent Auditor's Report", published elsewhere in Volume I.A of the Handbook.

* Issued in April, 2015.

order, that the auditor's report shall also include a statement on such matters as may be specified therein."

Accordingly, it may be noted that as when an Order is notified by the Central Government under section 143(11) of the Companies Act, 2013, the members would be required to report thereon as a part of their statutory audit reports.

Until the aforesaid Order is issued, no additional reporting under section 143(11) of the Companies Act, 2013 is required by the Auditors for the financial year 2014-15.

Members are advised to keep a watch on the MCA site (www.mca.gov.in) as well as the ICAI site (www.icaai.org) for further announcements in this regard.

27. 'Guidance on Reporting Under the Companies (Auditor's Report) Order, 2015 (CARO, 2015) and Consequential Amendment to the Format of the Auditor's Report of a Company'²⁹

I. Reporting Under CARO, 2015

1. As the members are aware, the Ministry of Corporate Affairs, on 10th April, 2015, notified the Companies (Auditor's Report) Order, 2015 (CARO, 2015). The text of the Order is available on the URL http://www.mca.gov.in/Ministry/pdf/Companies_Auditors_Report_Order_2015.pdf.

2. Members would have noted that, inter alia, the exemption criteria applicable to private companies as laid down in the paragraph 1(v) of the CARO, 2015 is same as that in the Companies (Auditor's Report) Order, 2003 (CARO, 2003). Also, it is noted that the twelve reporting clauses given in paragraph 3 of CARO, 2015 are similar in their requirements to the corresponding clauses in paragraph 4 of the CARO, 2003. Further, the requirement to state reasons for unfavourable or qualified answers as given in paragraph 4 of the CARO, 2015 is also similar to that contained in paragraph 4 of the CARO, 2003. Accordingly, members are advised to continue to draw in principle guidance from the relevant paragraphs of the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India.

3. For the benefit of the members, following is a reference table of reporting clauses of CARO, 2015 and the corresponding paragraphs of the Statements on CARO, 2003, wherefrom relevant guidance can be drawn (subject to necessary changes in the context of the provisions of the Companies Act, 2013 and the Rules issued thereunder):

Clause of CARO, 2015	Relevant Paragraph/s of the Statement on CARO, 2003
(i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;	44(a) to (n)
(b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material	45(a) to (g)

* Issued in April, 2015.

²⁹ This Announcement is being issued in terms of the decision taken at the 342nd meeting of the Council of the Institute of Chartered Accountants of India.

discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;	
(ii)(a) whether physical verification of inventory has been conducted at reasonable intervals by the management;	47(a) to (d)
(b) are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business. If not, the inadequacies in such procedures should be reported;	48(a) to (k)
(c) whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account;	49(a) to (h)
(iii) whether the company has granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 189 of the Companies Act. If so,	50(a) to (f)
(a) whether receipt of the principal amount and interest are also regular; and	52(a) to (e)
b) if overdue amount is more than rupees one lakh, whether reasonable steps have been taken by the company for recovery of the principal and interest	53(a) to (c)
(iv) is there an adequate internal control system commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods and services. Whether there is a continuing failure to correct major weaknesses in internal control system.	57(a) to (m)
(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 and the rules framed there under, where applicable, have been complied with? If not, the nature of contraventions should 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?	60(a) to (l)
(vi) where maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act, whether such accounts and records have been made and maintained;	62(a) to (g)
(vii) (a) is the company regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, wealth tax, service tax, duty of customs, duty of excise, value	63(a) to (r)

added tax, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at 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 by the auditor.	
(b) in case dues of income tax or sales tax or wealth tax or service tax or duty of customs or duty of excise or value added tax or cess 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 constitute a dispute).	64(a) to (h)
(c) whether the amount required to be transferred to investor education and protection fund in accordance with the relevant provisions of the Companies Act, 1956 (1 of 1956) and rules made thereunder has been transferred to such fund within time.	The members may note that the provisions relating to the Investor Education and Protection Fund (IEPF) are contained in section 205C of the Companies Act, 1956 and the IEPF (Awareness and Protection of Investors) Rules, 2001. For the purpose of reporting on this clause, the members would need to examine the date of transfer <i>vis a vis</i> the time prescribed in the aforesaid provisions and Rules and report accordingly.
(viii) whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty per cent of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year;	65(a) to (h)
(ix) whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported;	66(a) to (h)
(x) whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company;	71(a) to (h)
(xi) whether term loans were applied for the purpose for which the loans were obtained;	72(a) to (j)

(xii) whether any fraud on or by the company has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.	77(a) to (k)

4. Members may also continue to draw guidance, to the extent relevant, in respect of applicability of the CARO, 2015, form of report and Board's report, from the guidance given in the Statement on Companies (Auditor's Report) Order, 2003 (subject to necessary changes in the context of the provisions of the Companies Act, 2013 and the Rules thereunder).

II. Consequential Amendment to the Format of the Auditor's Report of A Company

5. The Auditing and Assurance Standards Board had, in December 2014, issued illustrative formats of the auditor's report on financial statements of a company under the Companies Act, 2013. While reporting on the requirements of CARO, 2015, a reference thereto also needs be added in the main audit report under the "Report on Legal and Other Regulatory Matters" paragraph as follows:

"Report on Other Legal and Regulatory Requirements

As required by the Companies (Auditor's Report) Order, 2015 ("the Order"), issued by the Central Government of India in terms of sub-section (11) of section 143 of the Companies Act, 2013, we give in the Annexure a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.

As required by Section 143 (3) of the Act, we report that:

.....
"

The aforesaid illustrative formats of the auditor's report, accordingly, stand amended to that extent.

28. *Clarification on Auditor's Report in respect of Financial Statements of a Company for Accounting Years Beginning Before 1st April, 2014³⁰

1. The Ministry of Corporate Affairs vide its General Circular No 07/2014, *Dissemination of Information With Regards to the Provisions of the Companies Act, 2013 as Notified Till Date vis a vis Corresponding Provisions of the Companies Act, 1956*, dated 01st April 2014 had provided information in respect of such sections of the Companies Act 1956 which will cease/continue to have effect after 01st April 2014 (i.e. the date when a number of sections of the Companies Act 2013 came into force).

2. Also, the Ministry of Corporate Affairs had on 04th April, 2014 issued a General Circular No. 8/2014 regarding "Commencement of provisions of the Companies Act 2013 with regard to maintenance of books of

* Issued in April, 2015.

³⁰ This "Clarification" was approved by the Council of the Institute of Chartered Accountants of India at its 342nd meeting held on 15-16 April, 2015.

accounts and preparations/adoption/filing of financial statements, auditor's report, Board's report and attachments to such statements and reports - Applicability with regard to relevant financial Year".

3. The aforesaid General Circular of 04th April 2014 *inter alia*, mentioned that "..... it is hereby notified that the financial statements (and documents required to be attached thereto), auditor's report and Board's report in respect of financial years that commenced earlier than 1st April, 2014 shall be governed by the relevant provisions/ Schedules/ rules of the Companies Act, 1956 and that in respect of financial years commencing on or after 1st April, 2014, the provisions of the new Act shall apply."

4. Also, such companies whose financial years ended at a date other than 31st March, are in the process of aligning their financial year to meet the definition of "financial year" as per the Companies Act, 2013.

5. The matters described in paragraph 1 above have given rise to a situation wherein, with effect from 01st April 2014, the various documents, minutes and registers, etc., are being maintained by companies in accordance with the provisions of the Companies Act, 2013. Consequently, in case of companies whose financial years commenced before 31st March 2014 but would end on or before 31st March 2015, w.e.f. 01st April 2014, various documents, minutes and registers, etc., may not be maintained in accordance with the provisions of the Companies Act, 1956 for such part of the financial year that falls after 01st April 2014 (i.e., the date when the Companies Act, 2013 comes into force).

6. The aforesaid situation is giving rise to practical difficulties for the statutory auditors while reporting in terms of certain provisions of section 227 of the Companies Act, 1956 in respect of the companies described in paragraph 5 above since necessary documents, minutes and registers, etc., under the Companies Act, 1956 may not be available for such part of the financial year that falls after 01st April 2014. Specifically, these difficulties relate to reporting under section 227(3)(f), relating to disqualification of the Directors under section 274(1)(g) of the Companies Act 1956. Similarly, problems would be faced while reporting on certain clauses of the Companies (Auditor's Report) Order, 2003 (CARO 2003). For example, clause (iii) relating to loans to/from parties covered in the register maintained under section 301 of the Companies Act 1956; or clause (v)(a) and (b) relating to contracts or arrangements referred to in section 301 of the Companies Act 1956; or clause (vi) relating to provisions of section 58A and 58AA of the Companies Act, 1956 relating to acceptance of deposits from the public; or clause (viii) relating to maintenance of cost records; or clause (xiv) relating to dealing or trade in shares, securities, debentures, other investments, etc *vis a vis inter alia*, exemption under section 49 of the Companies Act, 1956 or clause (xviii) relating to preferential allotment of shares to parties and companies covered in the register maintained under section 301 of the Companies Act, 1956. It may also be noted that in terms of MCA's aforesaid General Circular No 07/2014, of 01st April, 2014, sections 49, 58A, 58AA, 209, 274, 301 of the Companies Act, 1956 cease to have effect from 01st April 2014.

7. It is, therefore, suggested that in case of aforesaid situation, the statutory auditors should report on the relevant clauses only for that part of the financial year upto which the concerned provisions of the Companies Act 1956 were in force (i.e. upto 31st March 2014). Also, the statutory auditors should clearly bring out this fact in the relevant portions of their audit reports. An illustrative manner of such disclosure is as follows:

“Other Matters

The Ministry of Corporate Affairs had on 01st April, 2014, *vide* its General Circular No. 07/2014, *Dissemination of Information with Regards to the Provisions of the Companies Act, 2013 as Notified Till date vis a vis Corresponding Provisions of the Companies Act, 1956*, identified such sections of the Companies Act, 1956 that would cease/ continue to have effect from 01st April 2014.

Accordingly, in terms of the aforesaid Circular, our reporting in respect of section 227(3)(f) of the Companies Act, 1956, and clauses (iii), (v)(a) and (b), (vi), (viii), (xiv), (xviii) of the Companies (Auditor's Report) Order, 2003 (dealing with sections 49, 58A, 58AA, 209(1)(d) and 301 of the Companies Act, 1956) is only for the period beginning from ie (date) till 31st March 2014 since as per the aforementioned MCA Circular these sections have ceased to have effect from 01st April, 2014.”

8. This Announcement is effective from the date of its hosting on ICAI's website.

29. Auditor's Report on Consolidated Financial Statements Under The Companies Act, 2013*

The Auditing and Assurance Standards Board, under the authority of the Council, has already issued the illustrative formats of the auditor's report on standalone financial statements of a company under the Companies Act 2013 in December 2014. While reporting on the consolidated financial statements (CFS) of a company under the Companies Act 2013, the auditors may draw guidance from the aforementioned formats and suitably reword the same, as required, to meet the circumstances of audit of CFS. The auditors of CFS, while reporting in respect of the provisions of, *inter alia*, section 143(3) and section 143(11) of the Companies Act, 2013 in their report on CFS, are also advised to:

- consider the observations and comments as given in this regard in the auditors' reports of the component auditors.
- include in their report or draw suitable reference to, negative/adverse comments, if any, in respect of section 143(3) and section 143(11) of the Act relating to a component, as appearing in the component auditors' report.

The auditors of CFS are also advised to apply concept of materiality and professional judgment as provided in the Standards on Audit while reporting on the Consolidated Financial Statements.

The following illustrative formats of an auditors' report on CFS, covering some of the clauses of section 143(3) of the Companies Act, 2013 (and where the auditor does not have the responsibility for reporting on internal financial controls over financial reporting under section 143(3)(i) of the Companies Act, 2013), are being issued herewith just to provide a broad guidance on how such a report may be prepared. These formats may be applied for the FY 2014-15 and until further announcement. It is reiterated that the

* Issued in May, 2015.

auditors of CFS may suitably reword/redraft these formats to suit the circumstances of their audit engagement.

Type of Format	
Unmodified opinion on the consolidated financial statements ³¹	This format will be added in the Appendix to SA 700
Modified opinion on the consolidated financial statements ³²	This format will be added in the Appendix to SA 705

D. List of Mandatory Statements and Standards on Auditing

I. List of Statements on Auditing as on 01.10.2015

1. Statement on the Companies (Auditor's Report) Order, 2003 (Revised 2005).³³
2. Statement on Reporting under section 227 (1A) of the Companies Act, 1956³⁴.

II. List of Engagement and Quality Control Standards as on 01.10.2015

Quality Control						
Standard Number (SQC) (1-99)	Standards on Quality Control (SQCs)	Published in Journal	Date from which effective			
			April 1, 2008	April 1, 2009	April 1, 2010	April 1, 2011
1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements	October 2007		✓		
Audits and Reviews of Historical Financial Information						
Standard Number (SA) (100-999)	Standards on Auditing (SAs)		Date from which effective			
			April 1, 2008	April 1, 2009	April 1, 2010	April 1, 2011

³¹ The format has been included as a part of Appendix to SA 700, "Forming an Opinion and Reporting on Financial Statements", published elsewhere in Volume I.A of the Handbook.

³² The format has been included as a part of Appendix to SA 705, "Modifications to the Opinion in the Independent Auditor's Report", published elsewhere in Volume I.A of the Handbook.

³³ Issued in April, 2004 pursuant to the issuance of the Companies (Auditor's Report) Order, 2003. The revised edition issued in April 2005 pursuant to the issuance of the Companies (Auditor's Report) (Amendment) Order, 2004.

³⁴ The Council, at its 269th meeting held from July 18, 2007 to July 20, 2007, decided to withdraw the Statement on Qualifications in Auditor's Report except paragraphs 2.1 to 2.30 dealing with reporting under section 227 (1A) of the Companies Act, 1956 and to rename the Statement as 'Statement on Reporting under section 227 (1A) of the Companies Act, 1956'.

100-199	Introductory Matters					
200-299	General Principles and Responsibilities					
200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	March 2010			✓	
210	Agreeing the Terms of Audit Engagements	September 2009			✓	
220	Quality Control for an Audit of Financial Statements	March 2010			✓	
230	Audit Documentation	January 2009		✓		
240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	December20 07		✓		
250	Consideration of Laws and Regulations in an Audit of Financial Statements	December20 08		✓		
260	Communication with Those Charged with Governance	December20 08		✓		
265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	December20 09			✓	
299	Responsibility of Joint Auditors		Effective for all audits related to accounting periods beginning on or after April 1, 1996			
300-499	Risk Assessment and Response to Assessed Risks					
300	Planning an Audit of Financial Statements	December20 07	✓			
315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment	February 2008	✓			
320	Materiality in Planning and Performing an Audit	August 2009			✓	
330	The Auditor's Responses to Assessed Risks	February 2008	✓			
402	Audit Considerations Relating to an Entity Using a Service Organisation	August 2009			✓	
450	Evaluation of Misstatements	August 2009			✓	

	Identified during the Audit					
500–599	Audit Evidence					
500	Audit Evidence	April 2009		✓		
501	Audit Evidence - Specific Considerations for Selected Items	March 2010			✓	
505	External Confirmations	March 2010			✓	
510	Initial Audit Engagements—Opening Balances	March 2009			✓	
520	Analytical Procedures	March 2010			✓	
530	Audit Sampling	February 2009		✓		
540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	February 2009		✓		
550	Related Parties	March 2009			✓	
560	Subsequent Events	January 2009		✓		
570	Going Concern	December 2008		✓		
580	Written Representations	October 2008		✓		
600-699	Using Work of Others					
600	Using the Work of Another Auditor		Effective for all audits related to accounting periods beginning on or after April 1, 2002			
610	Using the Work of Internal Auditors	August 2009			✓	
620	Using the Work of an Auditor's Expert	March 2010			✓	
700-799	Audit Conclusions and Reporting					
700*	Forming an Opinion and Reporting on Financial	February 2010				✓

* The Council of the ICAI, in partial modification of the decision taken by it at its 291st meeting held in December 2009, has decided that the effective date/applicability of the three standards viz SA 700 (Revised), SA 705 and SA 706 be postponed by one year and consequently the said Standards shall now be effective/applicable for audits of financial statements for periods beginning on or after 1st April, 2012 (instead of audits of financial statements for periods beginning on or after 1st April, 2011 as was earlier decided). The complete text of the Announcement is published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

	Statements					
705*	Modifications to the Opinion in the Independent Auditor's Report	February 2010				✓
706*	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	February 2010				✓
710	Comparative Information - Corresponding Figures and Comparative Financial Statements	April 2010				✓
720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements	April 2009			✓	
800-899	Specialized Areas					
800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks	April 2010				✓
805	Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement	April 2010				✓
810	Engagements to Report on Summary Financial Statements	April 2010				✓
Standard Number (SRE) (2000-2699)	Standards on Review Engagements (SREs)	Published in Journal	Date from which effective			
			April 1, 2008	April 1, 2009	April 1, 2010	April 1, 2011
2400	Engagements to Review Financial Statements	May 2010			✓	
2400 (Revised)	Engagements to Review Historical Financial Statements		Effective for reviews of financial statements for periods beginning on or after April 1, 2016.			
2410	Review of Interim Financial Information Performed by the Independent Auditor of the Entity	May 2010			✓	

Assurance Engagements Other Than Audits or Reviews of Historical Financial Information						
Standard Number (SAE) (3000-3699)	Standards on Assurance Engagements (SAEs)	Published in Journal	Date from which effective			
			April 1, 2008	April 1, 2009	April 1, 2010	April 1, 2011
3000-3399	Applicable to all Assurance Engagements					
3400-3699	Subject Specific Standards					
3400	The Examination of Prospective Financial Information		Effective in relation to reports on projections/ forecasts, issued on or after April 1, 2007			
3402	Assurance Reports on Controls at a Service Organisation	April 2011				✓
Related Services						
Standard Number (SRS) (4000-4699)	Standards on Related Services (SRSs)		Date from which effective			
4400	Engagements to Perform Agreed-upon Procedures Regarding Financial Information		Applicable to all agreed upon procedures engagements beginning on or after April 1, 2004			
4410	Engagements to Compile Financial Information		Applicable to all compilation engagements beginning on or after April 1, 2004			
4410 (Revised)	Compilation Engagements		Effective for compilation engagements undertaken after March 31, 2016.			

STANDARDS

Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Services¹

(Effective from April 1, 2008)

Introduction

1. This Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services has been issued to facilitate understanding of the scope and authority of the pronouncements of the AASB issued under the authority of the Council of the Institute of Chartered Accountants of India (the ICAI).

2. The ICAI is committed to the goal of enabling the accountancy profession in India to provide services of high quality in the public interest and which are accepted worldwide. To further this goal, the ICAI develops and promulgates technical Standards and other professional literature. The ICAI being one of the founder members of the International Federation of Accountants (IFAC), the Standards developed and promulgated by the AASB under the authority of the Council of the ICAI are in conformity with the corresponding International Standards issued by the International Auditing and Assurance Standards Board (IAASB), established by the IFAC. The "Due Process" of the AASB for formulation of Standards, Statements, Guidance Notes and its other pronouncements is given in the **Appendix** to this Preface.

Standards Issued by AASB under the Authority of the Council of ICAI

3. The following Standards issued by the Auditing and Assurance Standards Board under the authority of the Council are collectively known as the Engagement Standards:

- (a) Standards on Auditing (SAs), to be applied in the audit of historical financial information.
- (b) Standards on Review Engagements (SREs), to be applied in the review of historical financial information.
- (c) Standards on Assurance Engagements (SAEs), to be applied in assurance engagements, other than audits and reviews of historical financial information.
- (d) Standards on Related Services (SRSs), to be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

4. Standards on Quality Control (SQC), issued by the AASB under the authority of the Council, are to be applied for all services covered by the Engagement Standards as described in paragraph 3 above.

A diagram containing the structure of the Standards issued by the Auditing and Assurance Standards Board under the authority of the Council is given as **Annexure** to this Preface.

Standards on Auditing

5. The Standards on Auditing (SAs) referred to in Paragraph 3(a) above are formulated in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The authority of SAs is set out in SA 200².

¹ Issued in July, 2007.

² SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing".

Standards on Quality Control

6. SQCs are written to apply to firms³ in respect of all their services falling under the Engagement Standards issued by the AASB of ICAI. The authority of SQCs is set out in the introduction to the SQCs.

Other Standards

7. The other Engagement Standards identified in paragraph 3 (b) to (d) as well as Standards on Quality Control referred to in paragraph 4 contain basic principles and essential procedures (identified in **bold type** lettering and by the word “should”) together with related guidance in the form of explanatory and other material, including appendices. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provides guidance for their application. It is therefore necessary to consider the entire text of a Standard to understand and apply the basic principles and essential procedures. Appendices, which form part of the application material, are an integral part of a Standard. The purpose and intended use of an appendix are explained in the body of the related Standard or within the title and introduction of the appendix itself. An individual Standard should be read in the context of the objective stated in the Standard as well as this Preface. Any limitation of the applicability of a specific Standard is made clear in the Standard itself.

Statements on Auditing

8. Statements on Auditing are issued with a view to securing compliance by professional accountants on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. Statements are, therefore, mandatory.

General Clarifications

9. General Clarifications are issued by the Board under the authority of the Council of the Institute with a view to clarify any issues arising from the Standards. General Clarifications are mandatory in nature.

Professional Judgment

10. The nature of the Standards/Statements/General Clarifications requires the professional accountant⁴ to exercise professional judgment in applying them.

Authority Attached to Other Standards, Statements on Auditing and General Clarifications

11. It is the duty of the professional accountants to ensure that the Standards/Statements/General Clarifications are followed in the engagements undertaken by them⁵. The need for the professional accountants to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the engagement, that procedure would be ineffective. If because of that reason, a professional accountant has not been able to perform an engagement procedure in accordance with any Standard/Statement/General Clarification, he is required to document how alternative procedures performed achieve the purpose of the procedure, and, unless otherwise clear, the reasons for the departure. Further, his report should draw attention to such departures. However, a

³ The term “firm” refers to a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.

⁴ The term “professional accountant” refers to a member of the Institute of Chartered Accountants of India.

⁵ Members’ attention is invited to Clause 5 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, according to which a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity. Further Clause 7 of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

mere disclosure in his report does not absolve a professional accountant from complying with the applicable Standards/Statements/General Clarifications ⁶.

12. There may be a situation where a matter is covered both by a Standard as also by a Statement on Auditing. In such a situation, the Statement shall prevail till the time the Standard becomes mandatory. Once a Standard becomes mandatory, the concerned Statement or the relevant portion(s) thereof will automatically be withdrawn.

Guidance Notes

13. Guidance Notes are issued to assist professional accountants in implementing the Engagement Standards and the Standards on Quality Control issued by the AASB under the authority of the Council. Guidance Notes are also issued to provide guidance on other generic or industry specific audit issues, not necessarily arising out of a Standard. Professional accountants should be aware of and consider Guidance Notes applicable to the engagement. A professional accountant who does not consider and apply the guidance included in a relevant Guidance Note should be prepared to justify the appropriateness and completeness of the alternate procedures adopted by him to deal with the objectives and basic principles set out in the Guidance Note.

Technical Guides, Practice Manuals, Studies and Other Papers Published by the Auditing and Assurance Standards Board

14. The Board may also publish Technical Guides, Practice Manuals, Studies and other papers. Technical Guides are ordinarily aimed at imparting broad knowledge about a particular aspect or of an industry to the professional accountants. Practice Manuals are aimed at providing additional guidance to professional accountants in performing audit and other related assignments. Studies and other papers are aimed at promoting discussion or debate or creating awareness on issues relating to quality control, auditing, assurance and related service, affecting the profession. Such publications of the Board do not establish any basic principles or essential procedures to be followed in audit, review, other assurance or related services engagements, and accordingly, have no authority of the Council attached to them.

Material Modifications to the Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services

Addition

This Preface deals, apart from the Standards, with the Statements on Auditing and the General Clarifications as the mandatory documents for use by the professional accountants in performing engagements by them, whereas, the Preface issued by the IAASB does not deal with such aspects. Further, the nomenclature of International Auditing Practice Statements (IAPSs) referred in the Preface issued by the IAASB has been changed to Guidance Notes in this Preface.

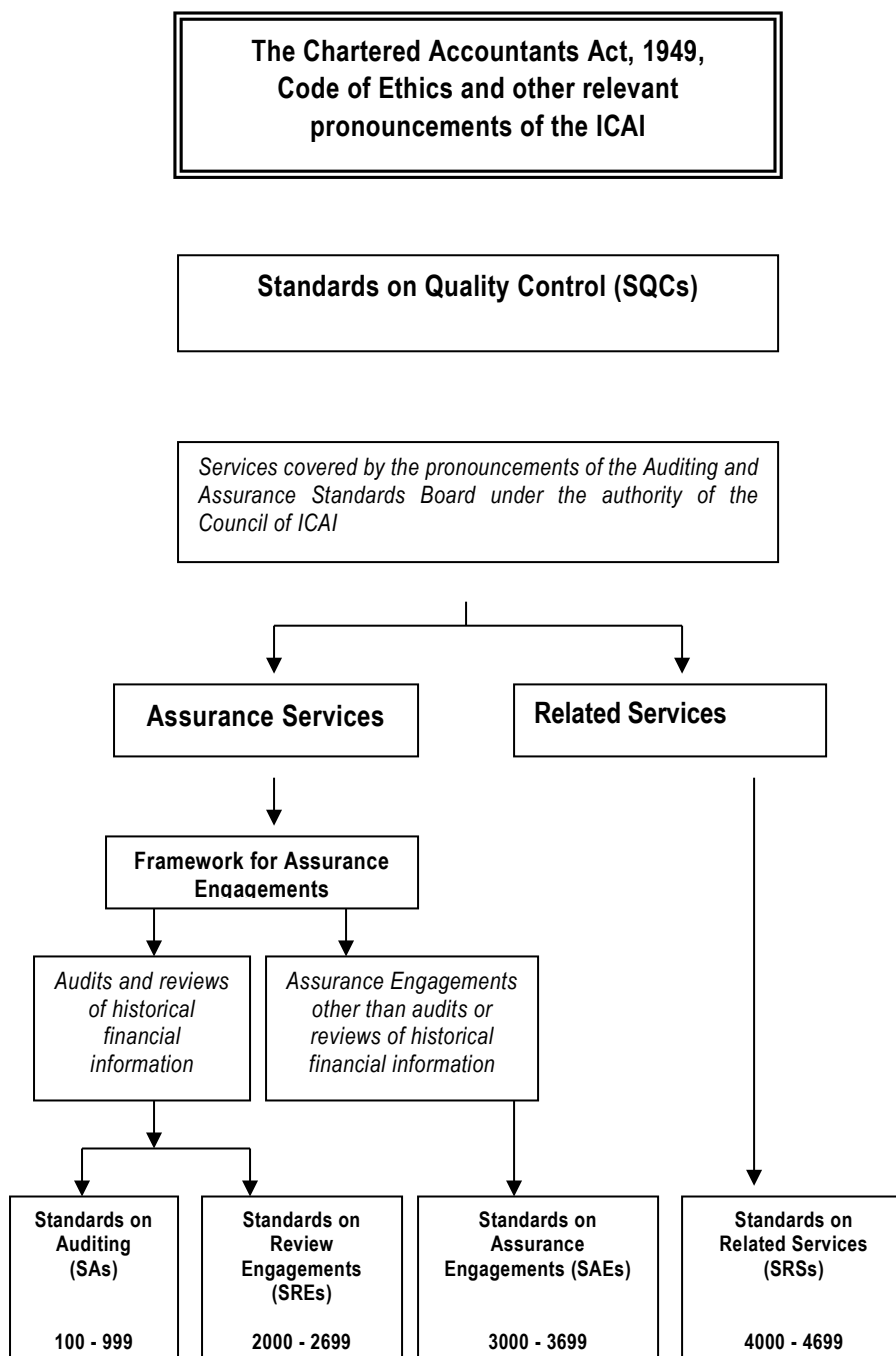
Deletion

The Preface issued by the IAASB provides to include, in appropriate cases, additional considerations specific to public sector entities within the body of the Standard. However, since the Standards, Statements, General Clarifications and Guidance Notes issued by the ICAI are equally applicable in case of all engagements, irrespective of the form, nature and size of the entity, this Preface does not deal separately with the public sector perspective.

⁶ Attention of the members is also drawn to Clause 9 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, whereby, a member is deemed to be guilty of professional misconduct if he fails to invite attention to any material departure from the generally accepted procedures of audit applicable to the circumstances.

Annexure

Structure of Standards issued by the Auditing and Assurance Standards Board under the Authority of the Council of ICAI



Appendix**Auditing and Assurance Standards Board and its Due Process****Brief History**

1. The Institute of Chartered Accountants of India (ICAI) constituted the Auditing Practices Committee (APC) on 17th September 1982, to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices so that these may be issued under the authority of the Council of the Institute. Subsequently, at its 226th meeting held in July 2002, the Council of the Institute approved certain recommendations of the APC to strengthen its role in the growth and development of the accountancy profession in India. The Council, at the said meeting, also approved the renaming of the Auditing Practices Committee as the Auditing and Assurance Standards Board (AASB) as well as renaming of the Statements on Standard Auditing Practices as Auditing and Assurance Standards (AASs).

2. The ICAI is one of the founder members of the International Federation of Accountants (IFAC). It is one of the membership obligations of the Institute to actively propagate the pronouncements of the International Auditing and Assurance Standards Board (IAASB) of the IFAC to contribute towards global harmonisation and acceptance of the Standards issued by the IAASB. Accordingly, while formulating Engagement and Quality Control Standards, the AASB takes into consideration the corresponding Standards, if any, issued by the IAASB. In addition, the AASB also takes into consideration the applicable laws, customs, usages and business environment prevailing in India within the parameters of the July 2006 Policy Paper, A Guide for National Standard Setters that Adopt IAASB's International Standards but Find it Necessary to Make Limited Modifications, issued by the IAASB.

Objectives and Functions of the Auditing and Assurance Standards Board

3. The following are the objectives and functions of the Auditing and Assurance Standards Board:
- (i) To review the existing and emerging auditing practices worldwide and identify areas in which Standards on Quality Control, Engagement Standards and Statements on Auditing need to be developed.
 - (ii) To formulate Engagement Standards, Standards on Quality Control and Statements on Auditing so that these may be issued under the authority of the Council of the Institute.
 - (iii) To review the existing Standards and Statements on Auditing to assess their relevance in the changed conditions and to undertake their revision, if necessary.
 - (iv) To develop Guidance Notes on issues arising out of any Standard, auditing issues pertaining to any specific industry or on generic issues, so that those may be issued under the authority of the Council of the Institute.
 - (v) To review the existing Guidance Notes to assess their relevance in the changed circumstances and to undertake their revision, if necessary.
 - (vi) To formulate General Clarifications, where necessary, on issues arising from Standards.
 - (vii) To formulate and issue Technical Guides, Practice Manuals, Studies and other papers under its own authority for guidance of professional accountants in the cases felt appropriate by the Board.

Composition

4. The composition of the AASB is fairly broad-based and attempts to ensure participation of all interest groups in the standard-setting process. Apart from amongst the elected members of the Council of the ICAI the following are also represented on AASB:

- (i) Eminent members of the profession, whether in industry or in practice, as co-opted members on the Board.
- (ii) One special invitee from each three regulatory bodies, viz., the Securities and Exchange Board of India,

the Reserve Bank of India and the Insurance Regulatory and Development Authority.

- (iii) One special invitee from the Indian Institute(s) of Management, or from any other prominent academic and/or research organisation, as considered appropriate.
- (iv) One special invitee from a prominent Industry association.
- (v) One special invitee representing public interest, e.g., not for profit organization, etc.

The special invitees mentioned at (ii) through (v) above are decided in consultation with the President of the Institute. Further, special invitees do not constitute the members of the Board, as referred to in this document.

Term of the Members

5. The term of the Chairman of the Board is three years. Where such period of three years exceeds the term of the Council of ICAI during which the Chairman has been appointed, the term of the Chairman is restricted to the abovementioned term of the Council. The Council of the ICAI may fill any vacancy in the Office of the Chairman and the Chairman so appointed holds office for the unexpired term of the Council. The term of other members of the Board and the special invitees is one year. However, in case the period of one year exceeds the term of the Council during which the members have been appointed, the term of the members is restricted to the abovementioned term of the Council.

Attendance at the Meetings

6. Each AASB meeting requires the presence, in person, of at least one third of the members of the Board. However, the AASB meetings whereat a Standard or Statement, at whatever stage (as envisaged in the following paragraphs), is proposed to be considered, requires attendance of at least two thirds of the AASB members, in person or by simultaneous telecommunication link (such as teleconferencing, videoconferencing, etc.).

7. In case any member of the AASB absents himself from three consecutive meetings of the Board, without seeking leave of absence the AASB would bring such fact to the attention of the Council.

AASB Working Procedure

Standards, Statements on Auditing and General Clarifications

Project Identification, Prioritization and Approval

8. Project proposals to develop new, or revise existing Standards, Statements or General Clarifications are identified based on international and national developments, input from members of the Council of the ICAI, AASB members, members of other committees of the ICAI and/or recommendations received from other interested parties, such as regulators or professional accountants.

9. The AASB determines the priorities of various projects on hand for commencement.

10. In the preparation of Standards, Statements and General Clarifications, AASB is assisted by Study Groups/Task Forces constituted to consider specific projects. The AASB appoints one of the professional accountants as a convenor of the Study Group/Task Force. The convenor, in consultation with the Chairman, AASB, nominates other members of the Study Group/Task Force, ordinarily five to seven in number. For operating convenience and economy, a study group is usually based in the area where the convenor is located. In situations considered necessary, the Board may also consider having an outside expert on such Study Groups/Task Forces and such an expert need not necessarily be a professional accountant. The Study Group/Task Force is responsible for preparing the basic draft of the Standard/ Statement/ General Clarification. In addition, a separate group of experts may be formed to advise the Study Group /Task Force.

11. The AASB may also conduct projects jointly with regulators and/or others. In such cases, the joint Study Group/Task Force is ordinarily chaired by the convenor appointed with mutual consent.

Consultation and Debate

12. The Study Group/Task Force develops the preliminary draft of the Standard/ Statement/ General Clarification based on appropriate research and consultation, which may include, depending on the circumstances, consultation with the other professionals, regulators and other interested parties, as well as reviewing professional pronouncements issued by IFAC member bodies and other professional bodies. The draft submitted by the study group, along with issue papers/background papers, is sent to the Chairman, AASB for approval.

13. The draft Standard/Statement/General clarification, along with other agenda papers, as approved by the Chairman, is hosted on the website of the AASB, ordinarily, at least twenty one days in advance of the AASB meeting at which such draft Standard/ Statement is planned to be considered. A notification to that effect is also sent to the AASB members. The printed version of the agenda papers, including background papers and draft Standard/ Statement/General Clarification prepared by the Study Group/Task Force for review and debate are made available to the members of and special invitees to the AASB at the concerned meeting.

14. The AASB considers the preliminary draft of the Standard/ Statement/General Clarification prepared by the Study Group/Task Force. The AASB may refer the draft to the Study Group/Task Force to examine the issues arising out of the deliberations of the AASB and accordingly modify the draft Standard/ Statement/General Clarification.

15. In case the revision to the Standard/ Statement/General Clarification is made by the Study Group/ Task Force in terms of the requirements of paragraph 14 above, the procedure laid down in paragraphs 12 to 14 above is followed for the revised draft of the Standard/ Statement/General Clarification.

16. The draft of the proposed Standard/ Statement/General Clarification, as modified in the light of the deliberations of the Board and approved by the Chairman, AASB, is circulated to the Council members of the ICAI for their comments before being issued as an Exposure Draft. Normally, a period of ten days is given for receiving comments on the Draft Exposure Draft. AASB finalises the Exposure Draft of the proposed Standard/ Statement on the basis of the comments so received, if any. Ordinarily, an Exposure Draft of a General Clarification is not issued.

Public Exposure

17. The Exposure Draft of the proposed Standard / Statement is issued, by way of publication in the monthly Journal of the Institute and/or hosted on the website of the ICAI wherefrom it is downloadable free of charge, for comments by the professional accountants and the public. The Board, however, may decide not to issue an Exposure Draft of a Statement, in which case, the reasons for such a decision is recorded in the minutes of the relevant AASB meeting. Each Exposure Draft is, ordinarily, accompanied by an explanatory memorandum that highlights the objectives and significant proposals contained in the draft. The explanatory memorandum may also direct the respondents to those aspects of the Exposure Draft on which specific feedback is sought.

18. The Exposure Draft is sent to the members of the Council of the ICAI, the Institute's past Presidents, Regional Councils and their branches. Copies of the Exposure Draft are also sent to the following bodies:

- i. The Ministry of Company Affairs, Government of India
- ii. The Comptroller and Auditor General of India
- iii. The Reserve Bank of India
- iv. The Insurance Regulatory and Development Authority
- v. The Central Board of Direct Taxes
- vi. The Central Board of Excise and Customs
- vii. The Securities and Exchange Board of India

- viii. The Central Registrar of Co-operative Societies
- ix. The Institute of Cost and Works Accountants of India
- x. The Institute of Company Secretaries of India
- xi. The Indian Banks Association
- xii. Industry organizations such as Federation of Indian Chambers of Commerce and Industry, Associated Chambers of Commerce, Confederation of Indian Industry
- xiii. Indian Institute(s) of Management
- xiv. The Telecom Regulatory Authority of India
- xv. The Standing Conference on Public Enterprises
- xvi. Recognised stock exchanges in India
- xvii. Any other body considered relevant by the AASB keeping in view the nature and requirement of AAS/Statement.

19. To allow adequate time for due consideration and comment from all interested parties, exposure period is ordinarily 45 (forty five) days or such other period, but not less than 45 days in any case, as may be decided by the AASB. Further, the exposure period would be reckoned from the date of hosting of the Exposure Draft on the website of the Institute.

Responses to Exposure Drafts and Consideration of Respondents' Comments

20. An acknowledgement is sent to every respondent to an Exposure Draft. Except where the respondent has specifically indicated otherwise, the respondents' comments are considered a matter of public records. Comments which are received upto ten days prior to the date of the AASB meeting at which such comments are proposed to be considered, are hosted on the website of the AASB and kept there till the date of the AASB meeting at which the Exposure Draft and comments thereon are considered. The members of the AASB as well as the Council of the Institute are notified when the comments are hosted on the website of the AASB. Copies of the Exposure Draft and comment letters are also made available to the AASB members at the AASB meeting at which the Exposure Draft is scheduled for discussion.

21. The comments and suggestions received within the exposure period are read and considered by the AASB. The AASB's deliberations on the significant issues raised in the comments letters received together with the AASB's decision thereon are recorded in the minutes of the relevant AASB meeting and also hosted on the website of the AASB. The AASB may decide to discuss with the respondents their comment letters or explain to them the reasons for not having accepted their proposals. The nature and outcome of such discussions are reported and recorded in the minutes of the relevant AASB meeting.

22. Such part of the AASB meetings whereat the Exposure Draft of proposed Standard/ Statement and the comments thereon are to be discussed is open for public. The members of the public, at their own expenditure, can attend the said part of the meeting(s) as observers. Such observers, however, do not have the right to participate in the discussions at the meeting. The notification as to the date of the said AASB meeting is hosted on the website of the Institute at least 30 days in advance and the members of the public desirous of attending the said meeting(s) are required to send their request for the same to the Board at least 15 days prior to the date of the concerned AASB meeting. The seats for the members of the public at such meetings are limited to such numbers as may be decided by the AASB and allotted on a first come first serve basis. The AASB may also hold a meeting with the representatives of the specified bodies, as may be identified by the Board on a case to case basis, to ascertain their views on the draft of the proposed Standard/ Statement.

23. After taking into consideration the comments received, the draft of the proposed Standard/ Statement is finalized by the AASB and submitted to the Council of the ICAI for its consideration and approval. The draft of

the General Clarification, as finalised by the AASB, is submitted to the Council of ICAI for its consideration and approval.

24. The Council of the ICAI considers the final draft of the proposed Standard/ Statement/General Clarification, and if found necessary, modifies the same in consultation with AASB. The concerned Standard/ Statement/ General Clarification is then issued under the authority of the Council of the ICAI.

Re-exposure

25. The AASB on a direction from the Council of the ICAI or on its own, in cases considered appropriate, may re-expose a proposed Standard/ Statement. The need for re-exposure may arise on account of factors such as significant issues coming to the notice of the Board subsequently, including, significant changes in the laws or regulations having an impact on the requirements of the Standard/ Statement or revision of the corresponding International Standard by IAASB. In cases where a re-exposure of a Standard or a Statement is required, the procedures as listed in paragraphs 12 to 24 are followed.

Procedure for Issuing the Guidance Notes

26. The AASB identifies the issues on which Guidance Notes need to be formulated and the priority in regard to selection thereof.

27. In the preparation of the Guidance Note, the AASB is assisted by Study Groups/Task Forces constituted to consider specific projects. The AASB appoints one of the professional accountants as a convenor of the Study Group / Task Force. The Convenor nominates other members of the Study Group/Task Force and in the formation of Study Groups / Task Forces, provision is made for participation of a cross-section of members of the ICAI. In situations considered necessary, the Board may also consider having an outside expert on such Study Groups/Task Forces and such "expert" need not necessarily be a professional accountant. The Study Group/Task Force will be responsible for preparing the basic draft of the Guidance Note.

28. The Study Group/Task Force develops the preliminary draft of the Guidance Note based on appropriate research and consultation, which may include, depending on the circumstances, consulting with the other professionals, regulators and other interested parties, as well as reviewing professional pronouncements issued by IFAC member bodies and other parties and submits the preliminary draft Guidance Note to the AASB. The draft Guidance Note, along with the background papers, if any, is sent to the Chairman, AASB for approval.

29. The AASB considers the preliminary draft prepared by the Study Group/Task Force and may refer the same to the Study Group/Task Force to examine the issues arising out of the deliberations of the AASB and accordingly modify the draft Guidance Note. The modified Draft Guidance Note is once again considered by the Board. The draft Guidance Note as finalised by the Board is submitted for the consideration of the Council of the ICAI.

30. Unlike Standards/Statements, ordinarily, no proposed Guidance Note is exposed for comments of the professional accountants and others. However, in situations considered necessary by the Board, an Exposure Draft of a Guidance Note may well be issued for public comments. In case an Exposure Draft of a Guidance Note is to be issued, the same procedures as required for an Exposure Draft of the Standard/ Statement (as mentioned in paragraphs 17 to 22 above) is required to be followed. The reasons for issuing an Exposure Draft of the Guidance Note are recorded in the minutes of the relevant AASB meeting. However, the part of the AASB meeting at such Exposure Draft is considered is not open for public.

31. The Council of the Institute considers the final draft of the proposed Guidance Note and, if necessary, suggests modifications thereto in consultation with the AASB. The Guidance Note is then issued under the authority of the Council of the ICAI.

Limited or Substantive Revision to the Standard, Statement or Guidance Note

32. Subsequent to issuance of a Standard, Statement or Guidance Note, the introduction of any new legal or professional requirement or any other national or international development in the field of auditing, may require a substantive revision to that Standard, Statement or Guidance Note. In that case, the Council of the ICAI makes substantive revision to such Standard/ Statement /Guidance Note. The procedure followed for substantive revision is the same as that followed for formulation of a new Standard, Statement or the Guidance Note, as the case may be, as detailed above.

33. Similarly, subsequent to issuance of a Standard, Statement or Guidance Note, some aspect(s) may require revision which are not substantive in nature. For this purpose, the Council of the ICAI may make limited revision to a Standard/ Statement /Guidance Note. In case of the Standards on Auditing (SAs), any revision to a Standard is treated as limited only if that revision is restricted to the application guidance of that Standard. The procedure followed for the limited revision is, in principle, the same as that followed for formulation of a Standard, Statement or Guidance Note, as the case may be. However, the AASB may decide to cut short some time limits, e.g. period of public exposure in case of a limited revision to a Standard/Statement, as detailed above, for the process.

Technical Guides, Practice Manuals, Studies and Other Papers Published by the Auditing and Assurance Standards Board

34. For issuance of a Technical Guides/Studies, etc., the procedure adopted by the AASB is ordinarily the same as in case of a Guidance Note except that the draft Technical Guide/ Practice Manual/ Study is not exposed for public comments nor such part of the AASB meeting at which the proposed Technical Guide, Practice Manual, etc., is considered, open for public. Also, since the Technical Guides, Practice Manuals, Studies, etc., are not issued under the authority of the Council, these are not required to be placed for consideration and final approval of the Council, and are issued by the AASB under its own authority.

Voting

35. The affirmative votes of a majority of the members of the Board, in person or by simultaneous telecommunication link, are required to approve the final draft of a Standard or Statement for submission to the Council.

36. Each member of the AASB has the right to one vote.

Glossary of Terms*

Access controls - Procedures designed to restrict access to on-line terminal devices, programs and data. Access controls consist of “user authentication” and “user authorization.” “User authentication” typically attempts to identify a user through unique logon identifications, passwords, access cards or biometric data. “User authorization” consists of access rules to determine the computer resources each user may access. Specifically, such procedures are designed to prevent or detect:

- (a) Unauthorized access to on-line terminal devices, programs and data;
- (b) Entry of unauthorized transactions;
- (c) Unauthorized changes to data files;
- (d) The use of computer programs by unauthorized personnel; and
- (e) The use of computer programs that have not been authorized.

Accounting estimate - An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where SA 540¹ addresses only accounting estimates involving measurement at fair value, the term “fair value accounting estimates” is used.

Accounting records - The records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

Accuracy Assertion - Amounts and other data relating to recorded transactions and events have been recorded appropriately.

Agreed-upon procedures engagement - An engagement in which an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. The recipients of the report form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures may misinterpret the results.

Analytical procedures - Evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Annual report - A document issued by an entity, ordinarily on an annual basis, which includes its financial statements together with the auditor's report thereon.

Anomaly - A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

Applicable financial reporting framework - The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

*Definitions given in this Glossary should be read in the context of the respective Standards where they are appearing.

¹ SA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”.

The term “fair presentation framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (a) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (b) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (a) or (b) above.

Application controls in information technology - Manual or automated procedures that typically operate at a business process level. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data.

Applied criteria (in the context of SA 810²) - The criteria applied by management in the preparation of the summary financial statements.

Appropriateness (of audit evidence) - The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.

Arm’s length transaction - A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

Assertion-based Engagements - In some assurance engagements, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users. These engagements are called “assertion-based engagements”.

Assertions - Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

Assess - Analyze identified risks of to conclude on their significance. “Assess,” by convention, is used only in relation to risk. (also see *Evaluate*) Association - (see *Auditor association with financial information*)

Assurance - (see *Reasonable assurance*)

Assurance engagement - An engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria (also see *Subject matter information*). Under the “Framework for Assurance Engagements” issued by the Institute of Chartered Accountants of India there are two types of assurance engagement a practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement.

² SA 810, “Engagements to Report on Summary Financial Statements.”

Reasonable assurance engagement—The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement³ as the basis for a positive form of expression of the practitioner's conclusion.

Limited assurance engagement—The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

Assurance engagement risk - The risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated.

Audit documentation - The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as “working papers” or “workpapers” are also sometimes used).

Audit evidence - Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. (See *Sufficiency of audit evidence* and *Appropriateness of audit evidence*.)

Audit file - One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

Audit firm - (see *Firm*)

Audit opinion - (see *Modified opinion* and *Unmodified opinion*)

Audit risk - The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

Audit sampling (sampling) - The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

Audited financial statements (in the context of SA 810) - Financial statements⁴ audited by the auditor in accordance with SAs, and from which the summary financial statements are derived.

Auditor - “Auditor” is used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an SA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term “engagement partner” rather than “auditor” is used.

Auditor association with financial information - An auditor is associated with financial information when the auditor attaches a report to that information or consents to the use of the auditor's name in a professional connection.

Auditor's expert - An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.

³ Engagement circumstances include the terms of the engagement, including whether it is a reasonable assurance engagement or a limited assurance engagement, the characteristics of the subject matter, the criteria to be used, the needs of the intended users, relevant characteristics of the responsible party and its environment, and other matters, for example events, transactions, conditions and practices, that may have a significant effect on the engagement.

⁴ SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing,” paragraph 13(f), defines the term “financial statements.”

Auditor's point estimate or auditor's range - The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.

Auditor's range - (see *Auditor's point estimate*)

Block Selection - Block selection involves selection of a block(s) of contiguous items from within the population.

Business risk - A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

Capabilities (of management's expert) - Capability relates to the ability of the management's expert to exercise that competence in the circumstances.

Classification assertion - Transactions and events have been recorded in the proper accounts.

Comparative financial statements - Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

Comparative information - The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

Competence (of management's expert) - Competence relates to the nature and level of expertise of the management's expert.

Compilation engagement - An engagement in which accounting expertise, as opposed to auditing expertise, is used to collect, classify and summarize financial information.

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

Completeness Assertion - All transactions and events that should have been recorded have been recorded.

Completion memorandum - A summary that describes the significant matters identified during the audit and how they were, or that includes cross reference to other relevant supporting audit documentation that provides such information.

Compliance framework - (see *Applicable financial reporting framework* and *General purpose framework*)

Component - An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.

Component auditor - An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

Component management - Management responsible for the preparation of the financial information of a component.

Component materiality - The materiality for a component determined by the group engagement team.

Computer-assisted audit techniques - Applications of auditing procedures using the computer as an audit tool (also known as CAATs).

Control activities - Those policies and procedures that help ensure that management directives are carried out. Control activities are a component of internal control.

Control environment - Includes the governance and management functions and the attitudes, awareness and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment is a component of internal control.

Control risk - The risk that a material misstatement that could occur will not be prevented, or detected or corrected, on a timely basis by related internal controls (see *Risk of material misstatement*)

Corresponding figures—Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures”). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

Corporate governance - (see *Governance*)

Capabilities (of management's expert) - Capability relates the ability of the management's expert to exercise that competence in the circumstances.

Criteria - The benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Criteria can be formal or less formal. There can be different criteria for the same subject matter. Suitable criteria are required for reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment.

Suitable criteria—Exhibit the following characteristics:

- (a) *Relevance*: relevant criteria contribute to conclusions that assist decision-making by the intended users.
- (b) *Completeness*: criteria are sufficiently complete when relevant factors that could affect the conclusions in the context of the engagement circumstances are not omitted. Complete criteria include, where relevant, benchmarks for presentation and disclosure.
- (c) *Reliability*: reliable criteria allow reasonably consistent evaluation or measurement of the subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by similarly qualified practitioners.
- (d) *Neutrality*: neutral criteria contribute to conclusions that are free from bias.
- (e) *Understandability*: understandable criteria contribute to conclusions that are clear, comprehensive, and not subject to significantly different interpretations.

Cut-off Assertion - Transactions and events have been recorded in the correct accounting period.

Date of approval of the financial statements - The date on which all the statements that comprise the financial statements, have been prepared and those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Date of report (in relation to quality control) - The date selected by the practitioner to date the report.

Date of the auditor's report - The date the auditor dates the report on the financial statements in accordance with Revised SA 700.⁵

Date of the financial statements—The date of the end of the latest period covered by the financial statements.

⁵ SA 700 (Revised), “Forming an Opinion and Reporting on Financial Statements.”

Date the financial statements are issued - The date that the auditor's report and audited financial statements are made available to third parties.

Deficiency in internal control - This exists when:

- (a) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
- (b) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

Detection risk - The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Direct Reporting Engagements - In other assurance engagements, the practitioner either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report. These engagements are called "direct reporting engagements".

Documentation of the audit plan - A record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks.

Documentation of the overall audit strategy - A record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

Element - (see *Element of a financial statement*)

Element of a financial statement (in the context of SA 805⁶)— An element, account or item of a financial statement.

Emphasis of Matter paragraph - A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Engagement documentation— The record of work performed, results obtained, and conclusions the practitioner reached (terms such as "working papers" or "workpapers" are sometimes used). The documentation for a specific engagement is assembled in an engagement file.

Engagement letter - Written terms of an engagement in the form of a letter.

Engagement partner - The partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

Engagement quality control review - A process designed to provide an objective evaluation, before the date of the report, of the significant judgments the engagement team made and the conclusions it reached in formulating the report.

Engagement quality control reviewer- A partner, other person⁷ in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating

⁶ SA 805, "Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement."

⁷ Such other person should be a member of the Institute of Chartered Accountants of India.

the report. However, in case the review is done by a team of individuals, such tem should be headed by a member of the Institute.

Engagement team - All personnel performing the engagement, including any experts contracted by the firm in connection with that engagement.⁸

Entity's risk assessment process - A component of internal control that is the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.

Environmental matters - (a) Initiatives to prevent, abate, or remedy damage to the environment, or to deal with conservation of renewable and non-renewable resources (such initiatives may be required by environmental laws and regulations or by contract, or they may be undertaken voluntarily);

(b) Consequences of violating environmental laws and regulations;

(c) Consequences of environmental damage done to others or to natural resources; and

(d) Consequences of vicarious liability imposed by law (for example, liability for damages caused by previous owners).

Environmental performance report - A report, separate from the financial statements, in which an entity provides third parties with qualitative information on the entity's commitments towards the environmental aspects of the business, its policies and targets in that field, its achievement in managing the relationship between its business processes and environmental risk, and quantitative information on its environmental performance.

Environmental risk - In certain circumstances, factors relevant to the assessment of inherent risk for the development of the overall audit plan may include the risk of material misstatement of the financial statements due to environmental matters.

Error - An unintentional misstatement in financial statements, including the omission of an amount or a disclosure.

Estimation uncertainty - The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

Evaluate - Identify and analyze the relevant issues, including performing further procedures as necessary, to come to a specific conclusion on a matter. "Evaluation," by convention, is used only in relation to a range of matters, including evidence, the results of procedures and the effectiveness of management's response to a risk. (also see Assess)

Exception - A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

Existence Assertion - Assets, liabilities, and equity interests exist.

Experienced auditor - An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:

(a) Audit processes;

(b) SAs and applicable legal and regulatory requirements;

(c) The business environment in which the entity operates; and

(d) Auditing and financial reporting issues relevant to the entity's industry.

⁸ SA 620, "Using the Work of an Auditor's Expert," paragraph 6(a), defines the term "auditor's expert".

Expert - (see *Auditor's expert* and *Management's expert*)

Expertise - Skills, knowledge and experience in a particular field.

Extent of Audit Procedure - Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity.

External confirmation - Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

Fair presentation framework - (see *Applicable financial reporting framework* and *General purpose framework*)

Financial Reporting Standards - Means the Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, or the Accounting Standards for Local Bodies issued by the ICAI, as may be applicable.

Financial statements - A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but it can also refer to a single financial statement.

Firm - A sole practitioner/proprietor, partnership or any such entity of professional accountants, as may be permitted by law.

Forecast - Prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions).

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

Fraud risk factors - Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Fraudulent financial reporting - Involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users.

General IT-controls - Policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General IT-controls commonly include controls over data center and network operations; system software acquisition, change and maintenance; access security; and application system acquisition, development, and maintenance.

General purpose financial statements - Financial statements prepared in accordance with a general purpose framework.

General purpose framework - A financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.

The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (a) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (b) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (a) or (b) above.⁹

Governance - Describes the role of person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity.

Group - All the components whose financial information is included in the group financial statements. A group always has more than one component.

Group audit - The audit of group financial statements.

Group audit opinion - The audit opinion on the group financial statements.

Group engagement partner - The partner or other person in the firm who is responsible for the group audit engagement and its performance, and for the auditor’s report on the group financial statements that is issued on behalf of the firm. Where joint auditors conduct the group audit, the joint engagement partners and their engagement teams collectively constitute the group engagement partner and the group engagement team.

Group engagement team - Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

Group financial statements - Financial statements that include the financial information of more than one component. The term “group financial statements” also refers to combined financial statements aggregating the financial information prepared by components that have no parent but are under common control.

Group management - Management responsible for the preparation of the group financial statements.

Group-wide controls - Controls designed, implemented and maintained by group management over group financial reporting.

Haphazard Selection - Haphazard selection is a sample selection method in which the auditor selects the sample without following a structured technique.

Historical financial information - Information expressed in financial terms in relation to a particular entity, derived primarily from that entity’s accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

Inconsistency - Other information that contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor’s opinion on the financial statements.

Independence - Comprises:

- (a) Independence of mind—the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

⁹ SA 200, paragraph 13(a).

(b) Independence in appearance—the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

Information system relevant to financial reporting - A component of internal control that includes the financial reporting system, and consists of the procedures and records designed and established to

- Initiate, record, process and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities and equity.
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- Process and account for system overrides or bypasses to controls;
- Transfer information from transaction processing systems to the general ledger;
- Capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables; and
- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized and appropriately reported in the financial statements.

Inherent risk - (see *Risk of material misstatement*)

Initial audit engagement - An engagement in which either:

- (a) The financial statements for the prior period were not audited; or
- (b) The financial statements for the prior period were audited by a predecessor auditor.

Inquiry - Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity.

Inspection (as an audit procedure) - Examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.

Inspection (in relation to quality control) - In relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.

Intended users - The person, persons or class of persons for whom the practitioner prepares the assurance report. The responsible party can be one of the intended users, but not the only one.

Interim financial information or statements - Financial information that is prepared and presented in accordance with an applicable financial reporting framework and comprises either a complete or a condensed set of financial statements for a period that is shorter than the entity's financial year.

Internal audit function - An appraisal activity established or provided as a service to the entity. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control.

Internal auditors - Those individuals who perform the activities of the internal audit function. Internal auditors may belong to an internal audit department or equivalent function.

Internal control - The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.

International Financial Reporting Standards - The International Financial Reporting Standards issued by the International Accounting Standards Board.

Investigate - Inquire into matters arising from other procedures to resolve them.

IT environment - The policies and procedures that the entity implements and the IT infrastructure (hardware, operating systems, etc.) and application software that it uses to support business operations and achieve business strategies.

Limited assurance engagement - (see *Assurance engagement*)

Listed entity - An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are traded under the regulations of a recognized stock exchange or other equivalent body.

Material Weakness - A weakness in internal control that could have a material effect on the financial statements.

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.

Management bias - A lack of neutrality by management in the preparation and presentation of information.

Management's expert - An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

Management's point estimate - The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate

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

Misstatement - A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Where the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

Misstatement of fact - Other information that is unrelated to matters appearing in the audited financial statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.

Modified opinion - A qualified opinion, an adverse opinion or a disclaimer of opinion.

Monitoring (in relation to quality control) - A process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to provide the firm with reasonable assurance that its system of quality control is operating effectively.

Monitoring of controls - A process to assess the effectiveness of internal control performance over time. It includes assessing the design and operation of controls on a timely basis and taking necessary remedial actions modified for changes in conditions. Monitoring of controls is a component of internal control.

Monetary Unit Sampling - Monetary Unit Sampling is a type of value-weighted sample selection method in which sample size, selection and evaluation results in a conclusion in monetary amounts.

Nature of Audit Procedure - The nature of an audit procedure refers to its purpose (i.e., test of controls or substantive procedures) and its type (i.e., inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure).

Negative confirmation request - A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

Network - A larger structure:

- (a) That is aimed at cooperation, and
- (b) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.

Network firm - A firm or entity that belongs to a network.

Non-compliance (in the context of SA 250¹⁰) - Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

Non-response - A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Non-sampling risk - The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

Objectivity (of management's expert) - Objectivity relates to the possible effects that bias, conflict of interest or the influence of others may have on the professional or business judgment of the management's expert.

Observation - Consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities.

Occurrence Assertion - Transactions and events that have been recorded have occurred and pertain to the entity.

Opening balances - Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

Other information - Financial and non-financial information (other than the financial statements and the auditor's report thereon) which is included, either by law, regulation, or custom, in a document containing audited financial statements and the auditor's report thereon.

Other Matter paragraph - A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Outcome of an accounting estimate - The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.

Outcome of the evaluation or measurement of a subject matter - The information that results from applying the criteria to the subject matter.

¹⁰ SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements".

Overall audit strategy - Sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

Partner - Any individual with authority to bind the firm with respect to the performance of a professional services engagement.

Performance materiality - The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Personnel - Partners and staff.

Pervasive - A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

- (a) Are not confined to specific elements, accounts or items of the financial statements;
- (b) If so confined, represent or could represent a substantial proportion of the financial statements; or
- (c) In relation to disclosures, are fundamental to users' understanding of the financial statements.

Population - The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

Positive confirmation request - A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

Practitioner - A professional accountant in public practice.

Practitioner's Association with Subject Matter - A practitioner is associated with a subject matter when the practitioner reports on information about the subject matter or consents to the use of the practitioner's name in a professional connection with that subject matter.

Preconditions for an audit - The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise¹¹ on which an audit is conducted.

Predecessor auditor - The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted - That management and, where appropriate, those charged with governance have acknowledged and understand that they have the following responsibilities that are fundamental to the conduct of an audit in accordance with ISAs. That is, responsibility:

- (a) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
- (b) For such internal control as management and, where appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

¹¹ SA 200, paragraph 13(j).

- (c) To provide the auditor with:
- (i) Access to all information of which management and, where appropriate, those charged with governance are aware that is relevant to the preparation of the financial statements such as records,
 - (ii) documentation and other matters;
 - (iii) Additional information that the auditor may request from management and, where appropriate, those charged with governance for the purpose of the audit; and
 - (iv) Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

In the case of a fair presentation framework, (a) above may be restated as “for the preparation and *fair* presentation of the financial statements in accordance with the financial reporting framework,” or “for the preparation of financial statements *that give a true and fair view* in accordance with the financial reporting framework.”

The “premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted” may also be referred to as the “premise.”

Professional accountant - Member of the Institute of Chartered Accountants of India.

Professional accountant in public practice - Refers to the member of the Institute of Chartered Accountants of India who is in practice in terms of section 2 of the Chartered Accountants Act, 1949. The term is also used to refer to a firm of chartered accountants in public practice.

Professional judgment - The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

Professional skepticism - An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence.

Professional standards - Engagement Standards as defined in the AASB’s “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, and relevant ethical requirements as contained in the Code.

Projection - Prospective financial information prepared on the basis of:

- (a) Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or
- (b) A mixture of best-estimate and hypothetical assumptions.

Prospective financial information - Financial information based on assumptions about events that may occur in the future and possible actions by an entity. It is highly subjective in nature and its preparation requires exercise of considerable judgment. Prospective financial information can be in the form of a forecast, a projection or a combination of both. (See *Forecast and Projection*)

Public sector - National governments, regional (for example, state, provincial, territorial) governments, local (for example, city, town) governments and related governmental entities (for example, agencies, boards, commissions and enterprises).

Random Selection - It is a sample selection method involving application of random number generators, for example, random number tables.

Reasonable assurance (in the context of assurance engagements, including audit engagements, and quality control) - A high, but not absolute, level of assurance.

Reasonable assurance engagement - (see *Assurance engagement*)

Recalculation - Consists of checking the mathematical accuracy of documents or records.

Related party - A party that is either:

- (a) A related party as defined in the applicable financial reporting framework; or
- (b) Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - (i) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
 - (ii) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
 - (iii) Another entity that is under common control with the reporting entity through having:
 - a. Common controlling ownership;
 - b. Owners who are close family members; or
 - c. Common key management.

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

Related services - Comprise agreed-upon procedures and compilations.

Relevant ethical requirements - Ethical requirements to which the engagement team and engagement quality control reviewer are subject, which ordinarily comprise Code of Ethics issued by Institute of Chartered Accountants of India (ICAI) together with other relevant pronouncements issued by the Institute.

Reperformance - The auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal controls.

Report on the description and design of controls at a service organization (referred to in SA 402¹² (Revised) as a Type 1 report) - A report that comprises:

- (a) A description, prepared by management of the service organization, of the service organization's system, control objectives and related controls that have been designed and implemented as at a specified date; and
- (b) A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organization's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.

Report on the description, design, and operating effectiveness of controls at a service organization (referred to in SA 402) as a Type 2 report) - A report that comprises:

- (a) A description, prepared by management of the service organization, of the service organization's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and
- (b) A report by the service auditor with the objective of conveying reasonable assurance that includes:

¹² SA 402, "Audit Considerations Relating to an Entity Using a Service Organization".

- (i) The service auditor's opinion on the description of the service organization's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
- (ii) A description of the service auditor's tests of the controls and the results thereof.

Responsible party - The person (or persons) who:

- (a) In a direct reporting engagement, is responsible for the subject matter; or
- (b) In an assertion-based engagement, is responsible for the subject matter information (the assertion), and may be responsible for the subject matter.

The responsible party may or may not be the party who engages the practitioner (the engaging party).

Review (in relation to quality control) - Appraising the quality of the work performed and conclusions reached by others.

Review engagement - The objective of a review engagement is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework.

Review procedures - The procedures deemed necessary to meet the objective of a review engagement, primarily inquiries of entity personnel and analytical procedures applied to financial data.

Rights and Obligations Assertion - The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

Risk assessment procedures - The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Risk of material misstatement - The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

- (a) Inherent risk—The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
- (b) Control risk—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Sampling - (see *Audit sampling*)

Sampling risk - 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:

- (a) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a 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.
- (b) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a 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.

Sampling unit - The individual items constituting a population.

Scope of a review - The review procedures deemed necessary in the circumstances to achieve the objective of the review.

Service auditor - An auditor who, at the request of the service organization, provides an assurance report on the controls of a service organization.

Service organization - A third-party organization (or segment of a third-party organization) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

Service organization's system - The policies and procedures designed, implemented and maintained by the service organization to provide user entities with the services covered by the service auditor's report.

Significance - The relative importance of a matter, taken in context. The significance of a matter is judged by the practitioner in the context in which it is being considered. This might include, for example, the reasonable prospect of its changing or influencing the decisions of intended users of the practitioner's report; or, as another example, where the context is a judgment about whether to report a matter to those charged with governance, whether the matter would be regarded as important by them in relation to their duties. Significance can be considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and effect on the subject matter and the expressed interests of intended users or recipients.

Significant component - A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

Significant deficiency in internal control - A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

Significant risk - An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

Single financial statement (for example, a cash flow statement) or to a specific element of a financial statement (for example, cash and bank balances) - Includes the related notes. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the financial statement or to the element.

Smaller entity - An entity which typically possesses qualitative characteristics such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
- (b) One or more of the following:
 - (i) Straightforward or uncomplicated transactions;
 - (ii) Simple record-keeping;
 - (iii) Few lines of business and few products within business lines;
 - (iv) Few internal controls;
 - (v) Few levels of management with responsibility for a broad range of controls; or
 - (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

Special purpose financial statements - Financial statements prepared in accordance with a special purpose framework.

Special purpose framework - A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.¹³

Staff - Professionals, other than partners, including any experts the firm employs.

Statistical sampling - An approach to sampling that has the following characteristics:

- (a) Random selection of the sample items; and
- (b) The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (a) and (b) is considered non-statistical sampling.

Stratification - The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

Subject matter information - The outcome of the evaluation or measurement of a subject matter. It is the subject matter information about which the practitioner gathers sufficient appropriate evidence to provide a reasonable basis for expressing a conclusion in an assurance report.

Subsequent events - Events occurring between the date of the 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.

Subservice organization - A service organization used by another service organization to perform some of the services provided to user entities that are part of those user entities' information systems relevant to financial reporting.

Substantive procedure - An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

- (a) Tests of details (of classes of transactions, account balances, and disclosures); and
- (b) Substantive analytical procedures.

Sufficiency (of audit evidence) - The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

Suitable criteria - (see *Criteria*)

Suitably qualified external person - An individual outside the firm with the competence and capabilities to act as an engagement partner, for example a partner of another firm, or an employee (with appropriate experience) of another firm.

Summary financial statements (in the context of ISA 810) - Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time.¹⁴ Different jurisdictions may use different terminology to describe such historical financial information.

¹³ SA 200, paragraph 13(a).

¹⁴ SA 200, paragraph 13(f).

Supplementary information - Information that is presented together with the financial statements that is not required by the applicable financial reporting framework used to prepare the financial statements, normally presented in either supplementary schedules or as additional notes.

Systematic Selection - Systematic selection is a sample selection method, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.

Test - The application of procedures to some or all items in a population.

Tests of controls - An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Those charged with governance - The person(s) or organization(s) (for example, 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 in some jurisdictions, 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.¹⁵

Timing of Audit Procedure - Timing of an audit procedure refers to when it is performed, or the period to date to which the audit evidence applies.

Tolerable misstatement - A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

Total rate of deviation - A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Uncertainty - A matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

Uncorrected misstatements - Misstatements that the auditor has accumulated during the audit and that have not been corrected.

Unmodified opinion - The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.¹⁶

User auditor - An auditor who audits and reports on the financial statements of a user entity.

User entity - An entity that uses a service organization and whose financial statements are being audited.

Valuation and Allocation Assertion - Assets, liabilities and equity interest are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Walk-through test - Involves tracing a few transactions through the financial reporting system.

¹⁵ For discussion of the diversity of governance structures, see paragraphs A1-A8 of SA 260, "Communication with Those Charged with Governance."

¹⁶ SA 700 (Revised), paragraphs 35-36, deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

Written representation - A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

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*

(Effective for all engagements relating to accounting periods beginning on or after April 1, 2009)

Introduction

1. The purpose of this Standard on Quality Control (SQC) is to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for audits and reviews of historical financial information, and for other assurance and related services engagements. This SQC is to be read in conjunction with the requirements of the Chartered Accountants Act, 1949, the Code of Ethics and other relevant pronouncements of the Institute¹ (hereinafter referred to as "the Code").
2. Additional standards and guidance on the responsibilities of firm personnel regarding quality control procedures for specific types of engagements are set out in other pronouncements of the Auditing and Assurance Standards Board (AASB) issued under the authority of the Council. For example, Standard on Auditing (SA) 220, "Quality Control for an Audit of Financial Statements", establishes standards and provides guidance on quality control procedures for audits of historical financial information.
3. **The firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm² or engagement partner(s) are appropriate in the circumstances.**
4. A system of quality control consists of policies designed to achieve the objectives set out in paragraph 3 and the procedures necessary to implement and monitor compliance with those policies.
5. This SQC applies to all firms. The nature of the policies and procedures developed by individual firms to comply with this SQC will depend on various factors such as the size and operating characteristics of the firm, and whether it is part of a network.

Definitions

6. In this SQC, the following terms have the meanings attributed below:
 - (a) *Engagement documentation* – the record of work performed, results obtained, and conclusions the practitioner reached (terms such as "working papers" or "workpapers" are also sometimes used). The documentation for a specific engagement is assembled in an engagement file;
 - (b) *Engagement partner* – the partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
 - (c) *Engagement quality control review* – a process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.

* Published in October, 2007 issue of the Journal.

¹ Attention of the members is invited, for instance, to the *Guidance Note on Independence of Auditors*, issued by the Committee on Ethical Standards.

² It is clarified that in India the reports are not issued/signed in the firm's name, rather they are issued/signed on behalf of the firm by the sole practitioner, proprietor or a partner of the firm, as the case may be, in his individual name. The definition of a 'firm' has been given in paragraph 6(f) of this Standard.

- (d) *Engagement quality control reviewer* – a partner, other person³ in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report. However, in case the review is done by a team of individuals, such team should be headed by a member of the Institute.
- (e) *Engagement team* – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.
- (f) *Firm* – a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.
- (g) *Inspection* – in relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.
- (h) *Listed entity* – an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are traded under the regulations of a recognized stock exchange or other equivalent body.
- (i) *Monitoring* – a process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively.
- (j) *Network firm* – A firm or entity that belongs to a network.
- (k) *Network* – A larger structure:
 - (i) That is aimed at cooperation, and
 - (ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.
- (l) *Partner* – any individual with authority to bind the firm with respect to the performance of a professional services engagement.
- (m) *Personnel* – partners and staff.
- (n) *Professional standards* – engagement standards, as defined in the AASB's "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," and relevant ethical requirements as contained in the Code.
- (o) *Reasonable assurance* – in the context of this SQC, a high, but not absolute, level of assurance.
- (p) *Staff* – professionals, other than partners, including any experts which the firm employs.
- (q) *Suitably qualified external person* – an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner or an employee⁴ (with appropriate experience) of another firm.

Elements of a System of Quality Control

7. The firm's system of quality control should include policies and procedures addressing each of

³ Such other person should be a member of the Institute of Chartered Accountants of India.

⁴ Such employee should be a member of the Institute of Chartered Accountants of India.

the following elements:

- (a) Leadership responsibilities for quality within the firm.
- (b) Ethical requirements.
- (c) Acceptance and continuance of client relationships and specific engagements.
- (d) Human resources.
- (e) Engagement performance.
- (f) Monitoring.

8. **The quality control policies and procedures should be documented and communicated to the firm's personnel.** Such communication describes the quality control policies and procedures and the objectives they are designed to achieve, and includes the message that each individual has a personal responsibility for quality and is expected to comply with these policies and procedures. In addition, the firm recognizes the importance of obtaining feedback on its quality control system from its personnel. Therefore, the firm encourages its personnel to communicate their views or concerns on quality control matters.

Leadership Responsibilities for Quality within the Firm

9. **The firm should establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Such policies and procedures should require the firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing partners (or equivalent), to assume ultimate responsibility for the firm's system of quality control.**

10. The firm's leadership and the examples it sets significantly influence the internal culture of the firm. The promotion of a quality-oriented internal culture depends on clear, consistent and frequent actions and messages from all levels of the firm's management emphasizing the firm's quality control policies and procedures, and the requirement to:

- (a) Perform work that complies with professional standards and regulatory and legal requirements; and
- (b) Issue reports that are appropriate in the circumstances.

Such actions and messages encourage a culture that recognizes and rewards high quality work. They may be communicated by training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. They are incorporated in the firm's internal documentation and training materials, and in partner and staff appraisal procedures such that they will support and reinforce the firm's view on the importance of quality and how, practically, it is to be achieved.

11. Of particular importance is the need for the firm's leadership to recognize that the firm's business strategy is subject to the overriding requirement for the firm to achieve quality in all the engagements that the firm performs. Accordingly:

- (a) The firm assigns its management responsibilities so that commercial considerations do not override the quality of work performed;
- (b) The firm's policies and procedures addressing performance evaluation, compensation, and promotion (including incentive systems) with regard to its personnel, are designed to demonstrate the firm's overriding commitment to quality; and
- (c) The firm devotes sufficient resources for the development, documentation and support of its quality control policies and procedures.

12. **Any person or persons assigned operational responsibility for the firm's quality control system by the firm's chief executive officer or managing board of partners should have sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility.**

13. Sufficient and appropriate experience and ability enables the responsible person or persons to identify and understand quality control issues and to develop appropriate policies and procedures. Necessary authority enables the person or persons to implement those policies and procedures.

Ethical Requirements

14. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

15. Ethical requirements relating to audits and reviews of historical financial information, and other assurance and related services engagements are contained in the Code. The Code establishes the fundamental principles of professional ethics, which include:

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality; and
- (e) Professional behavior.

16. The Code includes a conceptual approach to independence for assurance engagements, including aspects such as threats to independence, accepted safeguards and the public interest.

17. The firm's policies and procedures should emphasize the fundamental principles, which are reinforced in particular by (a) the leadership of the firm, (b) education and training, (c) monitoring, and (d) a process for dealing with non-compliance. Independence for assurance engagements is so significant that it is addressed separately in paragraphs 18-27 below. These paragraphs need to be read in conjunction with the Code.

Independence

18. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including experts contracted by the firm and network firm personnel), maintain independence where required by the Code. Such policies and procedures should enable the firm to:

- (a) Communicate its independence requirements to its personnel and, where applicable, to others subject to them; and
- (b) Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.

19. Such policies and procedures should require:

- (a) Engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall impact, if any, on independence requirements;
- (b) Personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken; and
- (c) The accumulation and communication of relevant information to appropriate personnel so that:
 - (i) The firm and its personnel can readily determine whether they satisfy independence requirements;
 - (ii) The firm can maintain and update its records relating to independence; and

(iii) The firm can take appropriate action regarding identified threats to independence.

20. The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for:

- (a) All who are subject to independence requirements to promptly notify the firm of independence breaches of which they become aware;
- (b) The firm to promptly communicate identified breaches of these policies and procedures to:
 - (i) The engagement partner who, with the firm, needs to address the breach; and
 - (ii) Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action; and
- (c) Prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in subparagraph (b)(ii) of the actions taken to resolve the matter, so that the firm can determine whether it should take further action.

21. Comprehensive guidance on threats to independence and safeguards, including application to specific situations are contained in the Code.

22. A firm receiving notice of a breach of independence policies and procedures promptly communicates relevant information to engagement partners, others in the firm, as appropriate and, where applicable, experts contracted by the firm and network firm personnel, for appropriate action. Appropriate action by the firm and the relevant engagement partner includes applying appropriate safeguards to eliminate the threats to independence or to reduce them to an acceptable level, or withdrawing from the engagement. In addition, the firm provides independence education to personnel who are required to be independent.

23. At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent in terms of the requirements of the Code.

24. Written confirmation may be in paper or electronic form. By obtaining confirmation and taking appropriate action on information indicating non-compliance, the firm demonstrates the importance that it attaches to independence and makes the issue current for, and visible to, its personnel.

25. The Code discusses the familiarity threat that may be created by using the same senior personnel on an assurance engagement over a long period of time and the safeguards that might be appropriate to address such a threat. **Accordingly, the firm should establish policies and procedures:**

- (a) **Setting out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time; and**
- (b) **For all audits of financial statements of listed entities, requiring the rotation of the engagement partner after a specified period in compliance with the Code.**

26. Using the same senior personnel on assurance engagements over a prolonged period may create a familiarity threat or otherwise impair the quality of performance of the engagement. Therefore, the firm should establish criteria for determining the need for safeguards to address this threat. In determining appropriate criteria, the firm considers such matters as (a) the nature of the engagement, including the extent to which it involves a matter of public interest, and (b) the length of service of the senior personnel on the engagement. Examples of safeguards include rotating the senior personnel or requiring an engagement quality control review.

27. The familiarity threat is particularly relevant in the context of financial statement audits of listed entities. **For these audits, the engagement partner should be rotated after a pre-defined period, normally not more than seven years⁵.**

Acceptance and Continuance of Client Relationships and Specific Engagements

28. The firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will undertake or continue relationships and engagements only where it:

- (a) Has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity;
- (b) Is competent to perform the engagement and has the capabilities, time and resources to do so; and
- (c) Can comply with the ethical requirements.

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

29. With regard to the integrity of a client, matters that the firm considers include, for example:

- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

30. Information on such matters that the firm obtains may come from, for example:

- Communications with existing or previous providers of professional accountancy services to the client in accordance with the Code, and discussions with other third parties.
- Inquiry of other firm personnel or third parties such as bankers, legal counsel and industry peers.

⁵ The provision of rotation of partners shall not be applicable in case the audit of listed entities is being done by a sole practitioner/proprietor. However, in order to ensure that appropriate system of quality control exists in the firm and that appropriate reports are issued in the circumstances by sole practitioners/proprietors, such practice unit(s) shall be compulsorily reviewed under the process of peer review. The complete text of the Announcement is published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

- Background searches of relevant databases.
31. In considering whether the firm has the capabilities, competence, time and resources to undertake a new engagement from a new or an existing client, the firm reviews the specific requirements of the engagement and existing partner and staff profiles at all relevant levels. Matters the firm considers include whether:
- Firm personnel have knowledge of relevant industries or subject matters;
 - Firm personnel have experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively;
 - The firm has sufficient personnel with the necessary capabilities and competence;
 - Experts are available, if needed;
 - Individuals meeting the criteria and eligibility requirements to perform engagement quality control review are available, where applicable; and
 - The firm would be able to complete the engagement within the reporting deadline.
32. The firm also considers whether accepting an engagement from a new or an existing client may give rise to an actual or perceived conflict of interest⁶. Where a potential conflict is identified, the firm considers whether it is appropriate to accept the engagement.
33. Deciding whether to continue a client relationship includes consideration of significant matters that have arisen during the current or previous engagements, and their implications for continuing the relationship. For example, a client may have started to expand its business operations into an area where the firm does not possess the necessary knowledge or expertise.
- 34. Where the firm obtains information that would have caused it to decline an engagement if that information had been available earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of:**
- (a) **The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities; and**
 - (b) **The possibility of withdrawing from the engagement or from both the engagement and the client relationship.**
35. Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship address issues that include the following:
- Discussing with the appropriate level of the client's management and those charged with its governance regarding the appropriate action that the firm might take based on the relevant facts and circumstances.
 - If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship, and the reasons for the withdrawal.
 - Considering whether there is a professional, regulatory or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
 - Documenting significant issues, consultations, conclusions and the basis for the conclusions.

⁶ Attention of the members is invited to the 'Code of Ethics' and the 'Guidance Note on Independence of Auditors' issued by the ICAI.

Human Resources

36. The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

37. Such policies and procedures address the following personnel issues:

- (a) Recruitment;
- (b) Performance evaluation;
- (c) Capabilities;
- (d) Competence;
- (e) Career development;
- (f) Promotion;
- (g) Compensation; and
- (h) Estimation of personnel needs.

Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm's engagements. The firm's recruitment processes include procedures that help the firm select individuals of integrity as well as the capacity to develop the capabilities and competence necessary to perform the firm's work.

38. Capabilities and competence are developed through a variety of methods, including the following:

- Professional education.
- Continuing professional development, including training.
- Work experience.
- Coaching by more experienced staff, for example, other members of the engagement team.

39. The continuing competence of the firm's personnel depends to a significant extent on an appropriate level of continuing professional development so that personnel maintain and also enhance their knowledge and capabilities. The firm therefore emphasizes in its policies and procedures, the need for continuing training for all levels of firm personnel, and provides the necessary training resources and assistance to enable personnel to develop and maintain the required capabilities and competence. Where internal technical and training resources are unavailable, or for any other reason, the firm may use a suitably qualified external person for that purpose.

40. The firm's performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles. In particular, the firm:

- (a) Makes personnel aware of the firm's expectations regarding performance and ethical principles;
- (b) Provides personnel with evaluation of, and counseling on, performance, progress and career development; and
- (c) Helps personnel understand that advancement to positions of greater responsibility depends, among other things, upon performance quality and adherence to ethical principles, and that failure to comply with the firm's policies and procedures may result in disciplinary action.

41. The size and circumstances of the firm will influence the structure of the firm's performance evaluation process. Smaller firms, in particular, may employ less formal methods of evaluating the performance of their personnel.

Assignment of Engagement Teams

42. The firm should assign responsibility for each engagement to an engagement partner. The firm should establish policies and procedures requiring that:

- (a) **The identity and role of the engagement partner are communicated to key members of the client's management and those charged with governance;**
- (b) **The engagement partner has the appropriate capabilities, competence, authority and time to perform the role; and**
- (c) **The responsibilities of the engagement partner are clearly defined and communicated to that partner.**

43. Policies and procedures include systems to monitor the workload and availability of engagement partners so as to enable these individuals to have sufficient time to adequately discharge their responsibilities.

44. The firm should also assign appropriate staff with the necessary capabilities, competence and time to perform engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

45. The firm establishes procedures to assess its staff's capabilities and competence. The capabilities and competence considered when assigning engagement teams, and in determining the level of supervision required, include the following:

- An understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation.
- An understanding of professional standards and regulatory and legal requirements.
- Appropriate technical knowledge, including knowledge of relevant information technology.
- Knowledge of the relevant industries in which the clients operate.
- Ability to apply professional judgment.
- An understanding of the firm's quality control policies and procedures.

Engagement Performance

46. The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

47. Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Matters addressed include the following:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- Processes for complying with applicable engagement standards.
- Processes of engagement supervision, staff training and coaching.

- Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- Appropriate documentation of the work performed and of the timing and extent of the review.
- Processes to keep all policies and procedures current.

48. It is important that all members of the engagement team understand the objectives of the work they are to perform. Appropriate team-working and training are necessary to assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

49. Supervision includes the following:

- Tracking the progress of the engagement.
- Considering the capabilities and competence of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the planned approach to the engagement.
- Addressing significant issues arising during the engagement, considering their significance and appropriately modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members during the engagement.

50. Review responsibilities are determined on the basis that more experienced engagement team members, including the engagement partner, review work performed by less experienced team members. Reviewers consider whether:

- (a) The work has been performed in accordance with professional standards and regulatory and legal requirements;
- (b) Significant matters have been raised for further consideration;
- (c) Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- (d) There is a need to revise the nature, timing and extent of work performed;
- (e) The work performed supports the conclusions reached and is appropriately documented;
- (f) The evidence obtained is sufficient and appropriate to support the report; and
- (g) The objectives of the engagement procedures have been achieved.

Consultation

51. The firm should establish policies and procedures designed to provide it with reasonable assurance that:

- (a) **Appropriate consultation takes place on difficult or contentious matters;**
- (b) **Sufficient resources are available to enable appropriate consultation to take place;**
- (c) **The nature and scope of such consultations are documented; and**
- (d) **Conclusions resulting from consultations are documented and implemented.**

52. Consultation includes discussion, at the appropriate professional level, with individuals within or outside the firm who have specialized expertise, to resolve a difficult or contentious matter.

53. Consultation uses appropriate research resources as well as the collective experience and technical expertise of the firm. Consultation helps to promote quality and improves the application of professional

judgment. The firm seeks to establish a culture in which consultation is recognized as a strength and encourages personnel to consult on difficult or contentious matters.

54. Effective consultation with other professionals requires that those consulted be given all the relevant facts that will enable them to provide informed advice on technical, ethical or other matters. Consultation procedures require consultation with those having appropriate knowledge, seniority and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical and other matters, and appropriate documentation and implementation of conclusions resulting from consultations.

55. A firm needing to consult externally, for example, a firm without appropriate internal resources, may take advantage of advisory services provided by (a) other firms, or (b) professional and regulatory bodies. Before contracting for such services, the firm considers whether the external provider is suitably qualified for that purpose.

56. The documentation of consultations with other professionals that involve difficult or contentious matters is agreed by both the individual seeking consultation and the individual consulted. The documentation is sufficiently complete and detailed to enable an understanding of:

- (a) The issue on which consultation was sought; and
- (b) The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

Differences of Opinion

57. The firm should establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those consulted and, where applicable, between the engagement partner and the engagement quality control reviewer. Conclusions reached should be documented and implemented.

58. Such procedures encourage identification of differences of opinion at an early stage, provide clear guidelines as to the successive steps to be taken thereafter, and require documentation regarding the resolution of the differences and the implementation of the conclusions reached. **The report should not be issued until the matter is resolved.**

59. A firm using a suitably qualified external person(s) to conduct an engagement quality control review recognizes that differences of opinion can occur and establishes procedures to resolve such differences, for example, by consulting with another practitioner or firm, or a professional or regulatory body.

Engagement Quality Control Review

60. The firm should establish policies and procedures requiring, for appropriate engagements, an engagement quality control review that provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report. Such policies and procedures should:

- (a) **Require an engagement quality control review for all audits of financial statements of listed entities;**
- (b) **Set out criteria against which all other audits and reviews of historical financial information, and other assurance and related services engagements should be evaluated to determine whether an engagement quality control review should be performed; and**
- (c) **Require an engagement quality control review for all engagements meeting the criteria established in compliance with subparagraph (b).**

61. The firm's policies and procedures should require the completion of the engagement quality control review before the report is issued.

62. Criteria that a firm considers when determining which engagements other than audits of financial statements of listed entities are to be subject to an engagement quality control review include the following:

- The nature of the engagement, including the extent to which it involves a matter of public interest.
- The identification of unusual circumstances or risks in an engagement or class of engagements.
- Whether laws or regulations require an engagement quality control review.

63. The firm should establish policies and procedures setting out:

- (a) **The nature, timing and extent of an engagement quality control review;**
- (b) **Criteria for the eligibility of engagement quality control reviewers; and**
- (c) **Documentation requirements for an engagement quality control review.**

Nature, Timing and Extent of the Engagement Quality Control Review

64. An engagement quality control review ordinarily involves discussion with the engagement partner, a review of the financial statements or other subject matter information and the report, and, in particular, consideration of whether the report is appropriate. It also involves a review of selected working papers relating to the significant judgments that the engagement team made and the conclusions they reached. The extent of the review depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. The review does not reduce the responsibilities of the engagement partner.

65. An engagement quality control review for audits of financial statements of listed entities includes considering the following:

- The engagement team's evaluation of the firm's independence in relation to the specific engagement.
- Significant risks identified during the engagement and the responses to those risks.
- Judgments made, particularly with respect to materiality and significant risks.
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.
- Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.
- The appropriateness of the report to be issued.

Engagement quality control reviews for engagements other than audits of financial statements of listed entities may, depending on the circumstances, include some or all of these considerations.

66. The engagement quality control reviewer conducts the review in a timely manner at appropriate stages during the engagement so that significant matters may be promptly resolved to the reviewer's satisfaction before the report is issued.

67. Where the engagement quality control reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the report is not issued until the matter is resolved by following the firm's procedures for dealing with differences of opinion.

Criteria for the Eligibility of Engagement Quality Control Reviewers

68. The firm's policies and procedures should address the appointment of engagement quality control reviewers and establish their eligibility through:

- (a) **The technical qualifications required to perform the role, including the necessary experience and authority; and**
- (b) **The degree to which an engagement quality control reviewer can be consulted on the engagement without compromising the reviewer's objectivity.**

69. The firm's policies and procedures on the technical qualifications of engagement quality control reviewers address the technical expertise, experience and authority necessary to perform the role. What constitutes sufficient and appropriate technical expertise, experience and authority depends on the circumstances of the engagement. In addition, the engagement quality control reviewer for an audit of the financial statements of a listed entity is an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements of listed entities.

70. The firm's policies and procedures are designed to maintain the objectivity of the engagement quality control reviewer. For example, the engagement quality control reviewer:

- (a) Is not selected by the engagement partner;
- (b) Does not otherwise participate in the engagement during the period of review;
- (c) Does not make decisions for the engagement team; and
- (d) Is not subject to other considerations that would threaten the reviewer's objectivity.

71. The engagement partner may consult the engagement quality control reviewer during the engagement. Such consultation need not compromise the engagement quality control reviewer's eligibility to perform the role. Where the nature and extent of the consultations become significant, however, care is taken by both the engagement team and the reviewer to maintain the reviewer's objectivity. Where this is not possible, another individual within the firm or a suitably qualified external person is appointed to take on the role of either the engagement quality control reviewer or the person to be consulted on the engagement. The firm's policies provide for the replacement of the engagement quality control reviewer where the ability to perform an objective review may be impaired.

72. Suitably qualified external persons may be contracted where sole practitioners or small firms identify engagements requiring engagement quality control reviews. Alternatively, some sole practitioners or small firms may wish to use other firms to facilitate engagement quality control reviews. Where the firm contracts suitably qualified external persons, the firm follows the requirements and guidance in paragraphs 69-72.

Documentation of the Engagement Quality Control Review

73. Policies and procedures on documentation of the engagement quality control review should require documentation that:

- (a) **The procedures required by the firm's policies on engagement quality control review have been performed;**
- (b) **The engagement quality control review has been completed before the report is issued; and**
- (c) **The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.**

Engagement Documentation***Completion of the Assembly of Final Engagement Files***

74. The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized.

75. Law or regulation may prescribe the time limits by which the assembly of final engagement files for specific types of engagement should be completed. Where no such time limits are prescribed in law or regulation, the firm establishes time limits appropriate to the nature of the engagements that reflect the need to complete the assembly of final engagement files on a timely basis. In the case of an audit, for example, such a time limit is ordinarily not more than 60 days after the date of the auditor's report.

76. Where two or more different reports are issued in respect of the same subject matter information of an entity, the firm's policies and procedures relating to time limits for the assembly of final engagement files address each report as if it were for a separate engagement. This may, for example, be the case when the firm issues an auditor's report on a component's financial information for group consolidation purposes and, at a subsequent date, an auditor's report on the same financial information for statutory purposes.

Confidentiality, Safe Custody, Integrity, Accessibility and Retrievability of Engagement Documentation

77. The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.

78. Relevant ethical requirements establish an obligation for the firm's personnel to observe at all times the confidentiality of information contained in engagement documentation, unless specific client authority has been given to disclose information, or there is a legal or professional duty to do so. Specific laws or regulations may impose additional obligations on the firm's personnel to maintain client confidentiality, particularly where data of a personal nature are concerned.

79. Whether engagement documentation is in paper, electronic or other media, the integrity, accessibility or retrievability of the underlying data may be compromised if the documentation could be altered, added to or deleted without the firm's knowledge, or if it could be permanently lost or damaged. Accordingly, the firm designs and implements appropriate controls for engagement documentation to:

- (a) Enable the determination of when and by whom engagement documentation was created, changed or reviewed;
- (b) Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via the Internet;
- (c) Prevent unauthorized changes to the engagement documentation; and
- (d) Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

80. Controls that the firm may design and implement to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation include, for example:

- The use of a password among engagement team members to restrict access to electronic engagement documentation to authorized users.
- Appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement.
- Procedures for properly distributing engagement documentation to the team members at the start of engagement, processing it during engagement, and collating it at the end of engagement.
- Procedures for restricting access to, and enabling proper distribution and confidential storage of,

hardcopy engagement documentation.

81. For practical reasons, original paper documentation may be electronically scanned for inclusion in engagement files. In that case, the firm implements appropriate procedures requiring engagement teams to:

- (a) Generate scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;
- (b) Integrate the scanned copies into the engagement files, including indexing and signing off on the scanned copies as necessary; and
- (c) Enable the scanned copies to be retrieved and printed as necessary.

The firm considers whether to retain original paper documentation that has been scanned for legal, regulatory or other reasons.

Retention of Engagement Documentation

82. The firm should establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation.

83. The needs of the firm for retention of engagement documentation, and the period of such retention, will vary with the nature of the engagement and the firm's circumstances, for example, whether the engagement documentation is needed to provide a record of matters of continuing significance to future engagements. The retention period may also depend on other factors, such as whether local law or regulation prescribes specific retention periods for certain types of engagements, or whether there are generally accepted retention periods in the jurisdiction in the absence of specific legal or regulatory requirements. In the specific case of audit engagements, the retention period ordinarily is no shorter than seven years⁷ from the date of the auditor's report, or, if later, the date of the group auditor's report.

84. Procedures that the firm adopts for retention of engagement documentation include those that:

- Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation since the underlying technology may be upgraded or changed over time.
- Provide, where necessary, a record of changes made to engagement documentation after the engagement files have been completed.
- Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

Ownership of Engagement Documentation

85. Unless otherwise specified by law or regulation, engagement documentation is the property of the firm. The firm may, at its discretion, make portions of, or extracts from, engagement documentation 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 firm or its personnel.

⁷ The Council of the Institute had in August 2009, pursuant to the provisions of Rule 12 of the Chartered Accountants (Procedures of Investigations of Professional and Other Misconduct and Cases) Rules, 2007 had amended the audit documentation retention period appearing as ten years in paragraph 83 of SQC 1 to seven years. As a consequence of above decision of the Council, the audit documentation retention period appearing as ten years in paragraph A23 of SA 230, 'Audit Documentation', issued in January 2009, shall also stand amended to seven years. The complete text of the Announcement is published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

Monitoring

86. The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.

87. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

- (a) Adherence to professional standards and regulatory and legal requirements;
- (b) Whether the quality control system has been appropriately designed and effectively implemented; and
- (c) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

88. The firm entrusts responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility. Monitoring of the firm's system of quality control is performed by competent individuals and covers both the appropriateness of the design and the effectiveness of the operation of the system of quality control.

89. Ongoing consideration and evaluation of the system of quality control includes matters such as the following:

- Analysis of:
 - o New developments in professional standards and regulatory and legal requirements, and how they are reflected in the firm's policies and procedures where appropriate;
 - o Written confirmation of compliance with policies and procedures on independence;
 - o Continuing professional development, including training; and
 - o Decisions related to acceptance and continuance of client relationships and specific engagements.
- Determination of corrective actions to be taken and improvements to be made in the system, including the provision of feedback into the firm's policies and procedures relating to education and training.
- Communication to appropriate firm personnel of weaknesses identified in the system, in the level of understanding of the system, or compliance with it.
- Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

90. The inspection of a selection of completed engagements is ordinarily performed on a cyclical basis. Engagements selected for inspection include at least one engagement for each engagement partner over an inspection cycle, which ordinarily spans no more than three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, including the following:

- The size of the firm.
- The number and geographical location of offices.
- The results of previous monitoring procedures.
- The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them).

- The nature and complexity of the firm's practice and organization.
- The risks associated with the firm's clients and specific engagements.

91. The inspection process includes the selection of individual engagements, some of which may be selected without prior notification to the engagement team. Those inspecting the engagements are not involved in performing the engagement or the engagement quality control review. In determining the scope of the inspections, the firm may take into account the scope or conclusions of an independent external inspection program. However, an independent external inspection program does not act as a substitute for the firm's own internal monitoring program.

92. Small firms and sole practitioners may wish to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures. Alternatively, they may wish to establish arrangements to share resources with other appropriate organizations to facilitate monitoring activities.

93. The firm should evaluate the effect of deficiencies noted as a result of the monitoring process and should determine whether they are either:

- (a) Instances that do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with professional standards and regulatory and legal requirements, and that the reports issued by the firm or engagement partners are appropriate in the circumstances; or
- (b) Systemic, repetitive or other significant deficiencies that require prompt corrective action.

94. The firm should communicate to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.

95. The firm's evaluation of each type of deficiency should result in recommendations for one or more of the following:

- (a) Taking appropriate remedial action in relation to an individual engagement or member of personnel;
- (b) The communication of the findings to those responsible for training and professional development;
- (c) Changes to the quality control policies and procedures; and
- (d) Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.

96. Where the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement, the firm should determine what further action is appropriate to comply with relevant professional standards and regulatory and legal requirements. It should also consider obtaining legal advice.

97. At least annually, the firm should communicate the results of the monitoring of its quality control system to engagement partners and other appropriate individuals within the firm, including the firm's chief executive officer or, if appropriate, its managing partner(s). Such communication should enable the firm and these individuals to take prompt and appropriate action where necessary in accordance with their defined roles and responsibilities. Information communicated should include the following:

- (a) A description of the monitoring procedures performed.
- (b) The conclusions drawn from the monitoring procedures.
- (c) Where relevant, a description of systemic, repetitive or other significant deficiencies and of the

actions taken to resolve or amend those deficiencies.

98. The reporting of identified deficiencies to individuals other than the relevant engagement partners ordinarily does not include an identification of the specific engagements concerned, unless such identification is necessary for the proper discharge of the responsibilities of the individuals other than the engagement partners.

99. Some firms operate as part of a network and, for consistency, may implement some or all of their monitoring procedures on a network basis. Where firms within a network operate under common monitoring policies and procedures designed to comply with this SQC, and these firms place reliance on such a monitoring system:

- (a) At least annually, the network communicates the overall scope, extent and results of the monitoring process to appropriate individuals within the network firms;
- (b) The network communicates promptly any identified deficiencies in the quality control system to appropriate individuals within the relevant network firm or firms so that the necessary action can be taken; and
- (c) Engagement partners in the network firms are entitled to rely on the results of the monitoring process implemented within the network, unless the firms or the network advises otherwise.

100. Appropriate documentation relating to monitoring:

- (a) Sets out monitoring procedures, including the procedure for selecting completed engagements to be inspected;
- (b) Records the evaluation of:
 - (i) Adherence to professional standards and regulatory and legal requirements;
 - (ii) Whether the quality control system has been appropriately designed and effectively implemented; and
 - (iii) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances; and
- (c) Identifies the deficiencies noted, evaluates their effect, and sets out the basis for determining whether and what further action is necessary.

Complaints and Allegations

101. The firm should establish policies and procedures designed to provide it with reasonable assurance that it deals appropriately with:

- (a) **Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements; and**
- (b) **Allegations of non-compliance with the firm's system of quality control.**

102. Complaints and allegations (which do not include those that are clearly frivolous) may originate from within or outside the firm. They may be made by firm personnel, clients or other third parties. They may be received by engagement team members or other firm personnel.

103. As part of this process, the firm establishes clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals.

104. The firm investigates such complaints and allegations in accordance with established policies and procedures. The investigation is supervised by a partner with sufficient and appropriate experience and

authority within the firm but who is not otherwise involved in the engagement, and includes involving legal counsel as necessary. Small firms and sole practitioners may use the services of a suitably qualified external person or another firm to carry out the investigation. Complaints, allegations and the responses to them are documented.

105. Where the results of the investigations indicate deficiencies in the design or operation of the firm's quality control policies and procedures, or non-compliance with the firm's system of quality control by an individual or individuals, the firm takes appropriate action as discussed in paragraph 95.

Documentation

106. The firm should establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control.

107. How such matters are documented is the firm's decision. For example, large firms may use electronic databases to document matters such as independence confirmations, performance evaluations and the results of monitoring inspections. Smaller firms may use more simpler and informal methods such as manual notes, checklists and forms.

108. Factors to consider when determining the form and content of documentation evidencing the operation of each of the elements of the system of quality control include the following:

- The size of the firm and the number of offices.
- The degree of authority both personnel and offices have.
- The nature and complexity of the firm's practice and organization.

109. The firm retains this documentation for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

Effective Date

110. This Standard on Quality Control is recommendatory for all engagements relating to accounting periods beginning on or after April 1, 2008 and is mandatory for all engagements relating to accounting periods beginning on or after April 1, 2009.

Material Modifications to the International Standard on Quality Control (ISQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements"

Additions

1. Paragraph 6(d) of the ISQC 1, dealing with the definition of "engagement quality control reviewer" mentions that "other person in the firm" with sufficient and appropriate experience and authority can also act as quality control reviewer. The SQC 1 has retained this concept subject to the condition that such "other person in the firm" should also be a member of the Institute of Chartered Accountants of India.

2. Paragraph 6(d) of the ISQC 1, while defining the "engagement quality control reviewer" provides that the review can be done by a team of individuals comprising the partner, other person in the firm and/or the suitably qualified external person. The SQC 1 has retained this concept subject to the condition that in case of review by a team of individuals, such team should be headed by a member of the Institute.

3. Paragraph 6(f) of the ISQC 1 defines "firm" as "a sole practitioner, partnership, corporation or other entity of professional accountants". Since in India an individual can practice in his individual name and also in the name of the firm as proprietor of that firm, accordingly, the term 'Proprietor' has been added to the definition of the firm.

4. Paragraph 83 of the ISQC 1 prescribes the minimum period of engagement documentation as five years. The SQC 1 prescribes the minimum period of retention of engagement documentation as seven years since, as per the provisions of the Chartered Accountants Act, 1949, including regulations therein, prescribes the minimum period of retention of working papers as seven years.

Deletions

1. Paragraph 6(f) of the ISQC 1 defines “firm” as “a sole practitioner, partnership, corporation or other entity of professional accountants”. Since in India, the practitioners establish any corporate entity for practice, the word ‘Corporation’ has been deleted from the definition.

2. In terms of paragraph 6(p) of the ISQC 1, defining a “suitably qualified external person” as a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits and reviews of historical financial information, or other assurance or related services engagements, or of an organisation that provides relevant quality control services. Since, in India only the Institute of Chartered Accountants of India is the professional body whose members can carry out an audit or a review of historical financial information or other assurance engagement, a specific reference to this fact appearing in the context of “partner of another firm or an employee” has been deleted from the definition of “suitably qualified external person”.

3. Paragraph 6(p) lays down that “an organisation that provides relevant quality control services” can also act as a suitably qualified person. The SQC does not include any such requirement since it is felt that a review of a firm of accountants should be done by a similar firm of accountants only.

4. Paragraph 27 of the ISQC 1 requires that in all engagements of audit of listed companies, the engagement partner of the firm should be rotated within a period of seven years in order to avoid the familiarity threat. The SQC 1 does not mandate such a provision in the audit engagements of the listed entities that are audited by the sole practitioners/proprietors as it is not possible to apply the provision in such cases. However, the SQC 1 provides for peer review of those firms in order to mitigate familiarity threat.

5. The ISQC 1 also deals with the public sector perspective. However, since the Standards, Statements, General Clarifications and Guidance Notes issued by the ICAI are equally applicable in case of all engagements, irrespective of the form, nature and size of the entity, this Standard does not specifically mention that aspect.

Framework for Assurance Engagements*

(Effective From April 1, 2008)

Introduction

1. This Framework defines and describes the elements and objectives of an assurance engagement, and identifies engagements to which Standards on Auditing (SAs), Standards on Review Engagements (SREs) and Standards on Assurance Engagements (SAEs) apply. It provides a frame of reference for:

- (a) Professional accountants in public practice¹ (practitioners) when performing assurance engagements. Professional accountants who are neither in public practice nor in the public sector are encouraged to consider the Framework when performing assurance engagements²
- (b) Others involved with assurance engagements, including the intended users of an assurance report and the responsible party; and
- (c) The Auditing and Assurance Standards Board (AASB) in its development of SAs, SREs and SAEs.

This Framework does not cover engagements covered by Standards on Related Services (SRSs), such as engagements to perform agreed-upon procedures and engagements to compile financial or other information since the members do not express any assurance on the financial information or any other subject matter of their report.

2. This Framework does not itself establish standards or provide procedural requirements for the performance of assurance engagements. SAs, SREs and SAEs contain basic principles, essential procedures and related guidance, consistent with the concepts in this Framework, for the performance of assurance engagements.

3. The following is an overview of this Framework:

- *Introduction:* This Framework deals with assurance engagements performed by practitioners. It provides a frame of reference for practitioners and others involved with assurance engagements, such as those engaging a practitioner (the “engaging party”).
- *Definition and objective of an assurance engagement:* This section defines assurance engagements and identifies the objectives of the two types of assurance engagements a practitioner is permitted to perform. This Framework calls these two types reasonable assurance engagements and limited assurance engagements.³
- *Scope of the Framework:* This section distinguishes assurance engagements from other engagements, such as consulting engagements.

* Published in July, 2007 issue of the Journal.

¹ As defined in the Preface, the term “professional accountant” refers to the member of the Institute of Chartered Accountants of India. Further, the term “professional accountant in public practice (practitioner)” refers to the member of the Institute of Chartered Accountants of India who is in practice in terms of section 2 of the Chartered Accountants Act, 1949. The term is also used to refer to a firm of chartered accountants in public practice.

² If a professional accountant not in public practice applies this Framework, and (a) this Framework, the SAs, SREs or the SAEs are referred to in the professional accountant’s report; and (b) the professional accountant or other members of the assurance team and, when applicable, the professional accountant’s employer, are not independent of the entity in respect of which the assurance engagement is being performed, the lack of independence and the nature of the relationship(s) with the entity are prominently disclosed in the professional accountant’s report. Also, that report does not include the word “independent” in its title, and the purpose and users of the report are restricted.

³ For assurance engagements relating to historical financial information in particular, such engagements which provide reasonable assurance are called audits, and those engagements which provide limited assurance are called reviews.

- *Engagement acceptance*: This section sets out characteristics that must be exhibited before a practitioner can accept an assurance engagement.
- *Elements of an assurance engagement*: This section identifies and discusses five elements that assurance engagement performed by practitioners' exhibit: a three party relationship, a subject matter, criteria, evidence and an assurance report. It explains important distinctions between reasonable assurance engagements and limited assurance engagements (also outlined in **Appendix** to the Framework). This section also discusses, for example, the significant variation in the subject matters of assurance engagements, the required characteristics of suitable criteria, the role of risk and materiality in assurance engagements, and how conclusions are expressed in each of the two types of assurance engagements.
- *Inappropriate use of the practitioner's name*: This section discusses implications of a practitioner's association with a subject matter.

Ethical Principles and Quality Control Standards

4. In addition to this Framework and SAs, SREs and SAEs, practitioners who perform assurance engagements are governed by:

- (a) The requirements of the Chartered Accountants Act, 1949;
- (b) The Code of Ethics (the Code), issued by the Institute, which establishes fundamental ethical principles for professional accountants;
- (c) Other relevant pronouncements of the Institute of Chartered Accountants of India⁴; and
- (d) Standards on Quality Control (SQC), which establish standards and provide guidance on a firm's system of quality control⁵.

5. The Code of Ethics sets out the fundamental ethical principles that all professional accountants are required to observe, including:

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality; and
- (e) Professional behaviour.

Definition and Objective of an Assurance Engagement

6. "Assurance engagement" means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

7. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to the subject matter. For example:

- The recognition, measurement, presentation and disclosure represented in the financial statements (outcome) result from applying a financial reporting framework for recognition, measurement, presentation

⁴ Attention of the members is invited, for instance, to the *Guidance Note on Independence of Auditors*, issued by the Institute of Chartered Accountants of India.

⁵ Additional Standards and guidance on quality control procedures for specific types of assurance engagements are set out in SAs, SREs and SAEs.

and disclosure, such as the Accounting Standards, (criteria) to an entity's financial position, financial performance and cash flows (subject matter).

- An assertion about the effectiveness of internal control (outcome) results from applying a framework for evaluating the effectiveness of internal control, (criteria) to internal control, a process (subject matter).

In the remainder of this Framework, the term "subject matter information" will be used to mean the outcome of the evaluation or measurement of a subject matter. It is the subject matter information about which the practitioner gathers sufficient appropriate evidence to provide a reasonable basis for expressing a conclusion in an assurance report.

8. Subject matter information can fail to be properly expressed in the context of the subject matter and the criteria, and can therefore be misstated, potentially to a material extent. This occurs when the subject matter information does not properly reflect the application of the criteria to the subject matter, for example, when an entity's financial statements do not give a true and fair view of (or present fairly, in all material respects) its financial position, financial performance and cash flows in accordance with the generally accepted accounting principles, or when an entity's assertion that its internal control is effective is not fairly stated, in all material respects, based on the established internal control framework.

9. In some assurance engagements, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users. These engagements are called "assertion-based engagements". In other assurance engagements, the practitioner either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report. These engagements are called "direct reporting engagements".

10. Under this Framework, there are two types of assurance engagements a practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement. The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement⁶ as the basis for a positive form of expression of the practitioner's conclusion. The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

Scope of the Framework

11. Not all engagements performed by practitioners are assurance engagements. Other frequently performed engagements that do not meet the above definition (and therefore are not covered by this Framework) include:

- Engagements covered by Standards for Related Services, such as agreed-upon procedures engagements and compilations of financial or other information.
- The preparation of tax returns where no conclusion conveying assurance is expressed.

⁶ Engagement circumstances include the terms of the engagement, including whether it is a reasonable assurance engagement or a limited assurance engagement, the characteristics of the subject matter, the criteria to be used, the needs of the intended users, relevant characteristics of the responsible party and its environment, and other matters, for example events, transactions, conditions and practices, that may have a significant effect on the engagement.

➤ Consulting (or advisory) engagements⁷, such as management and tax consulting.

12. An assurance engagement may be part of a larger engagement, for example, when a business acquisition consulting engagement includes a requirement to convey assurance regarding historical or prospective financial information. In such circumstances, this Framework is relevant only to the assurance portion of the engagement.

13. The following engagements, which may meet the definition in paragraph 6, need not be performed in accordance with this Framework:

- (a) Engagements to testify in legal proceedings regarding accounting, auditing, taxation or other matters; and
- (b) Engagements that include professional opinions, views or wording from which a user may derive some assurance, if all of the following apply:
 - (i) Those opinions, views or wording are merely incidental to the overall engagement;
 - (ii) Any written report issued is expressly restricted for use by only the intended users specified in the report;
 - (iii) Under a written understanding with the specified intended users, the engagement is not intended to be an assurance engagement; and
 - (iv) The engagement is not represented as an assurance engagement in the professional accountant's report.

Reports on Non-Assurance Engagements

14. A practitioner reporting on an engagement that is not an assurance engagement within the scope of this Framework, clearly distinguishes that report from an assurance report. So as not to confuse users, a report that is not an assurance report avoids, for example:

- Implying compliance with this Framework, SAs, SREs or SAEs.
- Inappropriately using the words "assurance," "audit" or "review."
- Including a statement that could reasonably be mistaken for a conclusion designed to enhance the degree of confidence of intended users about the outcome of the evaluation or measurement of a subject matter against criteria.

15. The practitioner and the responsible party may agree to apply the principles of this Framework to an engagement when there are no intended users other than the responsible party but where all other requirements of the SAs, SREs or SAEs are met. In such cases, the practitioner's report includes a statement restricting the use of the report to the responsible party.

Engagement Acceptance

16. A practitioner accepts an assurance engagement only where the practitioner's preliminary knowledge of the engagement circumstances indicates that:

⁷ Consulting engagements employ a professional accountant's technical skills, education, observations, experiences and knowledge of the consulting process. The consulting process is an analytical process that typically involves some combination of activities relating to: objective-setting, fact-finding, definition of problems or opportunities, evaluation of alternatives, development of recommendations including actions, communication of results and sometimes implementation and follow-up. Reports (if issued) are generally written in a narrative (or "long form") style. Generally the work performed is only for the use and benefit of the client. The nature and scope of work is determined by agreement between the professional accountant and the client. Any service that meets the definition of an assurance engagement is not a consulting engagement but an assurance engagement.

- (a) Relevant ethical requirements, such as independence and professional competence will be satisfied, and
- (b) The engagement exhibits all of the following characteristics:
 - (i) The subject matter is appropriate;
 - (ii) The criteria to be used are suitable and are available to the intended users;
 - (iii) The practitioner has access to sufficient appropriate evidence to support the practitioner's conclusion;
 - (iv) The practitioner's conclusion, in the form appropriate to either a reasonable assurance engagement or a limited assurance engagement, is to be contained in a written report; and
 - (v) The practitioner is satisfied that there is a rational purpose for the engagement. If there is a significant limitation on the scope of the practitioner's work (see paragraph 54), it may be unlikely that the engagement has a rational purpose. Also, a practitioner may believe the engaging party intends to associate the practitioner's name with the subject matter in an inappropriate manner (see paragraph 60).

Specific SAs, SREs or SAEs may include additional requirements that need to be satisfied prior to accepting an engagement.

17. When a potential engagement cannot be accepted as an assurance engagement because it does not exhibit all the characteristics in the previous paragraph, the engaging party may be able to identify a different engagement that will meet the needs of intended users. For example:

- (a) If the original criteria were not suitable, an assurance engagement may still be performed if:
 - (i) the engaging party can identify an aspect of the original subject matter for which those criteria are suitable, and the practitioner could perform an assurance engagement with respect to that aspect as a subject matter in its own right. In such cases, the assurance report makes it clear that it does not relate to the original subject matter in its entirety; or
 - (ii) alternative criteria suitable for the original subject matter can be selected or developed.
- (b) The engaging party may request an engagement that is not an assurance engagement, such as a consulting or an agreed-upon procedures engagement.

18. Having accepted an assurance engagement, a practitioner may not change that engagement to a non-assurance engagement, or from a reasonable assurance engagement to a limited assurance engagement without reasonable justification. A change in circumstances that affects the intended users' requirements, or a misunderstanding concerning the nature of the engagement, ordinarily will justify a request for a change in the engagement. If such a change is made, the practitioner does not disregard evidence that was obtained prior to the change.

Elements of an Assurance Engagement

19. The following elements of an assurance engagement are discussed in this section:

- (a) A three party relationship involving a practitioner, a responsible party, and intended users;
- (b) An appropriate subject matter;
- (c) Suitable criteria;
- (d) Sufficient appropriate evidence; and
- (e) A written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement.

Three Party Relationship

20. Assurance engagements involve three separate parties: a practitioner, a responsible party and intended users.

21. The responsible party and the intended users may be from different entities or the same entity. As an example of the latter case, in a two-tier board structure, the supervisory board may seek assurance about information provided by the management board of that entity. The relationship between the responsible party and the intended users needs to be viewed within the context of a specific engagement and may differ from more traditionally defined lines of responsibility. For example, an entity's senior management (an intended user) may engage a practitioner to perform an assurance engagement on a particular aspect of the entity's activities that is the immediate responsibility of a lower level of management (the responsible party), but for which senior management is ultimately responsible.

Practitioner

22. The term "practitioner" as used in this Framework is broader than the term "auditor" as used in SAs and SREs, which relates only to practitioners performing audit or review engagements with respect to historical financial information.

23. A practitioner may be requested to perform assurance engagements on a wide range of subject matters. Some subject matters may require specialized skills and knowledge beyond those ordinarily possessed by an individual practitioner. As noted in paragraph 17 (a), a practitioner does not accept an engagement if preliminary knowledge of the engagement circumstances indicates that ethical requirements regarding professional competence will not be satisfied. In some cases this requirement can be satisfied by the practitioner using the work of persons from other professional disciplines, referred to as experts. In such cases, the practitioner is satisfied that those persons carrying out the engagement collectively possess the requisite skills and knowledge, and that the practitioner has an adequate level of involvement in the engagement and understanding of the work for which any expert is used.

Responsible Party

24. The responsible party is the person (or persons) who:

- (a) in a direct reporting engagement, is responsible for the subject matter; or
- (b) in an assertion-based engagement, is responsible for the subject matter information (the assertion), and may be responsible for the subject matter. An example of when the responsible party is responsible for both the subject matter information and the subject matter, is when an entity engages a practitioner to perform an assurance engagement regarding a report it has prepared about its own sustainability practices. An example of when the responsible party is responsible for the subject matter information but not the subject matter, is when a government organization engages a practitioner to perform an assurance engagement regarding a report about a private company's sustainability practices that the organization has prepared and is to distribute to intended users.

The responsible party may or may not be the party who engages the practitioner (the engaging party).

25. The responsible party ordinarily provides the practitioner with a written representation that evaluates or measures the subject matter against the identified criteria, whether or not it is to be made available as an assertion to the intended users. In a direct reporting engagement, the practitioner may not be able to obtain such a representation when the engaging party is different from the responsible party.

Intended Users

26. The intended users are the person, persons or class of persons for whom the practitioner prepares the assurance report. The responsible party can be one of the intended users, but not the only one.

27. Whenever practical, the assurance report is addressed to all the intended users, but in some cases there may be other intended users. The practitioner may not be able to identify all those who will read the assurance report, particularly where there is a large number of people who have access to it. In such cases, particularly where possible readers are likely to have a broad range of interests in the subject matter, intended users may be limited to major stakeholders with significant and common interests. Intended users may be identified in different ways, for example, by agreement between the practitioner and the responsible party or engaging party, or by law.

28. Whenever practical, intended users or their representatives are involved with the practitioner and the responsible party (and the engaging party, if different) in determining the requirements of the engagement. Regardless of the involvement of others however, and unlike an agreed-upon procedures engagement (which involves reporting findings based upon the procedures, rather than a conclusion):

- (a) The practitioner is responsible for determining the nature, timing and extent of procedures; and
- (b) The practitioner is required to pursue any matter the practitioner becomes aware of that leads the practitioner to question whether a material modification should be made to the subject matter information.

29. In some cases, intended users (for example, bankers and regulators) impose a requirement on, or request the responsible party (or the engaging party, if different) to arrange for, an assurance engagement to be performed for a specific purpose. When engagements are designed for specified intended users or a specific purpose, the practitioner considers including a restriction in the assurance report that limits its use to those users or that purpose.

Subject Matter

30. The subject matter, and subject matter information, of an assurance engagement can take many forms, such as:

- Financial performance or conditions (for example, historical or prospective financial position, financial performance and cash flows) for which the subject matter information may be the recognition, measurement, presentation and disclosure represented in financial statements.
- Non-financial performance or conditions (for example, performance of an entity) for which the subject matter information may be key indicators of efficiency and effectiveness.
- Physical characteristics (for example, capacity of a facility) for which the subject matter information may be a specifications document.
- Systems and processes (for example, an entity's internal control or IT system) for which the subject matter information may be an assertion about effectiveness.
- Behaviour (for example, corporate governance, compliance with regulation, human resource practices) for which the subject matter information may be a statement of compliance or a statement of effectiveness.

31. Subject matters have different characteristics, including the degree to which information about them is qualitative versus quantitative, objective versus subjective, historical versus prospective, and relates to a point in time or covers a period. Such characteristics affect the:

- (a) precision with which the subject matter can be evaluated or measured against criteria; and
- (b) the persuasiveness of available evidence.

The assurance report notes characteristics of particular relevance to the intended users.

32. An appropriate subject matter is:

- (a) identifiable, and capable of consistent evaluation or measurement against the identified criteria; and

- (b) such that the information about it can be subjected to procedures for gathering sufficient appropriate evidence to support a reasonable assurance or limited assurance conclusion, as appropriate.

Criteria

33. Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Criteria can be formal, for example in the preparation of financial statements, the criteria may be Accounting Standards issued by the Institute; when reporting on internal control, the criteria may be an established internal control framework or individual control objectives specifically designed for the engagement; and when reporting on compliance, the criteria may be the applicable law, regulation or contract. Examples of less formal criteria are an internally developed code of conduct or an agreed level of performance (such as the number of times a particular committee is expected to meet in a year).

34. Suitable criteria are required for reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment. Without the frame of reference provided by suitable criteria, any conclusion is open to individual interpretation and misunderstanding. Suitable criteria are context-sensitive, that is, relevant to the engagement circumstances. Even for the same subject matter there can be different criteria. For example, one responsible party might select the number of customer complaints resolved to the acknowledged satisfaction of the customer for the subject matter of customer satisfaction; another responsible party might select the number of repeat purchases in the three months following the initial purchase.

35. Suitable criteria exhibit the following characteristics:

- (a) *Relevance*: relevant criteria contribute to conclusions that assist decision-making by the intended users.
- (b) *Completeness*: criteria are sufficiently complete when relevant factors that could affect the conclusions in the context of the engagement circumstances are not omitted. Complete criteria include, where relevant, benchmarks for presentation and disclosure.
- (c) *Reliability*: reliable criteria allow reasonably consistent evaluation or measurement of the subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by similarly qualified practitioners.
- (d) *Neutrality*: neutral criteria contribute to conclusions that are free from bias.
- (e) *Understandability*: understandable criteria contribute to conclusions that are clear, comprehensive, and not subject to significantly different interpretations.

The evaluation or measurement of a subject matter on the basis of the practitioner's own expectations, judgments and individual experience would not constitute suitable criteria.

36. The practitioner assesses the suitability of criteria for a particular engagement by considering whether they reflect the above characteristics. The relative importance of each characteristic to a particular engagement is a matter of judgment. Criteria can either be established or specifically developed. Established criteria are those embodied in laws or regulations, or issued by authorized or recognized bodies of experts that follow a transparent due process. Specifically developed criteria are those designed for the purpose of the engagement. Whether criteria are established or specifically developed affects the work that the practitioner carries out to assess their suitability for a particular engagement.

37. Criteria need to be available to the intended users to allow them to understand how the subject matter has been evaluated or measured. Criteria are made available to the intended users in one or more of the following ways:

- (a) Publicly.
- (b) Through inclusion in a clear manner in the presentation of the subject matter information.
- (c) Through inclusion in a clear manner in the assurance report.

(d) By general understanding, for example the criterion for measuring time in hours and minutes.

Criteria may also be available only to specific intended users, for example, the terms of a contract, or criteria issued by an industry association that are available only to those in the industry. When identified criteria are available only to specific intended users, or are relevant only to a specific purpose, use of the assurance report is restricted to those users or for that purpose.⁸

Evidence

38. The practitioner plans and performs an assurance engagement with an attitude of professional skepticism to obtain sufficient appropriate evidence about whether the subject matter information is free of material misstatement. The practitioner considers materiality, assurance engagement risk, and the quantity and quality of available evidence when planning and performing the engagement, in particular when determining the nature, timing and extent of evidence-gathering procedures.

Professional Skepticism

39. The practitioner plans and performs an assurance engagement with an attitude of professional skepticism recognizing that circumstances may exist that cause the subject matter information to be materially misstated. An attitude of professional skepticism means the practitioner makes a critical assessment, with a questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations by the responsible party. For example, an attitude of professional skepticism is necessary throughout the engagement process for the practitioner to reduce the risk of overlooking suspicious circumstances, of over generalizing when drawing conclusions from observations, and of using faulty assumptions in determining the nature, timing and extent of evidence-gathering procedures and evaluating the results thereof.

40. An assurance engagement rarely involves the authentication of documentation, nor is the practitioner trained as or expected to be an expert in such authentication. However, the practitioner considers the reliability of the information to be used as evidence, for example, photocopies, facsimiles, filmed, digitized or other electronic documents, including consideration of controls over their preparation and maintenance where relevant.

Sufficiency and Appropriateness of Evidence

41. Sufficiency is the measure of the quantity of evidence. Appropriateness is the measure of the quality of evidence; that is, its relevance and its reliability. The quantity of evidence needed is affected by the risk of the subject matter information being materially misstated (the greater the risk, the more evidence is likely to be required) and also by the quality of such evidence (the higher the quality, the less may be required). Accordingly, the sufficiency and appropriateness of evidence are interrelated. However, merely obtaining more evidence may not compensate for its poor quality.

42. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. Generalizations about the reliability of various kinds of evidence can be made; however, such generalizations are subject to important exceptions. Even when evidence is obtained from sources external to the entity, circumstances may exist that could affect the reliability of the information obtained. For example, evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognizing that exceptions may exist, the following generalizations about the reliability of evidence may be useful:

⁸ While an assurance report may be restricted whenever it is intended only for specified intended users or for a specific purpose, the absence of a restriction regarding a particular reader or purpose, does not itself indicate that a legal responsibility is owed by the practitioner in relation to that reader or for that purpose. Whether a legal responsibility is owed will depend on the circumstances of each case and the relevant jurisdiction.

- Evidence is more reliable when it is obtained from independent sources outside the entity.
- Evidence that is generated internally is more reliable when the related controls are effective.
- Evidence obtained directly by the practitioner (for example, observation of the application of a control) is more reliable than evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Evidence is more reliable when it exists in documentary form, whether paper, electronic, or other media (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of what was discussed).
- Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles.

43. The practitioner ordinarily obtains more assurance from consistent evidence obtained from different sources or of a different nature than from items of evidence considered individually. In addition, obtaining evidence from different sources or of a different nature may indicate that an individual item of evidence is not reliable. For example, corroborating information obtained from a source independent of the entity may increase the assurance the practitioner obtains from a representation from the responsible party. Conversely, when evidence obtained from one source is inconsistent with that obtained from another, the practitioner determines what additional evidence-gathering procedures are necessary to resolve the inconsistency.

44. In terms of obtaining sufficient appropriate evidence, it is generally more difficult to obtain assurance about subject matter information covering a period than about subject matter information at a point in time. In addition, conclusions provided on processes ordinarily are limited to the period covered by the engagement; the practitioner provides no conclusion about whether the process will continue to function in the specified manner in the future.

45. The practitioner considers the relationship between the cost of obtaining evidence and the usefulness of the information obtained. However, the matter of difficulty or expense involved is not in itself a valid basis for omitting an evidence-gathering procedure for which there is no alternative. The practitioner uses professional judgment and exercises professional skepticism in evaluating the quantity and quality of evidence, and thus its sufficiency and appropriateness, to support the assurance report.

Materiality

46. Materiality is relevant when the practitioner determines the nature, timing and extent of evidence-gathering procedures, and when assessing whether the subject matter information is free of misstatement. When considering materiality, the practitioner understands and assesses what factors might influence the decisions of the intended users. For example, when the identified criteria allow for variations in the presentation of the subject matter information, the practitioner considers how the adopted presentation might influence the decisions of the intended users. Materiality is considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and extent of the effect of these factors on the evaluation or measurement of the subject matter, and the interests of the intended users. The assessment of materiality and the relative importance of quantitative and qualitative factors in a particular engagement are matters for the practitioner's judgment.

Assurance Engagement Risk

47. Assurance engagement risk is the risk that the practitioner expresses an inappropriate conclusion when

the subject matter information is materially misstated⁹. In a reasonable assurance engagement, the practitioner reduces assurance engagement risk to an acceptably low level in the circumstances of the engagement to obtain reasonable assurance as the basis for a positive form of expression of the practitioner's conclusion. The level of assurance engagement risk is higher in a limited assurance engagement than in a reasonable assurance engagement because of the different nature, timing or extent of evidence-gathering procedures. However, in a limited assurance engagement, the combination of the nature, timing and extent of evidence-gathering procedures is at least sufficient for the practitioner to obtain a meaningful level of assurance as the basis for a negative form of expression. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential.

48. In general, assurance engagement risk can be represented by the following components, although not all of these components will necessarily be present or significant for all assurance engagements:

- (a) The risk that the subject matter information is materially misstated, which in turn consists of:
 - (i) *Inherent risk*: the susceptibility of the subject matter information to a material misstatement, assuming that there are no related controls; and
 - (ii) *Control risk*: the risk that a material misstatement that could occur will not be prevented, or detected and corrected, on a timely basis by related internal controls. When control risk is relevant to the subject matter, some control risk will always exist because of the inherent limitations of the design and operation of internal control; and
- (b) *Detection risk*: the risk that the practitioner will not detect a material misstatement that exists.

The degree to which the practitioner considers each of these components is affected by the engagement circumstances, in particular by the nature of the subject matter and whether a reasonable assurance or a limited assurance engagement is being performed.

Nature, Timing and Extent of Evidence-gathering Procedures

49. The exact nature, timing and extent of evidence-gathering procedures will vary from one engagement to the next. In theory, infinite variations in evidence-gathering procedures are possible. In practice, however, these are difficult to communicate clearly and unambiguously. The practitioner attempts to communicate them clearly and unambiguously and uses the form appropriate to a reasonable assurance engagement or a limited assurance engagement.¹⁰

50. "Reasonable assurance" is a concept relating to accumulating evidence necessary for the practitioner to conclude in relation to the subject matter information taken as a whole. To be in a position to express a

⁹ (a) This includes the risk, in those direct reporting engagements where the subject matter information is presented only in the practitioner's conclusion, that the practitioner inappropriately concludes that the subject matter does, in all material respects, conform with the criteria, for example: "In our opinion, internal control is effective, in all material respects, based on XYZ criteria".

(b) In addition to assurance engagement risk, the practitioner is exposed to the risk of expressing an inappropriate conclusion when the subject matter information is not materially misstated, and risks through loss from litigation, adverse publicity, or other events arising in connection with a subject matter reported on. These risks are not part of assurance engagement risk.

¹⁰ Where the subject matter information is made up of a number of aspects, separate conclusions may be provided on each aspect. While not all such conclusions need to relate to the same level of evidence-gathering procedures, each conclusion is expressed in the form that is appropriate to either a reasonable assurance or a limited assurance engagement.

conclusion in the positive form required in a reasonable assurance engagement, it is necessary for the practitioner to obtain sufficient appropriate evidence as part of an iterative, systematic engagement process involving:

- (a) Obtaining an understanding of the subject matter and other engagement circumstances which, depending on the subject matter, includes obtaining an understanding of internal control;
- (b) Based on that understanding, assessing the risks that the subject matter information may be materially misstated;
- (c) Responding to assessed risks, including developing overall responses, and determining the nature, timing and extent of further procedures;
- (d) Performing further procedures clearly linked to the identified risks, using a combination of inspection, observation, confirmation, recalculation, re-performance, analytical procedures and inquiry. Such further procedures involve substantive procedures including, where applicable, obtaining corroborating information from sources independent of the responsible party, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and
- (e) Evaluating the sufficiency and appropriateness of evidence.

51. "Reasonable assurance" is less than absolute assurance. Reducing assurance engagement risk to zero is very rarely attainable or cost beneficial as a result of factors such as the following:

- The use of selective testing.
- The inherent limitations of internal control.
- The fact that much of the evidence available to the practitioner is persuasive rather than conclusive.
- The use of judgment in gathering and evaluating evidence and forming conclusions based on that evidence.
- In some cases, the characteristics of the subject matter when evaluated or measured against the identified criteria.

52. Both reasonable assurance and limited assurance engagements require the application of assurance skills and techniques and the gathering of sufficient appropriate evidence as part of an iterative, systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances. The nature, timing and extent of procedures for gathering sufficient appropriate evidence in a limited assurance engagement are, however, deliberately limited relative to a reasonable assurance engagement. For some subject matters, there may be specific pronouncements to provide guidance on procedures for gathering sufficient appropriate evidence for a limited assurance engagement. For example, SRE 2400¹¹ (Revised), "Engagements to Review Financial Statements" establishes that sufficient appropriate evidence for reviews of financial statements is obtained primarily through analytical procedures and inquiries. In the absence of a relevant pronouncement, the procedures for gathering sufficient appropriate evidence will vary with the circumstances of the engagement, in particular, the subject matter, and the needs of the intended users and the engaging party, including relevant time and cost constraints. For both reasonable assurance and limited assurance engagements, if the practitioner becomes aware of a matter that leads the practitioner

¹¹ Published in May 2010 issue of the Journal.

to question whether a material modification should be made to the subject matter information, the practitioner pursues the matter by performing other procedures sufficient to enable the practitioner to report.

Quantity and Quality of Available Evidence

53. The quantity or quality of available evidence is affected by:

- (a) The characteristics of the subject matter and subject matter information. For example, less objective evidence might be expected when information about the subject matter is future-oriented rather than historical (see paragraph 31); and
- (b) Circumstances of the engagement other than the characteristics of the subject matter, when evidence that could reasonably be expected to exist is not available because of, for example, the timing of the practitioner's appointment, an entity's document retention policy, or a restriction imposed by the responsible party.

Ordinarily, available evidence will be persuasive rather than conclusive.

54. An unqualified conclusion is not appropriate for either type of assurance engagement in the case of a material limitation on the scope of the practitioner's work, that is, when:

- (a) Circumstances prevent the practitioner from obtaining evidence required to reduce assurance engagement risk to the appropriate level; or
- (b) The responsible party or the engaging party imposes a restriction that prevents the practitioner from obtaining evidence required to reduce assurance engagement risk to the appropriate level.

Assurance Report

55. The practitioner provides a written report containing a conclusion that conveys the assurance obtained about the subject matter information. SAs, SREs and SAEs establish basic elements for assurance reports. In addition, the practitioner considers other reporting responsibilities, including communicating with those charged with governance when it is appropriate to do so.

56. In an assertion-based engagement, the practitioner's conclusion can be worded either:

- (a) In terms of the responsible party's assertion (for example: "In our opinion *the responsible party's* assertion that internal control is effective, in all material respects, based on *XYZ criteria*, is fairly stated"); or
- (b) Directly in terms of the subject matter and the criteria (for example: "In our opinion internal control is effective, in all material respects, based on *XYZ criteria*").

In a direct reporting engagement, the practitioner's conclusion is worded directly in terms of the subject matter and the criteria.

57. In a reasonable assurance engagement, the practitioner expresses the conclusion in the positive form, for example: "In our opinion internal control is effective, in all material respects, based on *XYZ criteria*". This form of expression conveys "reasonable assurance". Having performed evidence-gathering procedures of a nature, timing and extent that were reasonable given the characteristics of the subject matter and other relevant engagement circumstances described in the assurance report, the practitioner has obtained sufficient appropriate evidence to reduce assurance engagement risk to an acceptably low level.

58. In a limited assurance engagement, the practitioner expresses the conclusion in the negative form, for example, "based on our work described in this report, nothing has come to our attention that causes us to

believe that internal control is not effective, in all material respects, based on XYZ criteria". This form of expression conveys a level of "limited assurance" that is proportional to the level of the practitioner's evidence-gathering procedures given the characteristics of the subject matter and other engagement circumstances described in the assurance report.

59. A practitioner does not express an unqualified conclusion for either type of assurance engagement when the following circumstances exist and, in the practitioner's judgment, the effect of the matter is or may be material:

- (a) There is a limitation on the scope of the practitioner's work (see paragraph 54). The practitioner expresses a qualified conclusion or a disclaimer of conclusion depending on how material or pervasive the limitation is. In some cases the practitioner considers withdrawing from the engagement.
- (b) In those cases where:
 - (i) The practitioner's conclusion is worded in terms of the responsible party's assertion, and that assertion is not fairly stated, in all material respects; or
 - (ii) The practitioner's conclusion is worded directly in terms of the subject matter and the criteria, and the subject matter information is materially misstated,¹²The practitioner expresses a qualified or adverse conclusion depending on how material or pervasive the matter is.
- (c) When it is discovered after the engagement has been accepted, that the criteria are unsuitable or the subject matter is not appropriate for an assurance engagement. The practitioner expresses:
 - (i) A qualified conclusion or adverse conclusion depending on how material or pervasive the matter is, when the unsuitable criteria or inappropriate subject matter is likely to mislead the intended users; or
 - (ii) A qualified conclusion or a disclaimer of conclusion depending on how material or pervasive the matter is, in other cases.

In some cases, the practitioner considers withdrawing from the engagement.

Inappropriate Use of the Practitioner's Name

60. A practitioner is associated with a subject matter when the practitioner reports on information about that subject matter or consents to the use of the practitioner's name in a professional connection with that subject matter. If the practitioner is not associated in this manner, third parties can assume no responsibility of the practitioner. If the practitioner learns that a party is inappropriately using the practitioner's name in association with a subject matter, the practitioner requires the party to cease doing so. The practitioner also considers what other steps may be needed, such as informing any known third party users of the inappropriate use of the practitioner's name or seeking legal advice.

Material Modifications to International Framework for Assurance Engagements

Deletions

1. The International Framework issued by the IAASB specifically makes it clear that such Framework is

¹² In those direct reporting engagements where the subject matter information is presented only in the practitioner's conclusion, and the practitioner concludes that the subject matter does not, in all material respects, conform with the criteria, for example: "In our opinion, except for [...], internal control is effective, in all material respects, based on XYZ criteria," such a conclusion would also be considered to be qualified (or adverse as appropriate).

also relevant to professional accountants in public sector. However, since the Standards, Statements, General Clarifications and Guidance Notes issued by the ICAI are equally applicable in case of all engagements, irrespective of the form, nature and size of the entity, this Framework does not specifically mention that aspect.

2. Paragraph 6 of the International Framework issued by the IAASB refers to Part B of the International Code of Ethics regarding threats to independence, accepted safeguards and the public interest, which is applicable to professional accountants in public practice, has been deleted since the Code of Ethics issued by the ICAI is woven around the Chartered Accountants Act, 1949 and Schedules annexed thereto.

Appendix

Differences Between Reasonable Assurance Engagements and Limited Assurance Engagements

This Appendix outlines the differences between a reasonable assurance engagement and a limited assurance engagement discussed in the Framework (see in particular the referenced paragraphs).

Type of Engagement	Objective	Evidence-gathering procedures ¹³	The Assurance Report
Reasonable Assurance Engagement	A reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion (Paragraph 10)	➤ Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes: ➤ Obtaining an understanding of the engagement circumstances; ➤ Assessing risks; ➤ Responding to assessed risks; ➤ Performing further procedures using a combination of inspection, observation, confirmation, recalculation, re-performance, analytical procedures and inquiry. Such further procedures involve substantive procedures, including, where applicable, obtaining corroborating information, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and ➤ Evaluating the evidence obtained (Paragraphs 50 and 51)	Description of the engagement circumstances and a positive form of expression of the conclusion (Paragraph 57)
Limited Assurance Engagement	A reduction in assurance engagement risk to a level that is	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes obtaining an understanding of the subject matter and other engagement	Description of the engagement circumstances, and a

¹³ A detailed discussion of evidence-gathering requirement is only possible within SAEs for specific subject matters.

	acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion (Paragraph 10)	circumstances, but in which procedures are deliberately limited relative to reasonable assurance engagement (Paragraph 52)	negative form of expression of the conclusion (Paragraph 58)

SA 200 *

**Overall Objectives of the Independent Auditor and
the Conduct of an Audit in Accordance with
Standards on Auditing**
*(Effective for all audits relating to accounting periods
beginning on or after April 1, 2010)*

Introduction**Scope of this SA**

1. This Standard on Auditing (SA) establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs. Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the SAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the SAs. The independent auditor is referred to as "the auditor" hereafter.

2. SAs are written in the context of an audit of financial statements by an auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

An Audit of Financial Statements

3. 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. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion. (Ref: Para. A1)

4. The financial statements subject to audit are those of the entity, prepared and presented by management of the entity with oversight from those charged with governance. SAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of those responsibilities. (Ref: Para. A2-A11)

5. As the basis for the auditor's opinion, SAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion

* Published in March, 2010 issue of the Journal.

when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. (Ref: Para. A28-A52)

6. 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 statements¹. In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they 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. The auditor's opinion deals with the financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.

7. The SAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The SAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:

- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
- Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

8. The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable laws or regulations. (Ref: Para. A12-A13)

9. The auditor may also have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, in relation to matters arising from the audit. These may be established by the SAs or by applicable laws or regulations².

Effective Date

10. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Overall Objectives of the Auditor

11. In conducting an audit of financial statements, the overall objectives of the auditor are:

- (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the

¹ SA 320, "Materiality in Planning and Performing an Audit" and SA 450, "Evaluation of Misstatements Identified during the Audit".

² See, for example, SA 260, "Communication with Those Charged with Governance"; and paragraph 43 of SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

auditor's findings.

12. In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the SAs require that the auditor disclaim an opinion or withdraw from the engagement, where withdrawal is legally permitted.

Definitions

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

- (a) Applicable financial reporting framework – The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

- (b) Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. For purposes of the SAs:
- (i) Sufficiency of audit evidence is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.
 - (ii) Appropriateness of audit evidence is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.
- (c) Audit risk – The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.
- (d) Auditor – "Auditor" is used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an SA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term "engagement partner" rather than "auditor" is used. "Engagement partner" and "firm" are to be read as referring to their public sector equivalents where relevant.
- (e) Detection risk – The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.
- (f) Financial statements – A structured representation of historical financial information, including related

notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement.

- (g) Historical financial information – Information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.
- (h) Management – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.
- (i) Misstatement – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

- (j) Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted – That management and, where appropriate, those charged with governance have the following responsibilities that are fundamental to the conduct of an audit in accordance with SAs. That is, responsibility:
 - (i) For the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and
 - (ii) To provide the auditor with:
 - a. All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;
 - b. Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and
 - c. Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

In the case of a fair presentation framework, the responsibility is for the preparation and *fair* presentation of the financial statements in accordance with the financial reporting framework; or the preparation of financial statements *that give a true and fair view* in accordance with the financial reporting framework. This applies to all references to "preparation and presentation of the financial statements" in the SAs.

The "premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted" may also be referred to as the "premise".

- (k) Professional judgment – The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the

courses of action that are appropriate in the circumstances of the audit engagement.

- (l) Professional skepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
- (m) Reasonable assurance – In the context of an audit of financial statements, a high, but not absolute, level of assurance.
- (n) Risk of material misstatement – The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:
 - (i) Inherent risk – The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
 - (ii) Control risk – The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
- (o) Those charged with governance – The person(s) or organisation(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 in some jurisdictions, 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.

Requirements

Ethical Requirements Relating to an Audit of Financial Statements

14. The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. (Ref: Para. A14-A17)

Professional Skepticism

15. The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A18-A22)

Professional Judgment

16. The auditor shall exercise professional judgment in planning and performing an audit of financial statements. (Ref: Para. A23-A27)

Sufficient Appropriate Audit Evidence and Audit Risk

17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (Ref: Para. A28-A52)

Conduct of an Audit in Accordance with SAs

Complying with SAs Relevant to the Audit

18. The auditor shall comply with all SAs relevant to the audit. An SA is relevant to the audit when the SA is in effect and the circumstances addressed by the SA exist. (Ref: Para. A53-A56)

19. The auditor shall have an understanding of the entire text of an SA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. (Ref: Para. A57-A65)

20. The auditor shall not represent compliance with SAs in the auditor's report unless the auditor has complied with the requirements of this SA and all other SAs relevant to the audit.

Objectives Stated in Individual SAs

21. To achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant SAs in planning and performing the audit, having regard to the interrelationships among the SAs, to: (Ref: Para. A66-A68)

- (a) Determine whether any audit procedures in addition to those required by the SAs are necessary in pursuance of the objectives stated in the SAs; and (Ref: Para. A69)
- (b) Evaluate whether sufficient appropriate audit evidence has been obtained. (Ref: Para. A70)

Complying with Relevant Requirements

22. Subject to paragraph 23, the auditor shall comply with each requirement of an SA unless, in the circumstances of the audit:

- (a) The entire SA is not relevant; or
- (b) The requirement is not relevant because it is conditional and the condition does not exist. (Ref: Para. A71-A72)

23. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an SA. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement. (Ref: Para. A73)

Failure to Achieve an Objective

24. If an objective in a relevant SA cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with the SAs, to modify the auditor's opinion or withdraw from the engagement. Failure to achieve an objective represents a significant matter requiring documentation in accordance with SA 230³. (Ref: Para. A74-A75)

Application and Other Explanatory Material**An Audit of Financial Statements****Scope of the Audit** (Ref: Para. 3)

A1. The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. In some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

Preparation of the Financial Statements (Ref: Para. 4)

A2. An audit in accordance with SAs is conducted on the premise that management and, where appropriate,

³ SA 230, "Audit Documentation", paragraph 8(c).

those charged with governance have responsibility:

- (a) For the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (b) To provide the auditor with:
 - (i) All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;
 - (ii) Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and
 - (iii) Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

A3. As part of their responsibility for the preparation and presentation of the financial statements, management and, where appropriate, those charged with governance are responsible for:

- The identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.
- The preparation and presentation of the financial statements in accordance with that framework.
- An adequate description of that framework in the financial statements.

The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

A4. The financial statements may be prepared in accordance with a financial reporting framework designed to meet:

- The common financial information needs of a wide range of users (i.e., “general purpose financial statements”); or
- The financial information needs of specific users (i.e., “special purpose financial statements”).

A5. The applicable financial reporting framework often encompasses financial reporting standards established by an authorised or recognised standards setting organisation, or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial reporting standards established by an authorised or recognised standards setting organisation and legislative or regulatory requirements. Other sources may provide direction on the application of the applicable financial reporting framework. In some cases, the applicable financial reporting framework may encompass such other sources, or may even consist only of such sources. Such other sources may include:

- The legal and ethical environment, including statutes, regulations, court decisions, and professional ethical obligations in relation to accounting matters;
- Published accounting interpretations of varying authority issued by standards setting, professional or regulatory organisations;
- Published views of varying authority on emerging accounting issues issued by standards setting, professional or regulatory organisations;
- General and industry practices widely recognised and prevalent; and

- Accounting literature.

Where conflicts exist between the financial reporting framework and the sources from which direction on its application may be obtained, or among the sources that encompass the financial reporting framework, the source with the highest authority prevails.

A6. The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

A7. Some financial reporting frameworks are fair presentation frameworks, while others are compliance frameworks. Financial reporting frameworks that encompass primarily the financial reporting standards established by an organisation that is authorised or recognised to promulgate standards to be used by entities for preparing and presenting general purpose financial statements are often designed to achieve fair presentation.

A8. The requirements of the applicable financial reporting framework also determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the state of affairs, results of operations and cash flows of an entity. For such frameworks, a complete set of financial statements would include a balance sheet; statement of profit and loss; a cash flow statement; and related notes. For some other financial reporting frameworks, a single financial statement and the related notes might constitute a complete set of financial statements:

- For example, normally, in government departments and local bodies, the primary financial statement is a statement of cash receipts and payments.
- Other examples of a single financial statement, each of which would include related notes, are:
 - Balance sheet.
 - Statement of profit & loss.
 - Statement of cash flows.
 - Statement of operations by product lines.

A9. SA 210 establishes requirements and provides guidance on determining the acceptability of the applicable financial reporting framework⁴. SA 800 deals with special considerations when financial statements are prepared in accordance with a special purpose framework⁵.

A10. Because of the significance of the premise to the conduct of an audit, the auditor is required to obtain agreement from management and, where appropriate, those charged with governance that they acknowledge and understand their responsibilities set out in paragraph A2 as a precondition for accepting the audit engagement⁶. The auditor is also required to obtain written representations about whether management and, where appropriate, those charged with governance have fulfilled those responsibilities⁷.

Considerations Specific to Central/State Governments and Related Government Entities

⁴ SA 210, "Agreeing the Terms of Audit Engagements", paragraph 6(a).

⁵ SA 800, "Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks", paragraph 8.

⁶ SA 210, paragraph 6(b).

⁷ SA 580, "Written Representations", paragraphs 10-11.

A11. The mandates for audits of the financial statements of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of such an entity is conducted may include additional responsibilities, such as, the responsibility for the execution of transactions and events in accordance with legislation or proper authority.

Form of the Auditor's Opinion (Ref: Para. 8)

A12. The opinion expressed by the auditor is on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The form of the auditor's opinion, however, will depend upon the applicable financial reporting framework and any applicable laws or regulations. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, preparation of the financial statements in accordance with the applicable financial reporting framework includes presentation.

A13. Where the financial reporting framework is a fair presentation framework, as is generally the case for general purpose financial statements, the opinion required by the SAs is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view. Where the financial reporting framework is a compliance framework, the opinion required is on whether the financial statements are prepared, in all material respects, in accordance with the framework. Unless specifically stated otherwise, references in the SAs to the auditor's opinion cover both forms of opinion.

Ethical Requirements Relating to an Audit of Financial Statements (Ref: Para. 14)

A14. The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics issued by the Institute of Chartered Accountants of India.

A15. The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements and provides a conceptual framework for applying those principles;

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality; and
- (e) Professional behavior.

A16. In the case of an audit engagement it is in the public interest and, therefore, required by the Code of Ethics, that the auditor be independent of the entity subject to the audit. The Code describes independence as comprising both independence of mind and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

A17. Standard on Quality Control (SQC) ¹⁸ sets out the responsibilities of the firm for establishing policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with

¹⁸ 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".

relevant ethical requirements, including those pertaining to independence⁹. SA 220 sets out the engagement partner's responsibilities with respect to relevant ethical requirements. These include evaluating whether members of the engagement team have complied with relevant ethical requirements, determining the appropriate action if matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement¹⁰. SA 220 recognises that the engagement team is entitled to rely on a firm's systems in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless information provided by the firm or other parties suggests otherwise.

Professional Skepticism (Ref: Para. 15)

A18. Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

A19. Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

A20. Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

A21. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence¹¹. In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter¹².

A22. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional

⁹ SQC 1, paragraphs 14-27.

¹⁰ SA 220, "Quality Control for an Audit of Financial Statements", paragraphs 9-12.

¹¹ SA 500, "Audit Evidence", paragraphs 7-9.

¹² SA 240, paragraph 13; SA 500, paragraph 11; and SA 505, paragraphs 10-11, and 16.

skepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

Professional Judgment (Ref: Para. 16)

A23. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the SAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:

- Materiality and audit risk.
- The nature, timing, and extent of audit procedures used to meet the requirements of the SAs and gather audit evidence.
- Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the SAs and thereby, the overall objectives of the auditor.
- The evaluation of management's judgments in applying the entity's applicable financial reporting framework.
- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

A24. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

A25. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as that required by SA 220¹³, assist the auditor in making informed and reasonable judgments.

A26. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report.

A27. Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit¹⁴. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence.

Sufficient Appropriate Audit Evidence and Audit Risk (Ref: Para. 5 and 17)

Sufficiency and Appropriateness of Audit Evidence

A28. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also

¹³ SA 220, paragraph 18.

¹⁴ SA 230, paragraph 8.

include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit¹⁵) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by an expert employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

A29. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

A30. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

A31. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. SA 500 and other relevant SAs establish additional requirements and provide further guidance applicable throughout the audit regarding the auditor's considerations in obtaining sufficient appropriate audit evidence.

Audit Risk

A32. Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

A33. For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Risks of Material Misstatement

A34. The risks of material misstatement may exist at two levels:

- The overall financial statement level; and
- The assertion level for classes of transactions, account balances, and disclosures.

A35. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

¹⁵ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 9.

A36. Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. Auditors use various approaches to accomplish the objective of assessing the risks of material misstatement. For example, the auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk. Some auditors find such a model to be useful when planning audit procedures.

A37. The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

A38. Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

A39. Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The SAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed¹⁶.

A40. The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

A41. SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

Detection Risk

A42. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the

¹⁶ SA 330, "The Auditor's Responses to Assessed Risks", paragraphs 7-17.

more persuasive the audit evidence required by the auditor.

A43. Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

- adequate planning;
- proper assignment of personnel to the engagement team;
- the application of professional skepticism; and
- supervision and review of the audit work performed,

assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

A44. SA 300¹⁷ and SA 330 establish requirements and provide guidance on planning an audit of financial statements and the auditor's responses to assessed risks. Detection risk, however, can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.

Inherent Limitations of an Audit

A45. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from:

- The nature of financial reporting;
- The nature of audit procedures; and
- The need for the audit to be conducted within a reasonable period of time and at a reasonable cost.

The Nature of Financial Reporting

A46. 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. For example, this is often the case with respect to certain accounting estimates. Nevertheless, the SAs require the auditor to give specific consideration to whether accounting estimates are reasonable in the context of the applicable financial reporting framework and related disclosures, and to the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments¹⁸.

The Nature of Audit Procedures

A47. There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

¹⁷ SA 300, "Planning an Audit of Financial Statements".

¹⁸ SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", and Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 12.

- 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. Accordingly, the auditor cannot be certain of the completeness of information, even though the auditor has performed audit procedures to obtain assurance that all relevant information has been obtained.
- Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
- 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.

Timeliness of Financial Reporting and the Balance between Benefit and Cost

A48. The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, 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. This is recognised in certain financial reporting frameworks (see, for example, the “Framework for the Preparation and Presentation of Financial Statements” issued by the Institute of Chartered Accountants of India (ICAI)). Therefore, 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.

A49. Consequently, it is necessary for the auditor to:

- Plan the audit so that it will be performed in an effective manner;
- Direct audit effort to areas most expected to contain risks of material misstatement, whether due to fraud or error, with correspondingly less effort directed at other areas; and
- Use testing and other means of examining populations for misstatements.

A50. In light of the approaches described in paragraph A49, the SAs contain requirements for the planning and performance of the audit and require the auditor, among other things, to:

- Have a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels by performing risk assessment procedures and related activities¹⁹; and
- Use testing and other means of examining populations in a manner that provides a reasonable basis for the auditor to draw conclusions about the population²⁰.

Other Matters that Affect the Inherent Limitations of an Audit

A51. In the case of certain assertions or subject matters, the potential effects of the inherent limitations on the auditor’s ability to detect material misstatements are particularly significant. Such assertions or subject matters

¹⁹ SA 315, paragraphs 5-10.

²⁰ SA 330; SA 500; SA 520, “Analytical Procedures”, and SA 530, “Audit Sampling”.

include:

- Fraud, particularly fraud involving senior management or collusion. See SA 240 for further discussion.
- The existence and completeness of related party relationships and transactions. See SA 550 ²¹ for further discussion.
- The occurrence of non-compliance with laws and regulations. See SA 250 ²² for further discussion.
- Future events or conditions that may cause an entity to cease to continue as a going concern. See SA 570 ²³ for further discussion.

Relevant SAs identify specific audit procedures to assist in mitigating the effect of the inherent limitations.

A52. Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.

Conduct of an Audit in Accordance with SAs

Nature of the SAs (Ref: Para. 18)

A53. The SAs, taken together, provide the standards for the auditor's work in fulfilling the overall objectives of the auditor. The SAs deal with the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific topics.

A54. The scope, effective date and any specific limitation of the applicability of a specific SA is made clear in the SA. Unless otherwise stated in the SA, the auditor is permitted to apply an SA before the effective date specified therein.

A55. In performing an audit, the auditor may be required to comply with legal or regulatory requirements in addition to the SAs. The SAs do not override laws and regulations that govern an audit of financial statements. In the event that those laws and regulations differ from the SAs, an audit conducted only in accordance with laws and regulations will not automatically comply with SAs.

A56. The SAs are also relevant to engagements in case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions). The auditor's responsibilities of those entities, however, may be affected by the audit mandate, or by obligations on those entities arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature, which may encompass a broader scope than an audit of financial statements in accordance with the SAs. These additional responsibilities are not dealt with in the SAs. They may be dealt with in the relevant laws and regulations in which the entities are operating.

Contents of the SAs (Ref: Para. 19)

²¹ SA 550, "Related Parties".

²² SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements".

²³ SA 570, "Going Concern".

A57. In addition to objectives and requirements (requirements are expressed in the SAs using “shall”), an SA contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the SA, and definitions. The entire text of an SA, therefore, is relevant to an understanding of the objectives stated in an SA and the proper application of the requirements of an SA.

A58. Where necessary, the application and other explanatory material provides further explanation of the requirements of an SA and guidance for carrying them out. In particular, it may:

- Explain more precisely what a requirement means or is intended to cover.
- Include examples of procedures that may be appropriate in the circumstances.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an SA. The application and other explanatory material may also provide background information on matters addressed in an SA.

A59. Appendices form part of the application and other explanatory material. The purpose and intended use of an appendix are explained in the body of the related SA or within the title and introduction of the appendix itself.

A60. Introductory material may include, as needed, such matters as explanation of:

- The purpose and scope of the SA, including how the SA relates to other SAs.
- The subject matter of the SA.
- The respective responsibilities of the auditor and others in relation to the subject matter of the SA.
- The context in which the SA is set.

A61. An SA may include, in a separate section under the heading “Definitions”, a description of the meanings attributed to certain terms for purposes of the SAs. These are provided to assist in the consistent application and interpretation of the SAs, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout the SAs. The Glossary of Terms relating to Engagement and Quality Control Standards issued by the Auditing and Assurance Standards Board contains a complete listing of terms defined in the SAs. It also includes descriptions of other terms found in SAs to assist in common and consistent interpretation.

A62. When appropriate, additional considerations specific to audits of smaller entities and to certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), are included within the application and other explanatory material of an SA. These additional considerations assist in the application of the requirements of the SA in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of the SAs.

Considerations Specific to Smaller Entities

A63. For purposes of specifying additional considerations to audits of smaller entities, a “smaller entity” refers to an entity which typically possesses qualitative characteristics such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
- (b) One or more of the following:
 - (i) Straightforward or uncomplicated transactions;

- (ii) Simple record-keeping;
- (iii) Few lines of business and few products within business lines;
- (iv) Few internal controls;
- (v) Few levels of management with responsibility for a broad range of controls; or
- (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

A64. The considerations specific to smaller entities included in the SAs have been developed primarily with unlisted entities in mind. Some of the considerations, however, may be helpful in audits of smaller listed entities.

A65. The SAs refer to the proprietor of a smaller entity who is involved in running the entity on a day-to-day basis as the "owner-manager".

Objectives Stated in Individual SAs (Ref: Para. 21)

A66. Each SA contains one or more objectives which provide a link between the requirements and the overall objectives of the auditor. The objectives in individual SAs serve to focus the auditor on the desired outcome of the SA, while being specific enough to assist the auditor in:

- Understanding what needs to be accomplished and, where necessary, the appropriate means of doing so; and
- Deciding whether more needs to be done to achieve them in the particular circumstances of the audit.

A67. Objectives are to be understood in the context of the overall objectives of the auditor stated in paragraph 11 of this SA. As with the overall objectives of the auditor, the ability to achieve an individual objective is equally subject to the inherent limitations of an audit.

A68. In using the objectives, the auditor is required to have regard to the interrelationships among the SAs. This is because, as indicated in paragraph A53, the SAs deal in some cases with general responsibilities and in others with the application of those responsibilities to specific topics. For example, this SA requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each SA. At a more detailed level, SA 315 and SA 330 contain, among other things, objectives and requirements that deal with the auditor's responsibilities to identify and assess the risks of material misstatement and to design and perform further audit procedures to respond to those assessed risks, respectively; these objectives and requirements apply throughout the audit. An SA dealing with specific aspects of the audit (for example, SA 540) may expand on how the objectives and requirements of such SAs as SA 315 and SA 330 are to be applied in relation to the subject of the SA but does not repeat them. Thus, in achieving the objective stated in SA 540 , the auditor has regard to the objectives and requirements of other relevant SAs.

Use of Objectives to Determine Need for Additional Audit Procedures (Ref: Para. 21(a))

A69. The requirements of the SAs are designed to enable the auditor to achieve the objectives specified in the SAs, and thereby the overall objectives of the auditor. The proper application of the requirements of the SAs by the auditor is therefore expected to provide a sufficient basis for the auditor's achievement of the objectives. However, because the circumstances of audit engagements vary widely and all such circumstances cannot be anticipated in the SAs, the auditor is responsible for determining the audit procedures necessary to fulfill the requirements of the SAs and to achieve the objectives. In the circumstances of an engagement, there may be particular matters that require the auditor to perform audit procedures in addition to those required by the SAs to meet the objectives specified in the SAs.

Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence Has Been Obtained (Ref: Para. 21(b))

A70. The auditor is required to use the objectives to evaluate whether sufficient appropriate audit evidence has been obtained in the context of the overall objectives of the auditor. If as a result the auditor concludes that the audit evidence is not sufficient and appropriate, then the auditor may follow one or more of the following approaches to meeting the requirement of paragraph 21(b):

- Evaluate whether further relevant audit evidence has been, or will be, obtained as a result of complying with other SAs;
- Extend the work performed in applying one or more requirements; or
- Perform other procedures judged by the auditor to be necessary in the circumstances. Where none of the above is expected to be practical or possible in the circumstances, the auditor will not be able to obtain sufficient appropriate audit evidence and is required by the SAs to determine the effect on the auditor's report or on the auditor's ability to complete the engagement.

Complying with Relevant Requirements

Relevant Requirements (Ref: Para. 22)

A71. In some cases, an SA (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function, nothing in SA 610²⁴ is not relevant.

A72. Within a relevant SA, there may be conditional requirements. Such a requirement is relevant when the circumstances envisioned in the requirement apply and the condition exists. In general, the conditionality of a requirement will either be explicit or implicit, for example:

- The requirement to modify the auditor's opinion if there is a limitation of scope²⁵ represents an explicit conditional requirement.
- The requirement to communicate significant deficiencies in internal control identified during the audit to those charged with governance²⁶, which depends on the existence of such identified significant deficiencies; and the requirement to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework²⁷, which depends on that framework requiring or permitting such disclosure, represent implicit conditional requirements.

Departure from a Requirement (Ref: Para. 23)

A73. SA 230 establishes documentation requirements in those exceptional circumstances where the auditor departs from a relevant requirement²⁸. The SAs do not call for compliance with a requirement that is not relevant in the circumstances of the audit.

Failure to Achieve an Objective (Ref: Para. 24)

A74. Whether an objective has been achieved is a matter for the auditor's professional judgment. That

²⁴ SA 610, "Using the Work of Internal Auditors".

²⁵ SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 13.

²⁶ SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", paragraph 9.

²⁷ SA 501, "Audit Evidence – Specific Considerations for Selected Items", paragraph 13.

²⁸ SA 230, paragraph 12.

judgment takes account of the results of audit procedures performed in complying with the requirements of the SAs, and the auditor's evaluation of whether sufficient appropriate audit evidence has been obtained and whether more needs to be done in the particular circumstances of the audit to achieve the objectives stated in the SAs. Accordingly, circumstances that may give rise to a failure to achieve an objective include those that:

- Prevent the auditor from complying with the relevant requirements of an SA.
- Result in its not being practicable or possible for the auditor to carry out the additional audit procedures or obtain further audit evidence as determined necessary from the use of the objectives in accordance with paragraph 21, for example due to a limitation in the available audit evidence.

A75. Audit documentation that meets the requirements of SA 230 and the specific documentation requirements of other relevant SAs provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor. While it is unnecessary for the auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor's evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor.

Modifications *vis-à-vis* ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing"

Deletion

Paragraph A11 of ISA 200 deals with the additional responsibilities for the execution of transactions and events in accordance with legislation or proper authority in case of public sector entities. Further, paragraph A57 of ISA 200 (A56 of SA 200) deals with the auditor's additional responsibility arising out of the mandatory or obligatory laws or regulations applicable to that public sector entity. These additional responsibilities are not dealt by the SAs but dealt by the laws or regulations under which the public sector entity operates. Also, paragraph A63 of ISA 200 (A62 of SA 200) deals with the inclusion of the paragraph specific to public sector entities in the application and explanatory material section. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of paragraphs A11, A57 and A63 in ISA, highlighting such fact, has been retained.

SA 210*

Agreeing the Terms of Audit Engagements

(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with governance, are present. SA 220¹ deals with those aspects of engagement acceptance that are within the control of the auditor. (Ref: Para. A1)

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

3. The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:

- (a) Establishing whether the preconditions for an audit are present; and
- (b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

Definitions

4. For purposes of the SAs, the following term has the meaning attributed below:

Preconditions for an audit – The use by management of an acceptable financial reporting framework² in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise³ on which an audit is conducted.

5. For the purposes of this SA, references to “management” should be read hereafter as “management and, where appropriate, those charged with governance”.

Requirements

Preconditions for an Audit

6. In order to establish whether the preconditions for an audit are present, the auditor shall:
- (a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and (Ref: Para. A2-A9)

*Published in September, 2009 issue of the Journal.

¹ SA 220, “Quality Control for an Audit of Financial Statements”, published in March, 2010 issue of the Journal.

² SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing”, paragraph 13 (a).

³ SA 200, Paragraph 13 (j).

- (b) Obtain the agreement of management that it acknowledges and understands its responsibility: (Ref: Para A10-A13, A19)
 - (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation; (Ref: Para. A14)
 - (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and (Ref: Para. A15-A18)
 - (iii) To provide the auditor with:
 - a. Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - b. Additional information that the auditor may request from management for the purpose of the audit; and
 - c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Limitation on Scope Prior to Audit Engagement Acceptance

7. If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

Other Factors Affecting Audit Engagement Acceptance

8. If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement:
- (a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable, except as provided in paragraph 19; or
 - (b) If the agreement referred to in paragraph 6(b) has not been obtained.

Agreement on Audit Engagement Terms

9. The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. (Ref: Para. A20)

10. Subject to paragraph 11, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include: (Ref: Para. A21-A24)

- (a) The objective and scope of the audit of the financial statements;
- (b) The responsibilities of the auditor;
- (c) The responsibilities of management;
- (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
- (e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

11. If law or regulation prescribes in sufficient detail the terms of the audit engagement referred to in paragraph 10, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b). (Ref: Para. A21, A25-A26)

12. If law or regulation prescribes responsibilities of management similar to those described in paragraph 6(b), the auditor may determine that the law or regulation includes responsibilities that, in the auditor's judgment, are equivalent in effect to those set out in that paragraph. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the written agreement. For those responsibilities that are not prescribed by law or regulation such that their effect is equivalent, the written agreement shall use the description in paragraph 6(b). (Ref: Para. A25)

Recurring Audits

13. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. (Ref: Para. A27)

Acceptance of a Change in the Terms of the Audit Engagement

14. The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so. (Ref: Para. A28-A30)

15. If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so. (Ref: Para. A31-A32)

16. If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

17. If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

- (a) Withdraw from the audit engagement where possible under applicable law or regulation; and
- (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Additional Considerations in Engagement Acceptance

Financial Reporting Standards⁴ Supplemented by Law or Regulation

18. If financial reporting standards established by an authorised or recognised standards setting organization are supplemented by law or regulation, the auditor shall determine whether there are any conflicts between the financial reporting standards and the additional requirements. If such conflicts exist, the auditor shall discuss with management the nature of the additional requirements and shall agree whether:

- (a) The additional requirements can be met through additional disclosures in the financial statements; or
- (b) The description of the applicable financial reporting framework in the financial statements can be amended accordingly.

If neither of the above actions is possible, the auditor shall determine whether it will be necessary to modify the auditor's opinion in accordance with SA 705⁵. (Ref: Para. A33)

⁴ Accounting Standards issued by the ICAI or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, or the Accounting Standards for Local Bodies issued by the ICAI, as may be applicable.

⁵ Standard on Auditing (SA) 705, "Modifications to the Opinion in the Independent Auditor's Report"; published in February, 2010 issue of the Journal.

Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance

19. If the auditor has determined that the financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation, the auditor shall accept the audit engagement only if the following conditions are present: (Ref: Para. A34)

- (a) Management agrees to provide additional disclosures in the financial statements required to avoid the financial statements being misleading; and
- (b) It is recognised in the terms of the audit engagement that:
 - (i) The auditor's report on the financial statements will incorporate an Emphasis of Matter paragraph, drawing users' attention to the additional disclosures, in accordance with SA 706⁶; and
 - (ii) Unless the auditor is required by law or regulation to express the auditor's opinion on the financial statements by using the phrases "present fairly, in all material respects", or "give a true and fair view" in accordance with the applicable financial reporting framework, the auditor's opinion on the financial statements will not include such phrases.

20. If the conditions outlined in paragraph 19 are not present and the auditor is required by law or regulation to undertake the audit engagement, the auditor shall:

- (a) Evaluate the effect of the misleading nature of the financial statements on the auditor's report; and
- (b) Include appropriate reference to this matter in the terms of the audit engagement.

Auditor's Report Prescribed by Law or Regulation

21. In some cases, the law or regulation applicable to the entity prescribes the layout or wording of the auditor's report in a form or in terms that are significantly different from the requirements of SAs. In these circumstances, the auditor shall evaluate:

- (a) Whether users might misunderstand the assurance obtained from the audit of the financial statements and, if so,
- (b) Whether additional explanation in the auditor's report can mitigate possible misunderstanding⁷.

If the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, the auditor shall not accept the audit engagement, unless required by law or regulation to do so. An audit conducted in accordance with such law or regulation does not comply with SAs. Accordingly, the auditor shall not include any reference within the auditor's report to the audit having been conducted in accordance with SAs⁸. (Ref: Para. A35-A36)

Application and Other Explanatory Material**Scope of this SA (Ref: Para. 1)**

A1. Assurance engagements, which include audit engagements, may only be accepted when the practitioner considers that relevant ethical requirements such as independence and professional competence will be satisfied, and when the engagement exhibits certain characteristics⁹. The auditor's responsibilities in respect

⁶ Standard on Auditing (SA) 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", published in February, 2010 issue of the Journal.

⁷ SA 706.

⁸ SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 43.

⁹ "Framework for Assurance Engagements," paragraph 16.

of ethical requirements in the context of the acceptance of an audit engagement and in so far as they are within the control of the auditor are dealt with in SA 220¹⁰. This SA deals with those matters (or preconditions) that are within the control of the entity and upon which it is necessary for the auditor and the entity's management to agree.

Preconditions for an Audit

The Financial Reporting Framework (Ref: Para. 6(a))

A2. A condition for acceptance of an assurance engagement is that the criteria referred to in the definition of an assurance engagement are suitable and available to intended users¹¹. Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Suitable criteria enable reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment. For purposes of the SAs, the applicable financial reporting framework provides the criteria the auditor uses to audit the financial statements, including where relevant their fair presentation.

A3. Without an acceptable financial reporting framework, management does not have an appropriate basis for the preparation of the financial statements and the auditor does not have suitable criteria for auditing the financial statements. In many cases the auditor may presume that the applicable financial reporting framework is acceptable, as described in paragraphs A8-A9.

Determining the Acceptability of the Financial Reporting Framework

A4. Factors that are relevant to the auditor's determination of the acceptability of the financial reporting framework to be applied in the preparation of the financial statements include:

- The nature of the entity (for example, whether it is a business enterprise, or a not for profit organization);
- The purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users or the financial information needs of specific users);
- The nature of the financial statements (for example, whether the financial statements are a complete set of financial statements or a single financial statement); and
- Whether law or regulation prescribes the applicable financial reporting framework.

A5. Many users of financial statements are not in a position to demand financial statements tailored to meet their specific information needs. While all the information needs of specific users cannot be met, there are financial information needs that are common to a wide range of users. Financial statements prepared in accordance with a financial reporting framework designed to meet the common financial information needs of a wide range of users are referred to as general purpose financial statements.

A6. In some cases, the financial statements will be prepared in accordance with a financial reporting framework designed to meet the financial information needs of specific users. Such financial statements are referred to as special purpose financial statements. The financial information needs of the intended users will determine the applicable financial reporting framework in these circumstances. SA 800 discusses the acceptability of financial reporting frameworks designed to meet the financial information needs of specific users.¹²

A7. Deficiencies in the applicable financial reporting framework that indicate that the framework is not acceptable may be encountered after the audit engagement has been accepted. When use of that framework

¹⁰ SA 220, "Quality Control for an Audit of Financial Statements", paragraphs 9-11.

¹¹ "Framework for Assurance Engagements," paragraph 16(b)(ii).

¹² Standard on Auditing (SA) 800, "Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework", paragraph 8.

is prescribed by law or regulation, the requirements of paragraphs 19-20 apply. When use of that framework is not prescribed by law or regulation, management may decide to adopt another framework that is acceptable. When management does so, as required by paragraph 16, new terms of the audit engagement are agreed to reflect the change in the framework as the previously agreed terms will no longer be accurate.

General purpose frameworks

A8. At present, there is no objective and authoritative basis that has been generally recognised globally for judging the acceptability of general purpose frameworks. In the absence of such a basis, financial reporting standards established by organizations that are authorised or recognised to promulgate standards to be used by certain types of entities are presumed to be acceptable for general purpose financial statements prepared by such entities, provided the organizations follow an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders. Examples of such financial reporting standards include:

- Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) and/ or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, as may be applicable;
- Accounting Standards for Local Bodies issued by the Institute of Chartered Accountants of India (ICAI);
- International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board; and
- International Public Sector Accounting Standards (IPSASs) issued by the International Public Sector Accounting Standards Board.

These financial reporting standards are often identified as the applicable financial reporting framework in law or regulation governing the preparation of general purpose financial statements.

Financial reporting frameworks prescribed by law or regulation

A9. In accordance with paragraph 6(a), the auditor is required to determine whether the financial reporting framework, to be applied in the preparation of the financial statements, is acceptable. Appendix 2 contains guidance on determining the acceptability of the financial reporting framework. In case of some entities, law or regulation may prescribe the financial reporting framework to be used in the preparation of general purpose financial statements. In the absence of indications to the contrary, such a financial reporting framework is presumed to be acceptable for general purpose financial statements prepared by such entities. In the event that the framework is not considered to be acceptable, paragraphs 19-20 apply.

Agreement of the Responsibilities of Management (Ref: Para. 6(b))

A10. An audit in accordance with SAs is conducted on the premise that management has acknowledged and understands that it has the responsibilities set out in paragraph 6(b)¹³. In case of certain entities, such responsibilities may be specified in the applicable law or regulation. In others, there may be little or no legal or regulatory definition of such responsibilities. SAs do not override law or regulation in such matters. However, the concept of an independent audit requires that the auditor's role does not involve taking responsibility for the preparation of the financial statements or for the entity's related internal control, and that the auditor has a reasonable expectation of obtaining the information necessary for the audit in so far as management is able to provide or procure it. Accordingly, the premise is fundamental to the conduct of an independent audit. To avoid misunderstanding, agreement is reached with management that it acknowledges and understands that it has such responsibilities as part of agreeing and recording the terms of the audit engagement in paragraphs 9-12.

¹³ SA 200, Paragraph A2.

A11. The way in which the responsibilities for financial reporting are divided between management and those charged with governance will vary according to the resources and structure of the entity and any relevant law or regulation, and the respective roles of management and those charged with governance within the entity. In most cases, management is responsible for execution while those charged with governance have oversight of management. In some cases, those charged with governance will have, or will assume, responsibility for approving the financial statements or monitoring the entity's internal control related to financial reporting. In larger or public entities, a subgroup of those charged with governance, such as an audit committee, may be charged with certain oversight responsibilities.

A12. SA 580 requires the auditor to request management to provide written representations that it has fulfilled certain of its responsibilities¹⁴. It may therefore be appropriate to make management aware that receipt of such written representations will be expected, together with written representations required by other SAs and, where necessary, written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements.

A13. Where management will not acknowledge its responsibilities, or agree to provide the written representations, the auditor will be unable to obtain sufficient appropriate audit evidence¹⁵. In such circumstances, it would not be appropriate for the auditor to accept the audit engagement, unless law or regulation requires the auditor to do so. In cases where the auditor is required to accept the audit engagement, the auditor may need to explain to management the importance of these matters, and the implications for the auditor's report.

Preparation of the Financial Statements (Ref: Para. 6(b)(i))

A14. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, preparation of the financial statements in accordance with the financial reporting framework includes presentation. In the case of a fair presentation framework the importance of the reporting objective of fair presentation is such that the premise agreed with management includes specific reference to fair presentation, or to the responsibility to ensure that the financial statements will "give a true and fair view" in accordance with the financial reporting framework.

Internal Control (Ref: Para. 6(b)(ii))

A15. Management maintains such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives due to the inherent limitations of internal control¹⁶.

A16. An independent audit conducted in accordance with the SAs does not act as a substitute for the maintenance of internal control necessary for the preparation of financial statements by management. Accordingly, the auditor is required to obtain the agreement of management that it acknowledges and understands its responsibility for internal control. However, the agreement required by paragraph 6(b)(ii) does not imply that the auditor will find that internal control maintained by management has achieved its purpose or will be free of deficiencies.

A17. It is for management to determine what internal control is necessary to enable the preparation of the financial statements. The term "internal control" encompasses a wide range of activities within components

¹⁴ SA 580, "Written Representations," paragraphs 10-11.

¹⁵ SA 580, paragraph A26.

¹⁶ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," paragraph A46.

that may be described as the control environment; the entity's risk assessment process; the information system, including the related business processes relevant to financial reporting, and communication; control activities; and monitoring of controls. This division, however, does not necessarily reflect how a particular entity may design, implement and maintain its internal control, or how it may classify any particular component.¹⁷ An entity's internal control (in particular, its accounting books and records, or accounting systems) will reflect the needs of management, the complexity of the business, the nature of the risks to which the entity is subject, and relevant laws or regulation.

A18. In some cases, law or regulation may refer to the responsibility of management for the adequacy of accounting books and records, or accounting systems. In some other cases, general practice may assume a distinction between accounting books and records or accounting systems on the one hand, and internal control or controls on the other. As accounting books and records, or accounting systems, are an integral part of internal control as referred to in paragraph A18, no specific reference is made to them in paragraph 6(b)(ii) for the description of the responsibility of management. To avoid misunderstanding, it may be appropriate for the auditor to explain to management the scope of this responsibility.

Considerations Relevant to Smaller Entities (Ref: Para. 6(b))

A19. One of the purposes of agreeing the terms of the audit engagement is to avoid misunderstanding about the respective responsibilities of management and the auditor. For example, when a third party has assisted with the preparation of the financial statements, it may be useful to remind management that the preparation of the financial statements in accordance with the applicable financial reporting framework remains its responsibility.

Agreement on Audit Engagement Terms

Agreeing the Terms of the Audit Engagement (Ref: Para. 9)

A20. The roles of management and those charged with governance in agreeing the terms of the audit engagement for the entity depend on the governance structure of the entity and relevant law or regulation.

Audit Engagement Letter or Other Form of Written Agreement¹⁸ (Ref: Para. 10-11)

A21. It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter before the commencement of the audit to help avoid misunderstandings with respect to the audit. In some entities, however, the objective and scope of an audit and the responsibilities of management and of the auditor may be sufficiently established by law, that is, they prescribe the matters described in paragraph 10. Although in these circumstances paragraph 11 permits the auditor to include in the engagement letter only reference to the fact that relevant law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b), the auditor may nevertheless consider it appropriate to include the matters described in paragraph 10 in an engagement letter for the information of management.

Form and Content of the Audit Engagement Letter

A22. The form and content of the audit engagement letter may vary for each entity. Information included in the audit engagement letter on the auditor's responsibilities may be based on SA 200¹⁹. Paragraphs 6(b) and 12 of this SA deal with the description of the responsibilities of management. In addition to including the matters required by paragraph 10, an audit engagement letter may make reference to, for example:

¹⁷ SA 315, paragraph A51 and Appendix 1.

¹⁸ In the paragraphs that follow, any reference to an audit engagement letter is to be taken as a reference to an audit engagement letter or other suitable form of written agreement.

¹⁹ SA 200, paragraph 3-9.

- Elaboration of the scope of the audit, including reference to applicable legislation, regulations, SAs, and ethical and other pronouncements of professional bodies to which the auditor adheres.
- The form of any other communication of results of the audit engagement.
- The fact that because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.
- Arrangements regarding the planning and performance of the audit, including the composition of the audit team.
- The expectation that management will provide written representations (see also paragraph A13).
- The agreement of management to make available to the auditor draft financial statements and any accompanying other information in time to allow the auditor to complete the audit in accordance with the proposed timetable.
- The agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.
- The basis on which fees are computed and any billing arrangements.
- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein.
- The fact that the audit process may be subjected to a peer review under the Chartered Accountants Act, 1949.

A23. When relevant, the following points could also be made in the audit engagement letter:

- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors and other staff of the entity.
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
- Any restriction of the auditor's liability when such possibility exists.
- A reference to any further agreements between the auditor and the entity.
- Any obligations to provide audit working papers to other parties.

An example of an audit engagement letter is set out in Appendix 1.

Audits of Components

A24. When the auditor of a parent entity is also the auditor of a component, the factors that may influence the decision whether to send a separate audit engagement letter to the component include the following:

- Who appoints the component auditor;
- Whether a separate auditor's report is to be issued on the component;
- Legal requirements in relation to audit appointments;
- Degree of ownership by parent; and
- Degree of independence of the component management from the parent entity.

Responsibilities of Management Prescribed by Law or Regulation (Ref: Para. 11-12)

A25. If, in the circumstances described in paragraphs A22 and A27, the auditor concludes that it is not necessary to record certain terms of the audit engagement in an audit engagement letter, the auditor is still required by paragraph 11 to seek the written agreement from management that it acknowledges and understands that it has the responsibilities set out in paragraph 6(b). However, in accordance with paragraph 12, such written agreement may use the wording of the law or regulation if such law or regulation establishes responsibilities for management that are equivalent in effect to those described in paragraph 6(b).

A26. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), law or regulation governing the operations of that entities generally mandate the appointment of the auditor and commonly set out the auditor's responsibilities and powers, including the power to access an entity's records and other information. When law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor may nonetheless consider that there are benefits in issuing a fuller audit engagement letter than permitted by paragraph 11.

Recurring Audits (Ref: Para. 13)

A27. The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

Acceptance of a Change in the Terms of the Audit Engagement

Request to Change the Terms of the Audit Engagement (Ref: Para. 14)

A28. A request from the entity for the auditor to change the terms of the audit engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances. The auditor, as required by paragraph 14, considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement.

A29. A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement.

A30. In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

Request to Change to a Review or a Related Service (Ref: Para. 15)

A31. Before agreeing to change an audit engagement to a review or a related service, an auditor who was engaged to perform an audit in accordance with SAs may need to assess, in addition to the matters referred to in paragraphs A29-A31 above, any legal or contractual implications of the change.

A32. If the auditor concludes that there is reasonable justification to change the audit engagement to a review or a related service, the audit work performed to the date of change may be relevant to the changed engagement; however, the work required to be performed and the report to be issued would be those appropriate to the revised engagement. In order to avoid confusing the reader, the report on the related service would not include reference to:

- (a) The original audit engagement; or
- (b) Any procedures that may have been performed in the original audit engagement, except where the audit engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

Additional Considerations in Engagement Acceptance

Financial Reporting Standards Supplemented by Law or Regulation (Ref: Para. 18)

A33. In case of some entities, law or regulation may supplement the financial reporting standards established by an authorised or recognised standards setting organization with additional requirements relating to the preparation of financial statements. In such cases, the applicable financial reporting framework for the purposes of applying the SAs encompasses both the identified financial reporting framework and such additional requirements provided they do not conflict with the identified financial reporting framework. This may, for example, be the case when law or regulation prescribes disclosures in addition to those required by the financial reporting standards or when they narrow the range of acceptable choices that can be made within the financial reporting standards²⁰.

Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance (Ref: Para. 19)

A34. Law or regulation may prescribe that the wording of the auditor's opinion use the phrases "present fairly, in all material respects" or "give a true and fair view" in a case where the auditor concludes that the applicable financial reporting framework prescribed by law or regulation would otherwise have been unacceptable. In this case, the terms of the prescribed wording of the auditor's report are significantly different from the requirements of SAs (see paragraph 21).

Auditor's Report Prescribed by Law or Regulation (Ref: Para. 21)

A35. SAs require that the auditor shall not represent compliance with SAs unless the auditor has complied with all of the SAs relevant to the audit²¹. When law or regulation prescribes the layout or wording of the auditor's report in a form or in terms that are significantly different from the requirements of SAs and the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, the auditor may consider including a statement in the auditor's report that the audit is not conducted in accordance with SAs. The auditor is, however, encouraged to apply SAs, including the SAs that address the auditor's report, to the extent practicable, notwithstanding that the auditor is not permitted to refer to the audit being conducted in accordance with SAs.

A36. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), specific requirements may exist within the legislation governing the

²⁰ SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 15.

²¹ SA 200, paragraph 20.

audit mandate; for example, the auditor may be required to report directly to a regulator or the legislative body or the stakeholders if the entity attempts to limit the scope of the audit.

Material Modifications to ISA 210, “Agreeing the Terms of Audit Engagements”

Addition

Paragraph A8 of ISA 210 provides the examples of the financial reporting standards, which can be used for the preparation and presentation of general purpose financial statements. Since in India, financial reporting standards, used for the preparation and presentation of financial statements, can be ‘Accounting Standards issued by the Institute of Chartered Accountants of India or Accounting Standards, notified under Companies (Accounting Standards) Rules, 2006’ or ‘Accounting Standards for Local Bodies issued by the Institute of Chartered Accountants of India (ICAI)’, these have been added in the list of examples of financial reporting standards. References have accordingly been changed.

Deletions

1. Paragraph A10 of the ISA 210 deals with situations where the entity operates in a jurisdiction that does not have a standard setting organization or a prescribed financial reporting framework. Since in India, this kind of situation does not exist, paragraph A10 has been deleted. However, the reference to Appendix 2, *Determining Acceptability of General Purpose Frameworks*, has been shifted to paragraph A9.
2. Paragraph A27 of ISA 210 deals with the condition where the law or regulation governs the operations of public sector audits, and also prescribes the public sector auditor’s responsibilities and powers. Paragraph A37 of ISA 210 deals with the specific reporting requirements within the legislation governing the audit which may mandate; for example, the auditor may be required to report directly to a minister or the legislature or to public if the entity attempts to limit the scope of the audit in case of public sector entities. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted. However, since it is also possible that such situations may also exist in case of certain non-public entities pursuant to a requirement under the statute or regulation under which they operate the spirit of erstwhile A27 and A37 has been retained.

Appendix 1

(Ref: Paras. A22-A23)

Example of an Audit Engagement Letter

The following is an example of an audit engagement letter for an audit of general purpose financial statements prepared in accordance with Financial Reporting Standards²² of a company registered under the Companies Act, 1956. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this SA. It will need to be varied according to individual requirements and circumstances. It is drafted to refer to the audit of financial statements for a single reporting period and would require adaptation if intended or expected to apply to recurring audits (see paragraph 13 of this SA). It may be appropriate to seek legal advice that any proposed letter is suitable.

To the Board of Directors of ABC Company Limited:²³

[The objective and scope of the audit]

²² Refer footnote 6.

²³ The addressees and references in the letter would be those that are appropriate in the circumstances of the engagement, including the relevant jurisdiction. It is important to refer to the appropriate persons – see paragraph A21.

You²⁴ have requested that we audit the financial statements of ABC Company Limited, which comprise the Balance Sheet as at March 31, 20X1, and the Statement of Profit & Loss, and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.²⁵

[The responsibilities of the auditor]

We will conduct our audit in accordance with Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

[The responsibilities of management and identification of the applicable financial reporting framework (for purposes of this example it is assumed that the auditor has determined that the provisions of the Companies Act, 1956 relating to responsibility of the Board of Directors be supplemented by the descriptions in paragraph 6(b) of this SA).]

Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance]²⁶ acknowledge and understand that they have responsibility:

²⁴ Throughout this letter, references to "you", "we", "us", "management", "those charged with governance" and "auditor" would be used or amended as appropriate in the circumstances.

²⁵ Where the financial statements of the entity include financial statements/ information of its component(s) which have been audited by another auditor/ auditors, the engagement letter may be modified as under:

"You have requested that we audit the financial statements of ABC Company Limited, which comprise the Balance Sheet as at March 31, 20X1, and the Statement of Profit & Loss, and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

Further, as informed by you, the financial statements of the components of ABC Company Limited, viz., PQR Company Limited and XYZ Company Pvt Limited, whose financial information/ financial statements have been included in the financial statements of ABC Company would be/ have been audited by another auditor/ auditors. However, we expect to be furnished the reports of such other auditor(s) before the date of our audit report so as to enable us to deal with such reports in accordance with the principles enunciated in the Standard on Auditing (SA) 600, *Using the Work of Another Auditor*, issued by the Institute of Chartered Accountants of India".

²⁶ Use terminology as appropriate in the circumstances.

- (a) For the preparation of financial statements that give a true and fair view in accordance with the Financial Reporting Standards.²⁷ This includes:
- the responsibility for the preparation of financial statements on a going concern basis.
 - the responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards.
 - The responsibility for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.
- (b) For such internal control as [management] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (c) To provide us with:
- (i) Access, at all times, to all information, including the books, account, vouchers and other records and documentation, of the Company, whether kept at the head office of the company or elsewhere, of which [management] is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - (ii) Additional information that we may request from [management] for the purpose of the audit; and
 - (iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence. This includes our entitlement to require from the officers of the Company such information and explanations as we may think necessary for the performance of our duties as auditor.

As part of our audit process, we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949 to be conducted by an Independent reviewer. The reviewer may inspect, examine or take abstract of our working papers during the course of the peer review.

We look forward to full cooperation from your staff during our audit.

[Other relevant information]

[Insert other information, such as fee arrangements, billings²⁸ and other specific terms, as appropriate.]

[Reporting]

[Insert appropriate reference to the expected form and content of the auditor's report.]

The form and content of our report may need to be amended in the light of our audit findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

XYZ & Co.
Chartered Accountants
Firm's Registration Number

²⁷ Or, if appropriate, "For the preparation and fair presentation of the financial statements in accordance with the Financial Reporting Standards".

²⁸ For example, "Our fees will be billed as the work progresses".

.....
(Signature)

Date : (Name of the Member)

Place : (Designation²⁹)

Acknowledged on behalf of ABC Company by

.....
(Signature)

Name and Designation

Date

Appendix 2

(Ref: Para. A9)

Determining the Acceptability of General Purpose Frameworks

1. Acceptable financial reporting frameworks normally exhibit the following attributes that result in information provided in financial statements that is useful to the intended users:

- (a) Relevance, in that the information provided in the financial statements is relevant to the nature of the entity and the purpose of the financial statements. For example, in the case of a business enterprise that prepares general purpose financial statements, relevance is assessed in terms of the information necessary to meet the common financial information needs of a wide range of users in making economic decisions. These needs are ordinarily met by presenting the financial position, financial performance and cash flows of the business enterprise.
- (b) Completeness, in that transactions and events, account balances and disclosures that could affect conclusions based on the financial statements are not omitted.
- (c) Reliability, in that the information provided in the financial statements:
 - (i) Where applicable, reflects the economic substance of events and transactions and not merely their legal form; and
 - (ii) Results in reasonably consistent evaluation, measurement, presentation and disclosure, when used in similar circumstances.
- (d) Neutrality, in that it contributes to information in the financial statements that is free from bias.
- (e) Understandability, in that the information in the financial statements is clear and comprehensive and not subject to significantly different interpretation.

2. The auditor may decide to compare the accounting conventions to the requirements of an existing financial reporting framework considered to be acceptable. For example, the auditor may compare the accounting conventions to IFRSs. For an audit of a small entity, the auditor may decide to compare the accounting conventions to a financial reporting framework specifically developed for such entities by an authorised or recognised standards setting organization. When the auditor makes such a comparison and differences are identified, the decision as to whether the accounting conventions adopted in the preparation and presentation of the financial statements constitute an acceptable financial reporting framework includes considering the reasons for the differences and whether application of the accounting conventions, or the description of the financial reporting framework in the financial statements, could result in financial statements that are misleading.

²⁹ Partner or proprietor, as the case may be.

3. A conglomeration of accounting conventions devised to suit individual preferences is not an acceptable financial reporting framework for general purpose financial statements. Similarly, a compliance framework will not be an acceptable financial reporting framework, unless it is generally accepted in the industry to which the entity belongs by preparers and users.

SA 220*

**Quality Control for an Audit of
Financial Statements**
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)*

Introduction**Scope of this SA**

1. This Standard on Auditing (SA) deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. It also addresses, where applicable, the responsibilities of the engagement quality control reviewer. This SA is to be read in conjunction with relevant ethical requirements.

System of Quality Control and Role of Engagement Teams

2. Quality control systems, policies and procedures are the responsibility of the audit firm. Under SQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

- (a) The firm and its personnel comply with professional standards and regulatory and legal requirements; and
- (b) The reports issued by the firm or engagement partners are appropriate in the circumstances¹.

This SA is premised on the basis that the firm is subject to SQC 1. (Ref: Para. A1)

3. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence.

4. Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise. (Ref: Para. A2)

Effective Date

5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

6. The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

- (a) The audit complies with professional standards and regulatory and legal requirements; and
- (b) The auditor's report issued is appropriate in the circumstances.

* Published in March, 2010 issue of the Journal.

¹ 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", paragraph 10.

Definitions

7. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) Engagement partner – the partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
 - (b) Engagement quality control review – a process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.
 - (c) Engagement quality control reviewer – a partner, other person² in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report. However, in case the review is done by a team of individuals, such team should be headed by a member of the Institute.
 - (d) Engagement team – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.
 - (e) Firm – a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.
 - (f) Inspection – in relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.
 - (g) Listed entity – an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are traded under the regulations of a recognized stock exchange or other equivalent body.
 - (h) Monitoring – a process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively.
 - (i) Network firm – A firm or entity that belongs to a network.
 - (j) Network – A larger structure:
 - (i) That is aimed at cooperation, and
 - (ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.
 - (k) Partner – any individual with authority to bind the firm with respect to the performance of a professional services engagement.
 - (l) Personnel – partners and staff.
 - (m) Professional Standards – Engagement Standards, as defined in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", issued by the Institute of Chartered Accountants of India and relevant ethical requirements as contained in the Code of Ethics issued by the Institute.
 - (n) Relevant ethical requirements – Ethical requirements to which the engagement team and engagement

² Such other person should be a member of the Institute of Chartered Accountants of India.

quality control reviewer are subject, which ordinarily comprise the Code of Ethics of the Institute of Chartered Accountants of India related to an audit of financial statements.

- (o) Staff – professionals, other than partners, including any experts which the firm employs.
- (p) Suitably qualified external person – an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner or an employee³ (with appropriate experience) of another firm.

Requirements

Leadership Responsibilities for Quality on Audits

8. The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. (Ref: Para. A3)

Relevant Ethical Requirements

9. Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. (Ref: Para. A4-A5)

10. If matters come to the engagement partner's attention through the firm's system of quality control or otherwise that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action. (Ref: Para. A5)

Independence

11. The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall:

- (a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- (b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and
- (c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action. (Ref: Para. A5-A7)

Acceptance and Continuance of Client Relationships and Audit Engagements

12. The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate. (Ref: Para. A8-A9)

13. If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action. (Ref: Para. A9)

Assignment of Engagement Teams

³ Such employee should be a member of the Institute of Chartered Accountants of India.

14. The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:

- (a) Perform the audit engagement in accordance with professional standards and regulatory and legal requirements; and
- (b) Enable an auditor's report that is appropriate in the circumstances to be issued. (Ref: Para. A10-A12)

Engagement Performance

Direction, Supervision and Performance

15. The engagement partner shall take responsibility for:

- (a) The direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements; and (Ref: Para. A13-A15, A20)
- (b) The auditor's report being appropriate in the circumstances.

Reviews

16. The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. (Ref: Para. A16-A17, A20)

17. On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued. (Ref: Para. A18-A20)

Consultation

18. The engagement partner shall:

- (a) Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;
- (b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;
- (c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and
- (d) Determine that conclusions resulting from such consultations have been implemented. (Ref: Para. A21-A22)

Engagement Quality Control Review

19. For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

- (a) Determine that an engagement quality control reviewer has been appointed;
- (b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and
- (c) Not date the auditor's report until the completion of the engagement quality control review. (Ref: Para. A23-A25)

20. The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. This evaluation shall involve:

- (a) Discussion of significant matters with the engagement partner;
 - (b) Review of the financial statements and the proposed auditor's report;
 - (c) Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and
 - (d) Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate. (Ref: Para. A26-A27, A29-A31)
21. For audits of financial statements of listed entities, the engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:
- (a) The engagement team's evaluation of the firm's independence in relation to the audit engagement;
 - (b) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations; and
 - (c) Whether audit documentation selected for review reflects the work performed in relation to the significant judgments made and supports the conclusions reached. (Ref: Para. A28-A31)

Differences of Opinion

22. If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

Monitoring

23. An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement. (Ref: Para A32-A34)

Documentation

24. The auditor shall document:
- (a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.
 - (b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.
 - (c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.
 - (d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement. (Ref: Para. A35)
25. The engagement quality control reviewer shall document, for the audit engagement reviewed, that:
- (a) The procedures required by the firm's policies on engagement quality control review have been performed;
 - (b) The engagement quality control review has been completed on or before the date of the auditor's report; and
 - (c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

Application and Other Explanatory Material**System of Quality Control and Role of Engagement Teams** (Ref: Para. 2)

A1. SQC 1 deals with the firm's responsibilities to establish and maintain its system of quality control for audit engagements. The system of quality control includes policies and procedures that address each of the following elements:

- Leadership responsibilities for quality within the firm;
- Relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance; and
- Monitoring.

Reliance on the Firm's System of Quality Control (Ref: Para. 4)

A2. Unless information provided by the firm or other parties suggest otherwise, the engagement team may rely on the firm's system of quality control in relation to, for example:

- Competence of personnel through their recruitment and formal training.
- Independence through the accumulation and communication of relevant independence information.
- Maintenance of client relationships through acceptance and continuance systems.
- Adherence to regulatory and legal requirements through the monitoring process.

Leadership Responsibilities for Quality on Audits (Ref: Para. 8)

A3. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

- (a) The importance to audit quality of:
 - (i) Performing work that complies with professional standards and regulatory and legal requirements;
 - (ii) Complying with the firm's quality control policies and procedures as applicable;
 - (iii) Issuing auditor's reports that are appropriate in the circumstances; and
 - (iv) The engagement team's ability to raise concerns without fear of reprisals; and
- (b) The fact that quality is essential in performing audit engagements.

Relevant Ethical Requirements**Compliance with Relevant Ethical Requirements** (Ref: Para. 9)

A4. The Code of Ethics issued by the Institute of Chartered Accountants of India establishes the fundamental principles of professional ethics, which include:

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality; and
- (e) Professional behavior.

Definition of "Firm", "Network" and "Network Firm" (Ref: Para. 9-11)

A5. The definitions of “firm”, “network” or “network firm” in relevant ethical requirements may differ from those set out in this SA. For example, the Code of Ethics of the Institute of Chartered Accountants of India (ICAI) defines the “Network Firm” as:

“Networking amongst two or more firms under common control, ownership or management with the firm or having affiliation with an accounting entity or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally”.

In complying with the requirements in paragraphs 9-11, the definitions used in the relevant ethical requirements apply in so far as is necessary to interpret those ethical requirements.

Threats to Independence (Ref: Para. 11(c))

A6. The engagement partner may identify a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level. In that case, as required by paragraph 11(c), the engagement partner reports to the relevant person(s) within the firm to determine appropriate action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement, where withdrawal is legally permitted.

A7. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), statutory measures may provide safeguards for the independence of auditors of certain entities. However, such auditors or audit firms carrying out audits on behalf of the statutory auditor may, depending on the terms of the applicable legal or regulatory framework, need to adapt their approach in order to promote compliance with the spirit of paragraph 11. This may include, where the auditor’s applicable law or regulation does not permit withdrawal of the auditor from the engagement, disclosure through a public report, of circumstances that have arisen that would, have otherwise lead the auditor to withdraw.

Acceptance and Continuance of Client Relationships and Audit Engagements (Ref: Para. 12)

A8. SQC 1 requires the firm to obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client⁴. Information such as the following assists the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:

- The integrity of the principal owners, key management and those charged with governance of the entity;
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- Whether the firm and the engagement team can comply with relevant ethical requirements; and
- Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

A9. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), auditors may be appointed in accordance with statutory procedures. Accordingly, certain of the requirements and considerations regarding the acceptance and continuance of client relationships and audit engagements as set out in paragraphs 12, 13 and A7 may not be relevant. Nonetheless, information gathered as a result of the process described may be valuable to the auditors of such entities in performing risk assessments and in carrying out reporting responsibilities.

⁴ SQC 1, paragraph 28.

Assignment of Engagement Teams (Ref: Para. 14)

A10. An engagement team also includes a member using expertise in a specialised area of accounting or auditing, whether engaged or employed by the firm, if any, who performs audit procedures on the engagement.

A11. When considering the appropriate competence and capabilities expected of the engagement team as a whole, the engagement partner may take into consideration such matters as the team's:

- Understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
- Understanding of professional standards and regulatory and legal requirements.
- Technical expertise, including expertise with relevant information technology and specialised areas of accounting or auditing.
- Knowledge of relevant industries in which the client operates.
- Ability to apply professional judgment.
- Understanding of the firm's quality control policies and procedures.

A12. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), additional appropriate competence may include skills that are necessary to discharge the terms of the audit mandate in a particular jurisdiction. Such competence may include an understanding of the applicable reporting arrangements, including reporting to the legislature or other governing body or in the public interest. The wider scope of audit of such entities may include, for example, some aspects of performance auditing or a comprehensive assessment of compliance with legislative authorities and preventing and detecting fraud and corruption.

Engagement Performance**Direction, Supervision and Performance** (Ref: Para. 15(a))

A13. Direction of the engagement team involves informing the members of the engagement team of matters such as:

- Their responsibilities, including the need to comply with relevant ethical requirements, and to plan and perform an audit with professional skepticism as required by SA 200⁵.
- Responsibilities of respective partners where more than one partner is involved in the conduct of an audit engagement.
- The objectives of the work to be performed.
- The nature of the entity's business.
- Risk-related issues.
- Problems that may arise.
- The detailed approach to the performance of the engagement.

Discussion among members of the engagement team allows less experienced team members to raise questions with more experienced team members so that appropriate communication can occur within the engagement team.

A14. Appropriate teamwork and training assist less experienced members of the engagement team to clearly

⁵ SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph 15.

understand the objectives of the assigned work.

A15. Supervision includes matters such as:

- Tracking the progress of the audit engagement.
- Considering the competence and capabilities of individual members of the engagement team, including whether they have sufficient time to carry out their work, whether they understand their instructions, and whether the work is being carried out in accordance with the planned approach to the audit engagement.
- Addressing significant matters arising during the audit engagement, considering their significance and modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement.

Reviews

Review Responsibilities (Ref: Para. 16)

A16. Under SQC 1, the firm's review responsibility policies and procedures are determined on the basis that work of less experienced team members is reviewed by more experienced team members⁶.

A17. A review consists of consideration whether, for example:

- The work has been performed in accordance with professional standards and regulatory and legal requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the auditor's report; and
- The objectives of the engagement procedures have been achieved.

The Engagement Partner's Review of Work Performed (Ref: Para. 17)

A18. Timely reviews of the following by the engagement partner at appropriate stages during the engagement allow significant matters to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report:

- Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement;
- Significant risks; and
- Other areas the engagement partner considers important.

The engagement partner need not review all audit documentation, but may do so. However, as required by SA 230, the partner documents the extent and timing of the reviews⁷.

A19. An engagement partner taking over an audit during the engagement may apply the review procedures as described in paragraphs A17 to review the work performed to the date of a change in order to assume the

⁶ SQC 1, paragraph 50.

⁷ SA 230, "Audit Documentation", paragraph 9(c).

responsibilities of an engagement partner.

Considerations Relevant Where a Member of the Engagement Team with Expertise in a Specialised Area of Accounting or Auditing Is Used (Ref: Para. 15-17)

A20. Where a member of the engagement team with expertise in a specialised area of accounting or auditing is used, direction, supervision and review of that engagement team member's work may include matters such as:

- Agreeing with that member the nature, scope and objectives of that member's work; and the respective roles of, and the nature, timing and extent of communication between that member and other members of the engagement team.
- Evaluating the adequacy of that member's work including the relevance and reasonableness of that member's findings or conclusions and their consistency with other audit evidence.

Consultation (Ref: Para. 18)

A21. Effective consultation on significant technical, ethical, and other matters within the firm or, where applicable, outside the firm can be achieved when those consulted:

- Are given all the relevant facts that will enable them to provide informed advice; and
- Have appropriate knowledge, seniority and experience.

A22. It may be appropriate for the engagement team to consult outside the firm, for example, where the firm lacks appropriate internal resources. They may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organisations that provide relevant quality control services.

Engagement Quality Control Review

Completion of the Engagement Quality Control Review before Dating of the Auditor's Report (Ref: Para. 19(c))

A23. SA 700 requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the auditor's opinion on the financial statements⁸. In cases of an audit of financial statements of listed entities or when an engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.

A24. Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the engagement quality control reviewer's satisfaction on or before the date of the auditor's report.

A25. Completion of the engagement quality control review means the completion by the engagement quality control reviewer of the requirements in paragraphs 20-21, and where applicable, compliance with paragraph 22. Documentation of the engagement quality control review may be completed after the date of the auditor's report as part of the assembly of the final audit file. SA 230 establishes requirements and provides guidance in this regard⁹.

Nature, Extent and Timing of Engagement Quality Control Review (Ref: Para. 20)

A26. Remaining alert for changes in circumstances allows the engagement partner to identify situations in which an engagement quality control review is necessary, even though at the start of the engagement, such a review was not required.

⁸ SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 41.

⁹ SA 230, paragraphs 14-16 and A21-A24.

A27. The extent of the engagement quality control review may depend, among other things, on the complexity of the audit engagement, whether the entity is a listed entity, and the risk that the auditor's report might not be appropriate in the circumstances. The performance of an engagement quality control review does not reduce the responsibilities of the engagement partner for the audit engagement and its performance.

Engagement Quality Control Review of Listed Entities (Ref: Para. 21)

A28. Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review of a listed entity include:

- Significant risks identified during the engagement in accordance with SA 315¹⁰, and the responses to those risks in accordance with SA 330¹¹, including the engagement team's assessment of, and response to, the risk of fraud in accordance with SA 240¹².
- Judgments made, particularly with respect to materiality and significant risks.
- The significance and disposition of corrected and uncorrected misstatements identified during the audit.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

These other matters, depending on the circumstances, may also be applicable for engagement quality control reviews for audits of financial statements of other entities.

Considerations Specific to Smaller Entities (Ref: Para. 20-21)

A29. In addition to the audits of financial statements of listed entities, an engagement quality control review is required for such audit engagements also that meet the criteria established by the firm that subjects engagements to an engagement quality control review. In some cases, none of the firm's audit engagements may meet the criteria that would subject them to such a review.

Considerations Specific to Central/State Governments and Related Government Entities (Ref: Para. 20-21)

A30. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), a statutorily appointed auditor (for example, an Auditor General, or other suitably qualified person appointed on behalf of the Auditor General), may act in a role equivalent to that of engagement partner with overall responsibility for certain entities audits. In such circumstances, where applicable, the selection of the engagement quality control reviewer includes consideration of the need for independence from the audited entity and the ability of the engagement quality control reviewer to provide an objective evaluation.

A31. Certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), may not necessarily be listed entities yet may be significant due to size, complexity or public interest aspects, and which consequently have a wide range of stakeholders. Examples include state owned corporations and public utilities. Ongoing transformations within the certain entities may also give rise to new types of significant entities. There are no fixed objective criteria on which the determination of significance is based. Nonetheless, auditors of such entities evaluate which of these entities may be of sufficient significance to warrant performance of an engagement quality control review.

Monitoring (Ref: Para. 23)

¹⁰ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

¹¹ SA 330, "The Auditor's Responses to Assessed Risks".

¹² SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

A32. SQC 1 requires the firm to establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control is relevant, adequate and operating effectively¹³.

A33. In considering deficiencies that may affect the audit engagement, the engagement partner may have regard to measures the firm took to rectify the situation that the engagement partner considers are sufficient in the context of that audit.

A34. A deficiency in the firm's system of quality control does not necessarily indicate that a particular audit engagement was not performed in accordance with professional standards and regulatory and legal requirements, or that the auditor's report was not appropriate.

Documentation

Documentation of Consultations (Ref: Para. 24(d))

A35. Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of:

- The issue on which consultation was sought; and
- The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

Modifications *vis-à-vis* ISA 220, "Quality Control for an Audit of Financial Statements"

Deletion

Paragraphs A7, A9, A12, A30 and A31 of the Application Section of ISA 220 dealt with the application of the requirements of ISA 220 to the audits of public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that these requirements may also exist in case of non public sector entities pursuant to a requirement under the statute. Accordingly, the spirit of paragraphs A7, A9, A12, A30 and A31 has, accordingly, been made more generic in its application.

¹³ SQC 1, Paragraph 86.

SA 230*

Audit Documentation

*(Effective for audits of financial statements
for periods beginning on or after April 1, 2009)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. It is to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The specific documentation requirements of other SAs do not limit the application of this SA. Laws or regulations may establish additional documentation requirements.

Nature and Purposes of Audit Documentation

2. Audit documentation that meets the requirements of this SA and the specific documentation requirements of other relevant SAs provides:

- (a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and
- (b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

3. Audit documentation serves 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 220¹.
- ◆ 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 1².
- ◆ Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective

5. The objective of the auditor is to prepare documentation that provides:

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

* Published in January, 2009 issue of the Journal.

¹ SA 220, "Quality Control for an Audit of Financial Statements", paragraph 15-17.

² SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", paragraphs 46, 60, 63, 65 and 85.

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

Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) **Audit documentation** – The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as “working papers” or “workpapers” are also sometimes used).
- (b) **Audit file** – One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
- (c) **Experienced auditor** – An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:
- (i) Audit processes;
 - (ii) SAs and applicable legal and regulatory requirements;
 - (iii) The business environment in which the entity operates; and
 - (iv) Auditing and financial reporting issues relevant to the entity’s industry.

Requirements**Timely Preparation of Audit Documentation**

7. The auditor shall prepare audit documentation on a timely basis. (*Ref: Para. A1*)

Documentation of the Audit Procedures Performed and Audit Evidence Obtained**Form, Content and Extent of Audit Documentation**

8. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (*Ref: Para. A2-A5, A16- A17*)

- (a) The nature, timing, and extent of the audit procedures performed to comply with the SAs and applicable legal and regulatory requirements; (*Ref: Para. A6-A7*)
- (b) The results of the audit procedures performed, and the audit evidence obtained; and
- (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (*Ref: Para. A8- A11*)

9. In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:

- (a) The identifying characteristics of the specific items or matters tested; (*Ref: Para. A12*)
- (b) Who performed the audit work and the date such work was completed; and
- (c) Who reviewed the audit work performed and the date and extent of such review. (*Ref: Para. A13*)

10. The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. (*Ref: Para. A14*)

11. If the auditor identified information that is inconsistent with the auditor’s final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency. (*Ref: Para. A15*)

Departure from a Relevant Requirement

12. If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement in a SA, the auditor shall document how the alternative audit procedures performed achieve the aim of that

requirement, and the reasons for the departure. (Ref: Para. A18-A19)

Matters Arising after the Date of the Auditor's Report

13. If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document: (Ref: Para. A20)

- (a) The circumstances encountered;
- (b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and
- (c) When and by whom the resulting changes to audit documentation were made and reviewed.

Assembly of the Final Audit File

14. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. (Ref: Para. A21-A22)

15. After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period. (Ref: Para. A23)

16. In circumstances other than those envisaged in paragraph 13 where the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor shall, regardless of the nature of the modifications or additions, document: (Ref: Para. A24 -A25)

- (a) The specific reasons for making them; and
- (b) When and by whom they were made and reviewed.

Application and Other Explanatory Material

Timely Preparation of Audit Documentation (Ref: Para. 7)

A1. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalised. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

Documentation of the Audit Procedures Performed and Audit Evidence Obtained

Form, Content and Extent of Audit Documentation (Ref: Para. 8)

A2. The form, content and extent of audit documentation depend on factors such as:

- ◆ The size and complexity of the entity.
- ◆ The nature of the audit procedures to be performed.
- ◆ The identified risks of material misstatement.
- ◆ The significance of the audit evidence obtained.
- ◆ The nature and extent of exceptions identified.
- ◆ The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- ◆ The audit methodology and tools used.

A3. Audit documentation may be recorded on paper or on electronic or other media. Examples of audit documentation include:

- ◆ Audit programmes.
- ◆ Analyses.
- ◆ Issues memoranda.
- ◆ Summaries of significant matters.
- ◆ Letters of confirmation and representation.
- ◆ Checklists.
- ◆ Correspondence (including e-mail) concerning significant matters.

The auditor may include abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) as part of audit documentation. Audit documentation, however, is not a substitute for the entity's accounting records.

A4. The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

A5. Oral explanations by the auditor, on their own, do not represent adequate support for the work auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.

Documentation of Compliance with SAs (Ref: Para. 8(a))

A6. In principle, compliance with the requirements of this SA will result in the audit documentation being sufficient and appropriate in the circumstances. Other SAs contain specific documentation requirements that are intended to clarify the application of this SA in the particular circumstances of those SAs. The specific documentation requirements of other SAs do not limit the application of this SA. Furthermore, the absence of a documentation requirement in any particular SA is not intended to suggest that there is no documentation that will be prepared as a result of complying with that SA.

A7. Audit documentation provides evidence that the audit complies with SAs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:

- ◆ The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- ◆ The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management, or where appropriate, those charged with governance.
- ◆ An auditor's report containing an appropriately qualified opinion demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the SAs.
- ◆ In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
 - For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with SAs. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.

- Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the SAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussion required by SA 315³.

Documentation of Significant Matters and Related Significant Professional Judgments (Ref: Para. 8(c))

A8. Judging the significance of a matter requires an objective analysis of the facts and circumstances. Examples of significant matters include:

- ◆ Matters that give rise to significant risks (as defined in SA 315)⁴.
- ◆ Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- ◆ Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- ◆ Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter paragraph in the auditor's report.

A9. An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

A10. Some examples of circumstances in which, in accordance with paragraph 8, it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- ◆ The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.
- ◆ The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- ◆ The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

A11. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross- references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters. It may also help the auditor

³ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 10.

⁴ SA 315, paragraph 4(e).

to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

Identification of Specific Items or Matters Tested, and of the Preparer and Reviewer (Ref: Para. 9)

A12. Recording the identifying characteristics serves a number of purposes. For example, it enables the engagement team to be accountable for its work and facilitates the investigation of exceptions or inconsistencies. Identifying characteristics will vary with the nature of the audit procedure and the item or matter tested. For example:

- ◆ For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers.
- ◆ For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register).
- ◆ For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point and the sampling interval (for example, a systematic sample of shipping reports selected from the shipping log for the period April 1 to September 30, starting with report number 12345 and selecting every 125th report).
- ◆ For a procedure requiring inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of the entity personnel.
- ◆ For an observation procedure, the auditor may record the process or matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

A13. SA 220⁵ requires the auditor to review the audit work performed through review of the audit documentation. The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The requirement, however, means documenting what audit work was reviewed, who reviewed such work, and when it was reviewed.

Documentation of Discussions of Significant Matters with Management, Those Charged with Governance, and Others (Ref: Para. 10)

A14. The documentation is not limited to records prepared by the auditor but may include other appropriate records such as minutes of meetings prepared by the entity's personnel and agreed by the auditor. Others with whom the auditor may discuss significant matters may include other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

Documentation of How Inconsistencies have been addressed (Ref: Para. 11)

A15. The requirement to document how the auditor addressed inconsistencies in information does not imply that the auditor needs to retain documentation that is incorrect or superseded.

Considerations Specific to Smaller Entities (Ref: Para. 8)

A16. The audit documentation for the audit of a smaller entity is generally less extensive than that for the audit of a larger entity. Further, in the case of an audit where the engagement partner performs all the audit work, the documentation will not include matters that might have to be documented solely to inform or instruct members of an engagement team, or to provide evidence of review by other members of the team (for example, there will be no matters to document relating to team discussions or supervision). Nevertheless, the engagement partner complies with the overriding requirement in paragraph 8 to prepare audit documentation

⁵ SA 220, paragraph 17.

that can be understood by an experienced auditor, as the audit documentation may be subject to review by external parties for regulatory or other purposes.

A17. When preparing audit documentation, the auditor of a smaller entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality, determined in accordance with SA 320⁶, assessed risks, significant matters noted during the audit, and conclusions reached.

Departure from a Relevant Requirement (Ref: Para. 12)

A18. The requirements of the SAs are designed to enable the auditor to achieve the objectives specified in the SAs, and thereby the overall objectives of the auditor. Accordingly, other than in exceptional circumstances, the SAs call for compliance with each requirement that is relevant in the circumstances of the audit.

A19. The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant⁷ only in the cases where:

- (a) The entire SA is not relevant [for example, if an entity does not have an internal audit function, nothing in SA 610⁸ is relevant]; or
- (b) The requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

Matters Arising after the Date of the Auditor's Report (Ref: Para. 13)

A20. Examples of exceptional circumstances include facts which become known to the auditor after the date of the auditor's report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor's report.⁹ The resulting changes to the audit documentation are reviewed in accordance with the review responsibilities set out in SA 220¹⁰, with the engagement partner taking final responsibility for the changes.

Assembly of the Final Audit File (Ref: Para. 14-16)

A21. SQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files.¹¹ An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.¹²

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

- ◆ Deleting or discarding superseded documentation.

⁶ SA 320, "Materiality in Planning and Performing an Audit".

⁷ Refer paragraph 22 of SA 200.

⁸ SA 610, "Using the Work of Internal Auditors."

⁹ SA 560, "Subsequent Events", paragraph 13.

¹⁰ SA 220, paragraph 16.

¹¹ Refer para 74 of SQC 1.

¹² Refer para 75 of SQC 1.

- ◆ Sorting, collating and cross referencing working papers.
- ◆ Signing off on completion checklists relating to the file assembly process.
- ◆ Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

A23. SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation.¹³ The retention period for audit engagements ordinarily is no shorter than seven years¹⁴ from the date of the auditor's report, or, if later, the date of the group auditor's report.¹⁵

A24. An example of a circumstance in which the auditor may find it necessary to modify existing audit documentation or add new audit documentation after file assembly has been completed is the need to clarify existing audit documentation arising from comments received during monitoring inspections performed by internal or external parties.

Ownership of Audit Documentation

A25. 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, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation 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.

Material Modifications to ISA 230, "Audit Documentation"

Addition

1. Paragraph A23 of ISA 230 prescribes the minimum period of engagement documentation as five years. The SA 230 prescribes the minimum period of retention of engagement documentation as seven years since, as per the provisions of the Chartered Accountants Act, 1949, and regulations made there under, prescribe the minimum period of retention of working papers as seven years.
2. An additional paragraph A25 has been added from SQC 1, giving provisions regarding Ownership of Audit Documentation.

¹³ Refer para 82 of SQC 1.

¹⁴ The Council of the Institute had in August 2009, pursuant to the provisions of Rule 12 of the Chartered Accountants (Procedures of Investigations of Professional and Other Misconduct and Cases) Rules, 2007 had amended the audit documentation retention period appearing as ten years in paragraph 83 of SQC 1 to seven years. As a consequence of above decision of the Council, the audit documentation retention period appearing as ten years in paragraph A23 of SA 230, 'Audit Documentation', issued in January 2009, shall also stand amended to seven years. The complete text of the Announcement is published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

¹⁵ Refer para 83 of SQC 1.

SA 240*

**The Auditor's Responsibilities Relating to Fraud
In An Audit of Financial Statements**
*(Effective for audits of financial statements
for periods beginning on or after April 1, 2009)*

Introduction**Scope of this SA**

1. This Standard on Auditing (SA) deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," and SA 330, "The Auditor's Responses to Assessed Risks," are to be applied in relation to risks of material misstatement due to fraud.

Characteristics of Fraud

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

3. Although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred. (Ref: Para. A1-A6)

Responsibility for the Prevention and Detection of Fraud

4. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

Responsibilities of the Auditor

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

* Published in December, 2007 issue of the Journal.

performed in accordance with the SAs.¹

6. As described in SA 200², the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

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

8. When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Effective Date

9. This SA is effective for audits of financial statements for periods beginning on or after 1st April, 2009.

Objectives

10. The objectives of the auditor are:

- (a) To identify and assess the risks of material misstatement in the financial statements due to fraud;
- (b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- (c) To respond appropriately to identified or suspected fraud.

Definitions

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

- (a) *Fraud* - An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.
- (b) *Fraud risk factors* - Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

¹ SA 200, paragraph A51.

² SA 200, paragraph A51.

Requirements**Professional Skepticism**

12. In accordance with SA 200³, the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7-A8)

13. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)

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

Discussion Among the Engagement Team

15. SA 315 requires a discussion among the engagement team members and a determination by the engagement partner of matters which are to be communicated to those team members not involved in the discussion⁴. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur notwithstanding the engagement team members' beliefs that management and those charged with governance are honest and have integrity. (Ref: Para. A10-A11)

Risk Assessment Procedures and Related Activities

16. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, required by SA 315⁵, the auditor shall perform the procedures in paragraphs 17-24 to obtain information for use in identifying the risks of material misstatement due to fraud.

Management and Others within the Entity

17. The auditor shall make inquiries of management regarding:

- (a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A12-A13)
- (b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A14)
- (c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and
- (d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.

18. The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A15-A17)

³ SA 200, paragraph 15.

⁴ SA 315, paragraph 10.

⁵ SA 315, paragraphs 5-24.

19. For those entities that have an internal audit function, the auditor shall make inquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref: Para. A18)

Those Charged with Governance

20. Unless all of those charged with governance are involved in managing the entity⁶, the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks. (Ref: Para. A19-A21)

21. The auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

Unusual or Unexpected Relationships Identified

22. The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

Other Information

23. The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A22)

Evaluation of Fraud Risk Factors

24. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23-A27)

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

25. In accordance with SA 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures⁷.

26. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 specifies the documentation required when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A28-A30)

27. The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks. (Ref: Para. A31-A32)

⁶ SA 260, "Communication with Those Charged with Governance", paragraph 12 (c).

⁷ SA 315, Paragraph 25.

Responses to the Assessed Risks of Material Misstatement Due to Fraud**Overall Responses**

28. In accordance with SA 330, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level.⁸ (Ref: Para. A33)

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

- (a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement; (Ref: Para. A34-A35)
- (b) Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and
- (c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures. (Ref: Para. A36)

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

30. In accordance with SA 330, the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.⁹ (Ref: Para. A37-A40)

Audit Procedures Responsive to Risks Related to Management Override of Controls

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

32. Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:

- (a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:
 - (i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
 - (ii) Select journal entries and other adjustments made at the end of a reporting period; and
 - (iii) Consider the need to test journal entries and other adjustments throughout the period. (Ref: Para. A41-A44)
- (b) Review accounting estimates¹⁰ for biases and evaluate whether the circumstances producing the bias,

⁸ SA 330, paragraph 5.

⁹ SA 330, paragraph 6.

¹⁰ Reference may be made to SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures".

if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall:

- (i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall re-evaluate the accounting estimates taken as a whole; and
 - (ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year¹¹. (Ref: Para. A45-A46)
- (c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. (Ref: Para. A47)

33. The auditor shall determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to above (i.e., when there are specific additional risks of management override that are not covered as part of the procedures performed to address the requirements in paragraph 32).

Evaluation of Audit Evidence (Ref: Para. A48)

34. The auditor shall evaluate whether analytical procedures¹² that are performed when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment indicate a previously unrecognized risk of material misstatement due to fraud. (Ref: Para. A49)

35. When the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. (Ref: Para. A50)

36. If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained. (Ref: Para. A51)

37. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit. (Ref: Para. A52)

Auditor Unable to Continue the Engagement

¹¹ Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires the adjustment of the prior period estimates, which may affect both the period of change in the Accounting Estimates and subsequent periods, in subsequent years.

¹² Reference may be made to SA 520, "Analytical Procedures".

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

- (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
- (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and
- (c) If the auditor withdraws:
 - (i) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
 - (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal. (Ref: Para. A53-A56)

Management Representations

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

- (a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;
- (b) They have disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;
- (c) They have disclosed to the auditor their knowledge of fraud or suspected fraud affecting the entity involving:
 - (i) Management;
 - (ii) Employees who have significant roles in internal control; or
 - (iii) Others where the fraud could have a material effect on the financial statements; and
- (d) They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (Ref: Para. A57-A58)

Communications to Management and with Those Charged with Governance

40. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: Para. A59)

41. Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:

- (a) Management;
- (b) Employees who have significant roles in internal control; or
- (c) Others where the fraud results in a material misstatement in the financial statements.

The auditor shall communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with

governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. (Ref: Para. A60-A62)

42. In accordance with SA 260, Communication with Those Charged with Governance¹³, the auditor shall communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities. (Ref: Para. A63)

Communications to Regulatory and Enforcement Authorities

43. If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. (Ref: Para. A64-A66)

Documentation

44. The auditor's documentation of the understanding of the entity and its environment and the assessment of the risks of material misstatement required by SA 315¹⁴ shall include:

- (a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and
- (b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.

45. The auditor's documentation of the responses to the assessed risks of material misstatement required by SA 330¹⁵ shall include:

- (a) The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and
- (b) The results of the audit procedures, including those designed to address the risk of management override of controls.

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

47. When the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor shall document the reasons for that conclusion.

Application and Other Explanatory Material

Characteristics of Fraud (Ref: Para. 3)

A1. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate

¹³ Reference may be made to SA 260, "Communication with Those Charged with Governance".

¹⁴ SA 315, paragraph 32.

¹⁵ SA 330, paragraph 28.

assets, for example, because the individuals are living beyond their means.

- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.
- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

A2. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

A3. Fraudulent financial reporting may be accomplished by the following:

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

A4. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

A5. Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

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

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

A6. The auditor may, at times, be required to by a legislation or a regulation to make a specific assertion in respect of frauds on/by the entity in his report. For example, Clause (xxi) of Paragraph 4 of the Companies (Auditor's Report) Order, 2003 requires the auditor to specifically report "whether any fraud on or by the entity has been noticed or reported during the year; if yes, the nature and amount involved is to be indicated". Similarly, in case of audit of banks, the auditors, in terms of the circular no. DBS.FGV.(F).No. BC/23.08.001/2001-02, is required to report to the Reserve Bank of India anything susceptible to fraud or fraudulent activity or act of excess power or any foul play in any transaction. Consequently, in such cases, the auditor's responsibilities may not be limited to consideration of risks of material misstatement of the financial statements, but may also include a broader responsibility to consider risks of fraud.

Professional Skepticism (Ref: Para. 12-14)

A7. Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

A8. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

A9. As explained in SA 200, an audit performed in accordance with SAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication.¹⁶ However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include:

- Confirming directly with the third party.
- Using the work of an expert to assess the document's authenticity.

Discussion among the Engagement Team (Ref: Para. 15)

¹⁶ SA 200, paragraph A47.

A10. Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team:

- Provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.
- Enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
- Permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention.

A11. The discussion may include such matters as:

- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
- A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.
- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team.
- An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material misstatement due to fraud and whether certain types of audit procedures are more effective than others.
- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

Risk Assessment Procedures and Related Activities

Inquiries of Management

Management's Assessment of the Risk of Material Misstatement Due to Fraud [Ref: Para. 17(a)]

A12. Management accepts responsibility for the entity's internal control and for the preparation of the entity's financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls may vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous

monitoring. In other entities, management's assessment may be less structured and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.

Considerations specific to smaller entities

A13. In some entities, particularly smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets.

Management's Process for Identifying and Responding to the Risks of Fraud (Ref: Para. 17(b))

A14. In the case of entities with multiple locations management's processes may include different levels of monitoring of operating locations, or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

Inquiry of Management and Others within the Entity (Ref: Para. 18)

A15. The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. Making inquiries of others within the entity may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated.

A16. Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:

- Operating personnel not directly involved in the financial reporting process.
- Employees with different levels of authority.
- Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
- In-house legal counsel.
- Chief ethics officer or equivalent person.
- The person or persons charged with dealing with allegations of fraud.

A17. Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

Inquiry of Internal Audit (Ref: Para. 19)

A18. SA 315 and SA 610, establishes requirements and provides guidance in audits of those entities that have an internal audit function.¹⁷ In carrying out the requirement of those SAs in the context of fraud, the auditor may inquire about specific internal audit activities including, for example:

- The procedures performed, if any, by the internal auditors during the year to detect fraud.
- Whether management has satisfactorily responded to any findings resulting from those procedures.

Obtaining an Understanding of Oversight Exercised by Those Charged With Governance (Ref: Para. 20)

A19. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk,

¹⁷ SA 315, paragraph 23 and SA 610, "Using the Work of Internal Auditors".

financial control and compliance with the law. In many entities, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and of the relevant internal control. Since the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.¹⁸

A20. An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of internal control over risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.

Considerations Specific to Smaller Entities

A21. In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity where a single owner manages the entity and no one else has a governance role. In these cases, there is ordinarily no action on the part of the auditor because there is no oversight separate from management.

Consideration of Other Information (Ref: Para. 23)

A22. In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

Evaluation of Fraud Risk Factors (Ref: Para. 24)

A23. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example:

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;
- The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
- A control environment that is not effective may create an opportunity to commit fraud.

A24. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

A25. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:

¹⁸ SA 260, "Communication with Those Charged with Governance", paragraphs A1-A8, discusses with whom the auditor communicates when the entity's governance structure is not well defined.

- An incentive or pressure to commit fraud;
- A perceived opportunity to commit fraud; and
- An ability to rationalize the fraudulent action.

Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information. Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

A26. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, there may be factors that generally constrain improper conduct by management, such as:

- Effective oversight by those charged with governance.
- An effective internal audit function.
- The existence and enforcement of a written code of conduct.

Furthermore, fraud risk factors considered at a business segment operating level may provide different insights when compared with those obtained when considered at an entity-wide level.

Considerations Specific to Smaller Entities

A27. In the case of a small entity, some or all of these considerations may be inapplicable or less relevant. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise deficient controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential deficiency in internal control since there is an opportunity for management override of controls.

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

Risks of Fraud in Revenue Recognition (Ref: Para. 26)

A28. Material misstatement due to fraudulent financial reporting relating to revenue recognition often results from an overstatement of revenues through, for example, premature revenue recognition or recording fictitious revenues. It may result also from an understatement of revenues through, for example, improperly shifting revenues to a later period.

A29. The risks of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition in the case of listed entities when, for example, performance is measured in terms of year-over-year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales.

A30. The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property.

Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the

Entity's Related Controls (Ref: Para. 27)

A31. As explained in SA 315 management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.¹⁹ In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

A32. It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In doing so, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

Responses to the Assessed Risks of Material Misstatement Due to Fraud**Overall Responses** (Ref: Para. 28)

A33. Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism, for example, through:

- Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
- Increased recognition of the need to corroborate management explanations or representations concerning material matters.

It also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters listed in paragraph 29, which are discussed below.

Assignment and Supervision of Personnel (Ref: Para. 29(a))

A34. The auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialized skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement.

A35. The extent of supervision reflects the auditor's assessment of risks of material misstatement due to fraud and the competencies of the engagement team members performing the work.

Unpredictability in the Selection of Audit Procedures (Ref: Para. 29(c))

A36. Incorporating an element of unpredictability in the selection of the nature, timing and extent of audit procedures to be performed is important as individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. This can be achieved by, for example:

- Performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk.
- Adjusting the timing of audit procedures from that otherwise expected.
- Using different sampling methods.

¹⁹ SA 315, paragraph A48.

- Performing audit procedures at different locations or at locations on an unannounced basis.

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level (Ref: Para. 30)

A37. The auditor's responses to address the assessed risks of material misstatement due to fraud at the assertion level may include changing the nature, timing, and extent of audit procedures in the following ways:

- The nature of audit procedures to be performed may need to be changed to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information. This may affect both the type of audit procedures to be performed and their combination. For example:
 - Physical observation or inspection of certain assets may become more important or the auditor may choose to use computer-assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files.
 - The auditor may design procedures to obtain additional corroborative information. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor might find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.
- The timing of substantive procedures may need to be modified. The auditor may conclude that performing substantive testing at or near the period end better addresses an assessed risk of material misstatement due to fraud. The auditor may conclude that, given the assessed risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period end would not be effective. In contrast, because an intentional misstatement—for example, a misstatement involving improper revenue recognition—may have been initiated in an interim period, the auditor may elect to apply substantive procedures to transactions occurring earlier in or throughout the reporting period.
- The extent of the procedures applied reflects the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate. Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

A38. If the auditor identifies a risk of material misstatement due to fraud that affects inventory quantities, examining the entity's inventory records may help to identify locations or items that require specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis or to conduct inventory counts at all locations on the same date.

A39. The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts and assertions. These may include asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other post-employment benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective

review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

A40. Examples of possible audit procedures to address the assessed risks of material misstatement due to fraud, including those that illustrate the incorporation of an element of unpredictability, are presented in Appendix 2. The appendix includes examples of responses to the auditor's assessment of the risks of material misstatement resulting from both fraudulent financial reporting, including fraudulent financial reporting resulting from revenue recognition, and misappropriation of assets.

Audit Procedures Responsive to Risks Related to Management Override of Controls

Journal Entries and Other Adjustments (Ref: Para. 32(a))

A41. Material misstatement of financial statements due to fraud often involve the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries. This may occur throughout the year or at period end, or by management making adjustments to amounts reported in the financial statements that are not reflected in journal entries, such as through consolidating adjustments and reclassifications.

A42. Further, the auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or to the financial reporting system. Furthermore, when IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

A43. When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are of relevance:

- The assessment of the risks of material misstatement due to fraud – the presence of fraud risk factors and other information obtained during the auditor's assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.
- Controls that have been implemented over journal entries and other adjustments – effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.
- The entity's financial reporting process and the nature of evidence that can be obtained – for many entities routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and controls. When information technology is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.
- The characteristics of fraudulent journal entries or other adjustments – inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or consistent ending numbers.
- The nature and complexity of the accounts – inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain inter-company

transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.

- Journal entries or other adjustments processed outside the normal course of business – non standard journal entries may not be subject to the same level of internal control as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements.

A44. The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. However, because fraudulent journal entries and other adjustments are often made at the end of a reporting period, paragraph 32(a)(ii) requires the auditor to select the journal entries and other adjustments made at that time. Further, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, paragraph 32(a)(iii) requires the auditor to consider whether there is also a need to test journal entries and other adjustments throughout the period.

Accounting Estimates (Ref: Para. 32(b))

A45. In preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant accounting estimates and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates. This may be achieved by, for example, understating or overstating all provisions or reserves in the same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.

A46. The purpose of performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year is to determine whether there is an indication of a possible bias on the part of management. It is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

Business Rationale for Significant Transactions (Ref: Para. 32(c))

A47. Indicators that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include:

- The form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties).
- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and there is inadequate documentation.
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve non-consolidated related parties, including special purpose entities, have not been properly reviewed or approved by those charged with governance of the entity.
- The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

Evaluation of Audit Evidence (Ref: Para. 34-37)

A48. SA 330 requires the auditor, based on the audit procedures performed and the audit evidence obtained, to evaluate whether the assessments of the risks of material misstatement at the assertion level remain

appropriate.²⁰ This evaluation is primarily a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. Appendix 3 contains examples of circumstances that may indicate the possibility of fraud.

Analytical Procedures Performed in the Overall Review of the Financial Statements (Ref: Para. 34)

A49. Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example: uncharacteristically large amounts of income being reported in the last few weeks of the reporting period or unusual transactions; or income that is inconsistent with trends in cash flow from operations.

Consideration of Identified Misstatements (Ref: Para. 35-37)

A50. Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence. Accordingly, misstatements, such as numerous misstatements at a specific location even though the cumulative effect is not material, may be indicative of a risk of material misstatement due to fraud.

A51. The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of evidence previously obtained may be called into question, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management or third parties.

A52. SA 450, "Evaluation of Misstatements Identified during the Audit"²¹, and SA 700, "Forming an Opinion and Reporting on Financial Statements", establish requirements and provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's opinion in the auditor's report.

Auditor Unable to Continue the Engagement (Ref: Para. 38)

A53. Examples of exceptional circumstances that may arise and that may bring into question the auditor's ability to continue performing the audit include:

- (a) The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements;
- (b) The auditor's consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or
- (c) The auditor has significant concern about the competence or integrity of management or those charged with governance.

A54. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity.

A55. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary under different legislations and regulations and, accordingly, the clients. Under some legislations/

²⁰ SA 330, paragraph 25.

²¹ SA 450, "Evaluation of Misstatements Identified during the Audit", paragraphs 12-19.

regulations, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor may consider it appropriate to seek legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to shareholders, regulators or others²².

A56. In some cases, the option of withdrawing from the engagement may not be available to the auditor due to the nature of the terms of appointment or public interest considerations.

Management Representations (Ref: Para. 39)

A57. SA 580, "Written Representations"²³, establishes requirements and provides guidance on obtaining appropriate representations from management and, where appropriate, those charged with governance in the audit. In addition to acknowledging that they have fulfilled their responsibility for the preparation of the financial statements, it is important that, irrespective of the size of the entity, management and, where appropriate, those charged with governance acknowledge their responsibility for internal control designed, implemented and maintained to prevent and detect fraud.

A58. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtain a written representation from management and, where appropriate, those charged with governance confirming that they have disclosed to the auditor:

- (a) The results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and
- (b) Their knowledge of actual, suspected or alleged fraud affecting the entity.

Communications to Management and with Those Charged with Governance

Communication to Management (Ref: Para. 40)

A59. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.

Communication with Those Charged with Governance (Ref: Para. 41)

A60. The auditor's communication with those charged with governance may be made orally or in writing. SA 260 identifies factors the auditor considers in determining whether to communicate orally or in writing.²⁴ Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor reports such matters on a timely basis and may consider it necessary to also report such matters in writing.

A61. In some cases, the auditor may consider it appropriate to communicate with those charged with governance when the auditor becomes aware of fraud involving employees other than management that does

²² The Code of Ethics issued by the Institute of Chartered Accountants of India contains guidance on communication between the outgoing and incoming auditor.

²³ SA 580, "Written Representations".

²⁴ SA 260, Paragraph A42.

not result in a material misstatement. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the auditor and those charged with governance agree at an early stage in the audit about the nature and extent of the auditor's communications in this regard.

A62. In the exceptional circumstances where the auditor has doubts about the integrity or honesty of management or those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

Other Matters Related to Fraud (Ref: Para. 42)

A63. Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example:

- Concerns about the nature, extent and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
- A failure by management to appropriately address identified significant deficiencies in internal control, or to appropriately respond to an identified fraud.
- The auditor's evaluation of the entity's control environment, including questions regarding the competence and integrity of management.
- Actions by management that may be indicative of fraudulent financial reporting, such as management's selection and application of accounting policies that may be indicative of management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.
- Concerns about the adequacy and completeness of the authorization of transactions that appear to be outside the normal course of business.

Communications to Regulatory and Enforcement Authorities (Ref: Para. 43)

A64. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. However, the auditor's legal responsibilities vary by law & statute and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. In some entities, for example, in case of audit of banks, the auditor has a statutory duty to report the occurrence of fraud to the supervisory authorities, i.e., the Reserve Bank of India, in terms of the latter's circular no. DBS.FGV.(F).No. BC/23.08.001/2001-02. Also, in some entities the auditor may have a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action.

A65. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action in the circumstances, the purpose of which is to ascertain the steps necessary in considering the public interest aspects of identified fraud.

A66. In some clients, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation.

Material Modifications to ISA 240, The Auditor's Responsibility relating to Fraud in an Audit of Financial Statements

Addition

In paragraph A64, the guidance has been made more entity specific, in the context of Indian legal requirement, by way of an example.

Deletions

1. Paragraph A6 of the Application Section of ISA 240 dealt with the application of the requirements of ISA

240 to the audits of public sector entities. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific reporting requirement may also exist in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A6, highlighting the fact that in some cases, the auditors may be required by the legislature or the regulator to specifically report on the instances of actual/suspected fraud in the client entity, has been retained and examples of such situations have also been added.

2. Paragraph A56 of the Application Section of ISA 240 dealt with the considerations specific to public sector entities. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that option of withdrawal may not be available in case of non public sector entities pursuant to a requirement under the statute or terms of appointment of the auditor. Accordingly, the spirit of erstwhile A56, highlighting that in some cases, the auditors may not be having an option to withdraw from the engagement has been retained.

3. Paragraph A66 of the Application Section of ISA 240 dealt with the application of the requirements of ISA 240 to the audits of public sector entities. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific reporting requirement may also exist in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of A66 as given in ISA 240, highlighting the fact that in some cases, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation, has been retained.

Appendix 1

(Ref: Para. A25)

Examples of Fraud Risk Factors

The fraud risk factors identified in this Appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration, i.e., fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

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

Incentives/Pressures

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

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

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

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.
- Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures.
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

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

- Significant financial interests in the entity.
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.²⁵
- Personal guarantees of debts of the entity.
- There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities

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

- Significant related-party transactions not in the ordinary course of business or with related entities not

²⁵ Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

audited or audited by another firm.

- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

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

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

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

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

Internal control components are deficient as a result of the following:

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

Attitudes/Rationalizations

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- Non-financial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to remedy known significant deficiencies in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.

- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
 - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
 - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
 - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
 - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

Risk Factors Arising from Misstatements Arising from Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and other deficiencies in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives/Pressures

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

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs.
- Recent or anticipated changes to employee compensation or benefit plans.
- Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities

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

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

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

- Inadequate segregation of duties or independent checks.

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

Attitudes/Rationalizations

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

Appendix 2

(Ref: Para. A40)

Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly they may not be the most appropriate nor necessary in each circumstance. Also the order of the procedures provided is not intended to reflect their relative importance.

Consideration at the Assertion Level

Specific responses to the auditor's assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the classes of transactions, account balances, disclosures and assertions they may affect.

The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or

counting cash at a particular date on a surprise basis.

- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information.
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigating the possibility of related parties and the sources of financial resources supporting the transactions.
- Performing substantive analytical procedures using disaggregated data. For example, comparing sales and cost of sales by location, line of business or month to expectations developed by the auditor.
- Conducting interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, discussing with them the extent of work necessary to be performed to address the assessed risk of material misstatement due to fraud resulting from transactions and activities among these components.
- If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.
- Performing audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight.
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.
- Performing computer-assisted techniques, such as data mining to test for anomalies in a population.
- Testing the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

Specific Responses—Misstatement Resulting from Fraudulent Financial Reporting

Examples of responses to the auditor's assessment of the risks of material misstatement due to fraudulent financial reporting are as follows:

Revenue Recognition

- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented. For example, acceptance criteria, delivery and

payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.

- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cut-off procedures.
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

Inventory Quantities

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.
- Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.
- Performing additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of an expert may be helpful in this regard.
- Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records.
- Using computer-assisted audit techniques to further test the compilation of the physical inventory counts—for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.

Management Estimates

- Using an expert to develop an independent estimate for comparison to management's estimate.
- Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate.

Specific Responses—Misstatements Due to Misappropriation of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to an assessed risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

Examples of responses to the auditor's assessment of the risk of material misstatements due to misappropriation of assets are as follows:

- Counting cash or securities at or near year-end.
- Confirming directly with customers the account activity (including credit memo and sales return activity

as well as dates payments were made) for the period under audit.

- Analyzing recoveries of written-off accounts.
- Analyzing inventory shortages by location or product type.
- Comparing key inventory ratios to industry norm.
- Reviewing supporting documentation for reductions to the perpetual inventory records.
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers.
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts.
- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.
- Analyzing sales discounts and returns for unusual patterns or trends.
- Confirming specific terms of contracts with third parties.
- Obtaining evidence that contracts are being carried out in accordance with their terms.
- Reviewing the propriety of large and unusual expenses.
- Reviewing the authorization and carrying value of senior management and related party loans.
- Reviewing the level and propriety of expense reports submitted by senior management.

Appendix 3

(Ref: Para. A48)

Examples of Circumstances that Indicate the Possibility of Fraud

The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence, including:

- Missing documents.
- Documents that appear to have been altered.
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.
- Significant unexplained items on reconciliations.
- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships, for example, receivables growing faster than revenues.
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.
- Unusual discrepancies between the entity's records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.
- Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statements and the accounts receivable sub-ledger.
- Missing or non-existent cancelled checks in circumstances where cancelled checks are ordinarily returned to the entity with the bank statement.
- Missing inventory or physical assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated.
- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

Problematic or unusual relationships between the auditor and management, including:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.

- Undue time pressures imposed by management to resolve complex or contentious issues.
- Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.
- Unusual delays by the entity in providing requested information.
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- An unwillingness to address identified deficiencies in internal control on a timely basis.

Other

- Unwillingness by management to permit the auditor to meet privately with those charged with governance.
- Accounting policies that appear to be at variance with industry norms.
- Frequent changes in accounting estimates that do not appear to result from changed circumstances.
- Tolerance of violations of the entity's Code of Conduct.

SA 250***Consideration of Laws and Regulations
in an Audit of Financial Statements*****(Effective for all audits commencing on or after April 1, 2009)***

Introduction**Scope of this SA**

1. This Standard on Auditing (SA) deals with the auditor's responsibility to consider laws and regulations when performing an audit of financial statements. This SA does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

Effect of Laws and Regulations

2. The effect on the financial statements of laws and regulations varies considerably. Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's financial statements. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health). Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

Responsibility of Management for Compliance with Laws and Regulations

3. It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. (Ref: Para. A1-A2)

Responsibility of the Auditor (Ref: Para. A3-A6)

4. The requirements in this SA are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

5. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.² In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in

* Published in December, 2008 issue of the Journal.

² SA 200, paragraph 5.

accordance with the SAs.³ In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

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

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

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

- (a) The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws. (see paragraph 13); and
- (b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements (see paragraph 14).

7. In this SA, differing requirements are specified for each of the above categories of laws and regulations. For the category referred to in paragraph 6(a), the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations. For the category referred to in paragraph 6(b), the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

8. The auditor is required by this SA to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected non-compliance to the auditor's attention. Maintaining professional skepticism throughout the audit, as required by SA 200,⁴ is important in this context, given the extent of laws and regulations that affect the entity.

Effective Date

9. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objectives

10. The objectives of the auditor are:

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

³ SA 200, paragraph 52.

⁴ SA 200, paragraph 15.

and disclosures in the financial statements;

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

Definition

11. For the purposes of this SA, the following term has the meaning attributed below:

Non-compliance – Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

Requirements

The Auditor's Consideration of Compliance with Laws and Regulations

12. As part of obtaining an understanding of the entity and its environment in accordance with SA 315,⁵ the auditor shall obtain a general understanding of:

- (a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and
- (b) How the entity is complying with that framework. (*Ref: Para. A7*)

13. The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements. (*Ref: Para. A8*)

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

- (a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and
- (b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities. (*Ref: Para. A9-A10*)

15. During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. (*Ref: Para. A11*)

16. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor. (*Ref: Para. A12*)

17. In the absence of identified or suspected non-compliance, the auditor is not required to perform audit procedures regarding the entity's compliance with laws and regulations, other than those set out in paragraphs 12-16.

Audit Procedures When Non-Compliance is Identified or Suspected

⁵ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 11.

18. If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain: (Ref: Para. A13)

- (a) An understanding of the nature of the act and the circumstances in which it has occurred; and
- (b) Further information to evaluate the possible effect on the financial statements. (Ref: Para. A14)

19. If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice. (Ref: Para. A15-A16)

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

21. The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action. (Ref: Para. A17-A18)

Reporting of Identified or Suspected Non-Compliance

Reporting Non-Compliance to Those Charged with Governance

22. Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor,⁶ the auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

23. If, in the auditor's judgment, the non-compliance referred to in paragraph 22 is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

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

Reporting Non-Compliance in the Auditor's Report on the Financial Statements

25. If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with SA 705⁷, express a qualified or adverse opinion on the financial statements.

26. If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SA 705.

27. If the auditor is unable to determine whether non-compliance has occurred because of limitations

⁶ SA 260, "Communication with Those Charged with Governance", paragraph 9.

⁷ SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 7-8.

imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion in accordance with SA 705.

Reporting Non-Compliance to Regulatory and Enforcement Authorities

28. If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity. (Ref: Para. A19-A20)

Documentation

29. The auditor shall document identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.⁸ (Ref: Para. A21)

Application and Other Explanatory Material

Responsibility for Compliance with Laws and Regulations

Responsibility of Management for Compliance with Laws and Regulations (Ref: Para. 3)

A1. Management, with the oversight of those charged with governance, is responsible for ensuring that the entity's operations are conducted in accordance with laws and regulations. Laws and regulations may affect an entity's financial statements in different ways: for example, most directly, they may affect specific disclosures required of the entity in the financial statements or they may prescribe the applicable financial reporting framework⁹. They may also establish certain legal rights and obligations of the entity, some of which will be recognised in the entity's financial statements. In addition, laws and regulations may impose penalties in cases of non-compliance.

A2. The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations:

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

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to the following:

- An internal audit function.
- An audit committee.

⁸ SA 230, "Audit Documentation", paragraphs 8-11, and paragraph A6.

⁹ SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing", paragraph 13 (a).

- A compliance function.

Responsibility of the Auditor (Ref: Para. 4-8)

A3. Non-compliance by the entity with laws and regulations may result in a material misstatement of the financial statements. Detection of non-compliance, regardless of materiality, may affect other aspects of the audit including, for example, the auditor's consideration of the integrity of management or employees.

A4. Whether an act constitutes non-compliance with laws and regulations is a matter for legal determination, which is ordinarily beyond the auditor's professional competence to determine. Nevertheless, the auditor's training, experience and understanding of the entity and its industry or sector may provide a basis to recognise that some acts, coming to the auditor's attention, may constitute non-compliance with laws and regulations.

A5. In accordance with specific statutory requirements, the auditor may be specifically required to report, as part of the audit of the financial statements, on whether the entity complies with certain provisions of laws or regulations. In these circumstances, Revised SA 700¹⁰ or SA 800¹¹ deal with how these audit responsibilities are addressed in the auditor's report. Furthermore, where there are specific statutory reporting requirements, it may be necessary for the audit plan to include appropriate tests for compliance with those provisions of the laws and regulations.

A6. In some audit engagements, specially those relating to audit of government ventures and undertakings, etc., there may be additional audit responsibilities with respect to the consideration of laws and regulations which may relate to the audit of financial statements or may extend to other aspects of the entity's operations.

The Auditor's Consideration of Compliance with Laws and Regulations

Obtaining an Understanding of the Legal and Regulatory Framework (Ref: Para. 12)

A7. To obtain a general understanding of the legal and regulatory framework, and how the entity complies with that framework, the auditor may, for example:

- Use the auditor's existing understanding of the entity's industry, regulatory and other external factors;
- Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements;
- Inquire of management as to other laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
- Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations; and
- Inquire of management regarding the policies or procedures adopted for identifying, evaluating and accounting for litigation claims.

Laws and Regulations Generally Recognised to have a Direct Effect on the Determination of Material Amounts and Disclosures in the Financial Statements (Ref: Para. 13)

A8. Certain laws and regulations are well-established, known to the entity and within the entity's industry or sector, and relevant to the entity's financial statements (as described in paragraph 6(a)). They could include those that relate to, for example:

- The form and content of financial statements;

¹⁰ Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 38.

¹¹ SA 800, "Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks", paragraph 11.

- Industry-specific financial reporting issues;
- Accounting for transactions under government contracts; or
- The accrual or recognition of expenses for income tax or retirement benefits.

Some matters may be relevant to specific assertions (for example, the completeness of income tax provisions), while others may be relevant to the financial statements as a whole (for example, the required statements constituting a complete set of financial statements). Non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements as described in paragraph 6(a).

Procedures to Identify Instances of Non-Compliance – Other Laws and Regulations (Ref: Para. 14)

A9. Certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity (as described in paragraph 6(b)). Non-compliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations, or call into question the entity's continuance as a going concern. For example, non-compliance with the requirements of the entity's license or other entitlement to perform its operations could have such an impact (for example, for a bank, non-compliance with capital or investment requirements). To illustrate further, a Non Banking Financial Company might have to cease to carry on the business of a non-banking financial institution if it fails to obtain a certificate of registration issued under Chapter III B of the Reserve Bank of India Act, 1934 and if its Net Owned Funds are less than the amount specified by the RBI in this regard. There are also many laws and regulations relating principally to the operating aspects of the entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.

A10. As the financial reporting consequences of other laws and regulations can vary depending on the entity's operations, the audit procedures required by paragraph 14 are directed to bringing to the auditor's attention instances of non-compliance with laws and regulations that may have a material effect on the financial statements.

Non-Compliance brought to the Auditor's Attention by Other Audit Procedures (Ref: Para. 15)

A11. Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. For example, such audit procedures may include:

- Reading minutes;
- Inquiring of the entity's management and in-house legal counsel or external legal counsel concerning litigation, claims and assessments; and
- Performing substantive tests of details of classes of transactions, account balances or disclosures.

Written Representations (Ref: Para. 16)

A12. Because the effect on financial statements of laws and regulations can vary considerably, written representations provide necessary audit evidence about management's knowledge of identified or suspected non-compliance with laws and regulations, whose effects may have a material effect on the financial statements. However, written representations do not provide sufficient appropriate audit evidence on their own and, accordingly, do not affect the nature and extent of other audit evidence that is to be obtained by the

auditor.¹²

Audit Procedures When Non-Compliance is Identified or Suspected

Indications of Non-Compliance with Laws and Regulations (Ref: Para. 18)

A13. When the auditor becomes aware of the existence of, or information about, the following matters, it may be an indication of non-compliance with laws and regulations:

- Investigations by regulatory organisations and government departments or payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
- Unusual payments towards legal and retainership fees.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorised transactions or improperly recorded transactions.
- Adverse media comment.

Matters Relevant to the Auditor's Evaluation (Ref: Para. 18(b))

A14. Matters relevant to the auditor's evaluation of the possible effect on the financial statements include:

- The potential financial consequences of non-compliance with laws and regulations on the financial statements including, for example, the imposition of fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations, and litigation.
- Whether the potential financial consequences require disclosure.
- Whether the potential financial consequences are so serious as to call into question the fair presentation of the financial statements, or otherwise make the financial statements misleading.

Audit Procedures (Ref: Para. 19)

A15. The auditor may discuss the findings with those charged with governance where they may be able to provide additional audit evidence. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to transactions or events that have led to the possibility of non-compliance with laws and regulations.

A16. If management or, as appropriate, those charged with governance do not provide sufficient information to the auditor that the entity is in fact in compliance with laws and regulations, the auditor may consider it

¹² SA 580, "Written Representations", paragraph 3.

appropriate to consult with the entity's in-house legal counsel or external legal counsel about the application of the laws and regulations to the circumstances, including the possibility of fraud, and the possible effects on the financial statements. When it is not considered appropriate to consult with the entity's legal counsel or when the auditor is not satisfied with the legal counsel's opinion, the auditor may consider it appropriate to consult the auditor's own legal counsel as to whether a contravention of a law or regulation is involved, the possible legal consequences, including the possibility of fraud, and what further action, if any, the auditor would take.

Evaluating the Implications of Non-Compliance (Ref: Para. 21)

A17. As required by paragraph 21, the auditor evaluates the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations. The implications of particular instances of non-compliance identified by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control activities and the level of management or employees involved, especially implications arising from the involvement of the highest authority within the entity.

A18. In exceptional cases, the auditor may consider whether, unless prohibited by law or regulation, withdrawal from the engagement is necessary when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances, even when the non-compliance is not material to the financial statements. When deciding whether withdrawal from the engagement is necessary, the auditor may consider seeking legal advice. If withdrawal from the engagement is prohibited, the auditor may consider alternative actions, including describing the non-compliance in an Other Matter(s) paragraph in the auditor's report.¹³

Reporting of Identified or Suspected Non-Compliance

Reporting Non-Compliance to Regulatory and Enforcement Authorities (Ref: Para. 28)

A19. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting identified or suspected non-compliance with laws and regulations to a party outside the entity. However, the auditor's legal responsibilities vary under different laws and regulations and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. Under the present legal and regulatory framework for financial institutions in India, their auditor has a statutory duty to report the occurrence, or suspected occurrence, of non-compliance with laws and regulations to supervisory authorities. For example, the auditor is required to report certain matters of non-compliance to the Reserve Bank of India as per the requirements of Non Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1988, issued by the Reserve Bank of India. Also, some laws or regulations require the auditor to report misstatements to authorities in those cases where management and, where applicable, those charged with governance fail to take corrective action. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action.

A20. In case of certain entities, such as national governments, regional (for example, state, provincial, territorial) governments, local (for example, city, town) governments and related governmental entities (for example, agencies, boards, commissions and enterprises), the auditor may be obliged to report on instances of non-compliance to governing authorities or to report them in the auditor's report.

Documentation (Ref: Para. 29)

A21. The auditor's documentation of findings regarding identified or suspected non-compliance with laws and

¹³ SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", paragraph 8.

regulations may include, for example:

- Copies of records or documents.
- Minutes of discussions held with management, those charged with governance or parties outside the entity.

Material Modifications to ISA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements”

Deletions

1. Paragraph A6 of the Application Section of ISA 250 deals with the application of the requirements of ISA 250 to the audits of public sector entities regarding the additional audit responsibilities with respect to the consideration of laws and regulations. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, there may be additional audit responsibilities with respect to the consideration of laws and regulations which may relate to the audit of financial statements or may extend to other aspects of the entity’s operations. Accordingly, the spirit of erstwhile A6, highlighting the fact that in case of certain entities, there may be additional audit responsibilities with respect to the consideration of laws and regulations, has been retained.

2. Paragraph A20 of the Application Section of ISA 250 deals with the application of the requirements of ISA 250 to the audits of public sector entities regarding the obligation to report on instances of non-compliance to governing authorities or to report them in the auditor’s report. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the auditor may be obliged to report on instances of non-compliance to governing authorities or to report them in the auditor’s report. Accordingly, the spirit of erstwhile A20, highlighting the fact that in case of certain entities, there may be instances of reporting non-compliance to governing authorities or to report them in the auditor’s report, has been retained.

SA 299

Joint Audit of Financial Statements

*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2018)*

Introduction

Scope of this SA

1. The practice of appointing more than one auditor to conduct the audit of large entities has been in vogue for a longtime, sometimes voluntarily by the shareholders or sometimes due to the requirements of laws or regulations. Such auditors, known as joint auditors, conduct the audit jointly and report on the financial statements of the entity. This Standard lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200 "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with Standards on Auditing". This Standard deals with the special considerations in carrying out audit by joint auditors. Accordingly, in addition to the requirements enunciated in this Standard, the joint auditors also need to comply with all the relevant requirements of other applicable Standards on Auditing.

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

Effective Date

3. This Standard on Auditing is effective for audits of financial statements for periods beginning on or after April 1, 2018.

Objectives

4. The objectives of this Standard are:

- (a) To lay down broad principles for the joint auditors in conducting the joint audit.
- (b) To provide a uniform approach to the process of joint audit.
- (c) To identify the distinct areas of work and coverage thereof by each joint auditor.
- (d) To identify individual responsibility and joint responsibility of the joint auditors in relation to audit.

Definitions

5. For purposes of the SAs, the following terms have the meaning attributed below:

'Joint Audit' and 'Joint Auditors'

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

Requirements

Audit Planning, Risk Assessment and Allocation of Work

6. The engagement partner and other key members of the engagement team from each of the joint auditors shall be involved in planning the audit.

7. The joint auditors shall jointly establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.
8. Prior to the commencement of the audit, the joint auditors shall discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors shall:
 - a. Identify division of audit areas and common audit areas amongst the joint auditors that define the scope of the work of each joint auditor; **(Ref: Para A1)**
 - b. Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
 - c. Consider and communicate among all joint auditors the factors that, in their professional judgment, are significant in directing the engagement team's efforts;
 - d. Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other or similar engagements performed earlier by the respective engagement partner(s) for the entity is relevant.
 - e. Ascertain the nature, timing and extent of resources necessary to perform the engagement.
9. At this stage, risks of material misstatement need to be considered and assessed by each of the joint auditors and shall be communicated to other joint auditors, and documented, whether pertaining to the overall financial statements level or to the area of allocation among the other joint auditors.
10. The joint auditors shall discuss and document the nature, timing, and the extent of the audit procedures for common and specific allotted areas of audit to be performed by each of the joint auditors and the same shall be communicated to those charged with governance.
11. The joint auditors shall obtain common engagement letter and common management representation letter.
12. After identification and allocation of work among the joint auditors, the work allocation document shall be signed by all the joint auditors and the same shall be communicated to those charged with governance of the entity. **(Ref: Para. A2)**

Responsibility and Co-ordination among Joint Auditors

13. In respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. **(Ref: Para. A3)**
14. All the joint auditors shall be jointly and severally responsible for: **(Ref: Para. A3)**
 - a. the audit work which is not divided among the joint auditors and is carried out by all joint auditors;
 - b. decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors. **(Ref: Para. A4)**
 - c. matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
 - d. examining that the financial statements of the entity comply with the requirements of the relevant statutes;
 - e. presentation and disclosure of the financial statements as required by the applicable financial reporting framework;
 - f. ensuring that the audit report complies with the requirements of the relevant statutes, the applicable Standards on Auditing and the other relevant pronouncements issued by ICAI.

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

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

Audit Conclusion and Reporting

17. The joint auditors are required to issue common audit report, however, where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to the separate audit report(s) issued by the other joint auditor(s). Further, separate audit report shall also make reference to the audit report issued by other joint auditors. Such reference shall be made under the heading "Other Matter Paragraph" as per Revised SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report". (Ref: Para. A5)

18. Each joint auditor is entitled to assume that:

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

19. Where financial statements of a division/branch are audited by one of the joint auditors, the other joint auditors are entitled to proceed on the basis that such financial statements comply with all the legal and regulatory requirements and present a true and fair view of the state of affairs and of the results of operations of the division/branch concerned. (Ref: Para. A6)

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

Communication with Those Charged with Governance

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

Application and Other Explanatory Material**Audit Planning, Risk Assessment and Allocation of Work**

A1. Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors. (Ref: Para. 8(a))

A2. The documentation of allocation of work helps in avoiding any dispute or confusion which may arise among the joint auditors regarding the scope of work to be carried out by them. Further, the communication of allocation of work to the entity helps in avoiding any dispute or confusion which may arise between the entity and the joint auditors. (Ref: Para. 12)

Responsibility and Co-ordination among Joint Auditors

A3. The audit process involves obtaining and evaluating information and explanations from the management. This responsibility is shared by all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility. In cases where specific divisions, zones or units are allocated to different joint auditors, it is the separate and specific responsibility of each joint auditor to obtain information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by said joint auditor. The joint auditors shall have proper coordination and rationality wherever required. (Ref: Para. 13 and 14)

A4. All the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing and extent of the audit procedures agreed upon among them, proper execution of these audit procedures is the individual responsibility of the joint auditor concerned. (Ref: Para. 14(b))

Audit Conclusion and Reporting

A5. In a situation where there is more than one opinion to be expressed by the joint auditors due to disagreement among them, it is important to note that each joint auditor with a differing opinion would be required to issue a separate audit report and the reference to the other joint auditors report would be required to be made by each such joint auditor in their respective audit report. For example, where an entity has three joint auditors and all of them have disagreements and this leads to three different sets of opinion, then each of them needs to issue a separate audit report. Further, each of them needs to include an 'Other Matter' paragraph in their respective audit report wherein they would make a reference to the separate audit reports issued by other joint auditors. (Ref: Para. 17)

A6. In the case of audit of a large entity with several branches, including unaudited branches and those required to be audited by branch auditors, the branch audit reports/returns may be required to be reviewed by different joint auditors in accordance with the allocation of work. In such cases, it is the specific and separate responsibility of each joint auditor to review the audit reports/returns of the divisions/branches allocated to said joint auditor and to ensure that they are properly incorporated into the accounts of the entity. It is also the separate and specific responsibility of each joint auditor to exercise judgement with regard to the necessity of visiting such divisions/branches in respect of which the work is allocated to said joint auditor. In respect of the branches which do not fall within any divisions or zones which are separately assigned to the various joint auditors, they may agree among themselves as regards the division of work relating to the review of such branch audit report/returns. (Ref: Para. 19)

SA 300*

Planning an Audit of Financial Statements
*(Effective for audits of financial statements
for periods beginning on or after April 1, 2008)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to plan an audit of financial statements. This SA is framed in the context of recurring audits. Additional considerations in initial audit engagements are separately identified. (Ref: Para. A1-A4)

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after 1st April 2008.

Objective

3. The objective of the auditor is to plan the audit so that it will be performed in an effective manner.

Requirements

Involvement of Key Engagement Team Members

4. The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members. (Ref: Para. A5)

Preliminary Engagement Activities

5. The auditor shall undertake the following activities at the beginning of the current audit engagement:
- (a) Performing procedures required by SA 220¹, "Quality Control for an Audit of Financial Statements" regarding the continuance of the client relationship and the specific audit engagement;
 - (b) Evaluating compliance with ethical requirements, including independence, as required by SA 220²; and
 - (c) Establishing an understanding of the terms of the engagement, as required by SA 210³. (Ref: Para. A6-A8)

Planning Activities

6. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.
7. In establishing the overall audit strategy, the auditor shall:
- (a) Identify the characteristics of the engagement that define its scope;

*Published in December, 2007 issue of the Journal.

¹ SA 220, paragraph 12-13.

² SA 220, paragraph 9-11.

³ SA 210, "Agreeing the Terms of Audit Engagements," paragraphs 9-13.

- (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
 - (c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
 - (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
 - (e) Ascertain the nature, timing and extent of resources necessary to perform the engagement. (Ref: Para. A9-A12)
8. The auditor shall develop an audit plan that shall include a description of:
- (a) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".
 - (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 "The Auditor's Responses to Assessed Risks".
 - (c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs. (Ref: Para. A13)
9. The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A14)
10. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A15-A16)

Documentation

11. The auditor shall document:
- (a) The overall audit strategy;
 - (b) The audit plan; and
 - (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A17-A20)

Additional Considerations in Initial Audit Engagements

12. The auditor shall undertake the following activities prior to starting an initial audit:
- (a) Performing procedures required by SA 220 regarding the acceptance of the client relationship and the specific audit engagement⁴; and
 - (b) Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. (Ref: Para. A21)

Application and Other Explanatory Material

The Role and Timing of Planning (Ref: Para. 1)

A1. Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

- Helping the auditor to devote appropriate attention to important areas of the audit.
- Helping the auditor identify and resolve potential problems on a timely basis.

⁴ SA 220, paragraphs 12-13.

- Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- Facilitating the direction and supervision of engagement team members and the review of their work.
- Assisting, where applicable, in coordination of work done by auditors of components and experts.

A2. The nature and extent of planning activities will vary according to the size and complexity of the entity, the key engagement team members' previous experience with the entity, and changes in circumstances that occur during the audit engagement.

A3. 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. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

- The analytical procedures to be applied as risk assessment procedures.
- Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- The determination of materiality.
- The involvement of experts.
- The performance of other risk assessment procedures.

A4. The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement (for example, to coordinate some of the planned audit procedures with the work of the entity's personnel). Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's responsibility. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit. For example, discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

Involvement of Key Engagement Team Members (Ref: Para. 4)

A5. The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process⁵.

Preliminary Engagement Activities (Ref: Para. 5)

A6. Performing the preliminary engagement activities specified in paragraph 5 at the beginning of the current audit engagement assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement.

A7. Performing these preliminary engagement activities enables the auditor to plan an audit engagement for

⁵ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 10, establishes requirements and provides guidance on the engagement team's discussion of the susceptibility of the entity to material misstatements of the financial statements. SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph 15 provides guidance on the emphasis given during this discussion to the susceptibility of the entity's financial statements to material misstatement due to fraud.

which, for example:

- The auditor maintains the necessary independence and ability to perform the engagement.
- There are no issues with management integrity that may affect the auditor's willingness to continue the engagement.
- There is no misunderstanding with the client as to the terms of the engagement.

A8. The auditor's consideration of client continuance and ethical requirements, including independence, occurs throughout the audit engagement as changes in conditions and circumstances occur. Performing initial procedures on both client continuance and evaluation of ethical requirements (including independence) at the beginning of the current audit engagement means that they are completed prior to the performance of other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often occur shortly after (or in connection with) the completion of the previous audit.

Planning Activities

The Overall Audit Strategy (Ref: Para. 6-7)

A9. The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

- The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;
- The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;
- When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and
- How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

A10. The Appendix lists examples of considerations in establishing the overall audit strategy.

A11. Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

Considerations Specific to Smaller Entities

A12. In audits of small entities, the entire audit may be conducted by a very small audit team. Many audits of small entities involve the engagement partner (who may be a sole practitioner) working with one engagement team member (or without any engagement team members). With a smaller team, co-ordination of, and communication between, team members are easier. Establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise; it varies according to the size of the entity, the complexity of the audit, and the size of the engagement team. For example, a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, updated in the current period based on discussions with the owner-manager, can serve as the documented audit strategy for the current audit engagement if it covers the matters noted in paragraph 7.

The Audit Plan (Ref: Para. 8)

A13. The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

Changes to Planning Decisions During the Course of the Audit (Ref: Para. 9)

A14. 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. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

Direction, Supervision and Review (Ref: Para. 10)

A15. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

- The size and complexity of the entity.
- The area of the audit.
- The assessed risks of material misstatement (for example, an increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work).
- The capabilities and competence of the individual team members performing the audit work.

SA 220 contains further guidance on the direction, supervision and review of audit work⁶.

Considerations Specific to Smaller Entities

A16. When an audit is carried out entirely by the engagement partner, questions of direction and supervision of engagement team members and review of their work do not arise. In such cases, the engagement partner, having personally conducted all aspects of the work, will be aware of all material issues. Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual also performs the entire audit. When particularly complex or unusual issues are involved, and the audit is performed by a sole practitioner, it may be desirable to consult with other suitably-experienced auditors or the auditor's professional body⁷.

Documentation (Ref: Para. 11)

A17. The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team. For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions

⁶ SA 220, paragraphs 15-17.

⁷ In India, the Institute of Chartered Accountants of India governs the accountancy profession to provide services of high quality in the public interest which are accepted worldwide.

regarding the overall scope, timing and conduct of the audit.

A18. The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A19. A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Considerations Specific to Smaller Entities

A20. As discussed in paragraph A12, a suitable, brief memorandum may serve as the documented strategy for the audit of a smaller entity. For the audit plan, standard audit programs and/or checklists (see paragraph A18) drawn up on the assumption of few relevant control activities, as is likely to be the case in a smaller entity, may be used provided that they are tailored to the circumstances of the engagement, including the auditor's risk assessments.

Additional Considerations in Initial Audit Engagements (Ref: Para. 12)

A21. The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements. For initial audits, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers.
- Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.
- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances (see SA 510⁸ "Initial Audit Engagements—Opening Balances").
- Other procedures required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

Modifications to ISA 300, "Planning an Audit of Financial Statements"

SA 300, "Planning an Audit of Financial Statements" does not contain any modifications *vis a vis* ISA 300.

⁸ SA 510, "Initial Audit Engagements—Opening Balances".

Appendix

(Ref: Para. 6-7 and A9-A12)

Considerations in Establishing the Overall Audit Strategy

This appendix provides examples of matters the auditor may consider in establishing the overall audit strategy. Many of these matters will also influence the auditor's detailed audit plan. The examples provided cover a broad range of matters applicable to many engagements. While some of the matters referred to below may be required by other SAs, not all matters are relevant to every audit engagement and the list is not necessarily complete.

Characteristics of the Engagement

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework.
- Industry-specific reporting requirements such as reports mandated by industry regulators.
- The expected audit coverage, including the number and locations of components to be included.
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- The extent to which components are audited by other auditors.
- The nature of the business segments to be audited, including the need for specialized knowledge.
- The reporting currency to be used, including any need for currency translation for the financial information audited.
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work.
- The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.
- The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques.
- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews.
- The availability of client personnel and data.

Reporting Objectives, Timing of the Audit, and Nature of Communications

- The entity's timetable for reporting, such as at interim and final stages.
- The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.
- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.
- The discussion with management regarding the expected communications on the status of audit work throughout the engagement.

- Communication with auditors of components regarding the expected types and timing of reports to be issued and other communications in connection with the audit of components.
- The expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.
- Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit.

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

- The determination of materiality in accordance with SA 320⁹, and, where applicable:
 - Determination of materiality for components and communication thereof to component auditors.
 - Preliminary identification of significant components and material classes of transactions, account balances and disclosures
- Preliminary identification of areas where there may be a higher risk of material misstatement.
- The impact of the assessed risk of material misstatement at the overall financial statement level on direction, supervision and review.
- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence.
- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them.
- The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity.
- Evidence of management's commitment to the design, implementation and maintenance of sound internal control, including evidence of appropriate documentation of such internal control.
- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.
- Importance attached to internal control throughout the entity to the successful operation of the business.
- Significant business developments affecting the entity, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

Nature, Timing and Extent of Resources

- The selection of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement.
- Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be higher risks of material misstatement.

⁹ SA 320, "Materiality in Planning and Performing an Audit".

SA 315*

**Identifying and Assessing the Risk of Material
Misstatement through understanding the
Entity and its Environment**
*(Effective for audits of financial statements
for periods beginning on or after April 1, 2008)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

Objective

3. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

Definitions

4. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) Assertions – Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.
 - (b) Business risk – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.
 - (c) Internal control – The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.
 - (d) Risk assessment procedures – The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material

* Published in February, 2008 issue of the Journal.

misstatement, whether due to fraud or error, at the financial statement and assertion levels.

- (e) Significant risk – An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

Requirements

Risk Assessment Procedures and Related Activities

5. The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1-A5)
6. The risk assessment procedures shall include the following:
 - (a) Inquiries of management 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)
 - (b) Analytical procedures. (Ref: Para. A7-A10)
 - (c) Observation and inspection. (Ref: Para. A11)
7. The auditor shall consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.
8. Where the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement.
9. When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. A12-A13)
10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A14-A16)

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

The Entity and Its Environment

11. The auditor shall obtain an understanding of the following:
 - (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A17-A22)
 - (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. (Ref: Para. A23-A27)

- (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. (Ref: Para. A28)
- (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A29-A35)
- (e) The measurement and review of the entity's financial performance. (Ref: Para. A36-A41)

The Entity's Internal Control

12. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A42-A65)

Nature and Extent of the Understanding of Relevant Controls

13. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A66-A68)

Components of Internal Control**Control environment**

14. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

- (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
- (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A69-A78)

The entity's risk assessment process

15. The auditor shall obtain an understanding of whether the entity has a process for:

- (a) Identifying business risks relevant to financial reporting objectives;
- (b) Estimating the significance of the risks;
- (c) Assessing the likelihood of their occurrence; and
- (d) Deciding about actions to address those risks. (Ref: Para. A79)

16. If the entity has established such a process (referred to hereafter as the 'entity's risk assessment process'), the auditor shall obtain an understanding of it, and the results thereof. Where the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process.

17. If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment

process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control. (Ref: Para. A80)

The information system, including the related business processes, relevant to financial reporting, and communication.

18. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:

- (a) The classes of transactions in the entity's operations that are significant to the financial statements;
- (b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;
- (d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
- (e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures;
- (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A81-A85)

19. The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including:

- (a) Communications between management and those charged with governance; and
- (b) External communications, such as those with regulatory authorities. (Ref: Para. A86-A87)

Control activities relevant to the audit

20. The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit requires an understanding of only those control activities related to significant class of transactions, account balance, and disclosure in the financial statements and the assertions which the auditor finds relevant in his risk assessment process. (Ref: Para. A88-A94)

21. In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A95-A97)

Monitoring of controls

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. A98-A100)

23. If the entity has an internal audit function,¹ 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:

¹ SA 610, "Using the Work of Internal Auditors", paragraph 7(a).

- (a) The nature of the internal audit function's responsibilities and how the internal audit function fits in the entity's organisational structure; and
 - (b) The activities performed, or to be performed, by the internal audit function. (Ref: Para. A101-A103)
24. The auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A104)

Identifying and Assessing the Risks of Material Misstatement

25. The auditor shall identify and assess the risks of material misstatement at:
- (a) the financial statement level; and (Ref: Para. A105-A108)
 - (b) the assertion level for classes of transactions, account balances, and disclosures; (Ref: Para. A109-A113)

to provide a basis for designing and performing further audit procedures.

26. For this purpose, the auditor shall:
- (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements; (Ref: Para. A114-A115)
 - (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
 - (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A116-A118)
 - (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Risks that Require Special Audit Consideration

27. As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

28. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

- (a) Whether the risk is a risk of fraud;
- (b) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;
- (c) The complexity of transactions;
- (d) Whether the risk involves significant transactions with related parties;
- (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A119-A123)

29. When the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A124-A126)

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

30. In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them. (Ref: Para. A127-A129)

Revision of Risk Assessment

31. The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly. (Ref: Para. A130)

Documentation

32. The auditor shall document:

- (a) The discussion among the engagement team where required by paragraph 10, and the significant decisions reached;
- (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components specified in paragraphs 14-24; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
- (c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 25; and
- (d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27-30. (Ref: Para. A131-A134)

Application and Other Explanatory Material

Risk Assessment Procedures and Related Activities (Ref: Para. 5)

A1. Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- ◆ Assessing risks of material misstatement of the financial statements;
- ◆ Determining materiality in accordance with SA 320²;
- ◆ Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
- ◆ Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
- ◆ Developing expectations for use when performing analytical procedures;

² SA 320, "Materiality in Planning and Performing an Audit".

- ◆ Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
- ◆ Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

A2. Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

A3. The auditor uses professional judgment to determine the extent of the understanding required. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to meet the objective stated in this SA. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

A4. The risks to be assessed include both those due to error and those due to fraud, and both are covered by this SA. However, the significance of fraud is such that further requirements and guidance are included in SA 240³, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud.

A5. Although the auditor is required to perform all the risk assessment procedures described in paragraph 6 in the course of obtaining the required understanding of the entity (see paragraphs 11-24), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed where the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures include:

- ◆ Reviewing information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications.
- ◆ Making inquiries of the entity's external legal counsel or of valuation experts that the entity has used.

Inquiries of Management 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. However, 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 towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
- ◆ 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 employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.

³ SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraphs 12-24.

- ◆ Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
- ◆ Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

Analytical Procedures (Ref: Para. 6(b))

A7. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks*. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

A8. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

A9. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

Considerations Specific to Smaller Entities

A10. Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available.

Observation and Inspection (Ref: Para. 6(c))

A11. Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:

- ◆ The entity's operations.
- ◆ Documents (such as business plans and strategies), records, and internal control manuals.
- ◆ Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
- ◆ The entity's premises and plant facilities.

Information Obtained in Prior Periods (Ref: Para. 9)

A12. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:

* SA 520, "Analytical Procedures", paragraphs A1-A3 describe the nature of analytical procedures.

- ◆ Past misstatements and whether they were corrected on a timely basis.
- ◆ The nature of the entity and its environment, and the entity's internal control (including deficiencies in internal control).
- ◆ Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

A13. The auditor is required to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

Discussion Among the Engagement Team (Ref: Para. 10)

A14. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement:

- ◆ Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
- ◆ Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- ◆ Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures.
- ◆ Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

SA 240 provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.⁴

A15. It is not always necessary or practical for the discussion to include all members in a single discussion (as, for example, in a multi-location audit), nor is it necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team including, if considered appropriate, specialists and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

Considerations Specific to Smaller Entities

A16. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material misstatement due to fraud or error.

⁴ SA 240, paragraph 15.

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control***The Entity and Its Environment****Industry, Regulatory and Other External Factors* (Ref: Para. 11(a))**Industry factors**

A17. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the auditor may consider include:

- ◆ The market and competition, including demand, capacity, and price competition.
- ◆ Cyclical or seasonal activity.
- ◆ Product technology relating to the entity's products.
- ◆ Energy supply and cost.

A18. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team include members with sufficient relevant knowledge and experience⁵.

Regulatory factors

A19. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment. Examples of matters the auditor may consider include:

- ◆ Accounting principles and industry specific practices.
- ◆ Regulatory framework for a regulated industry.
- ◆ Legislation and regulation that significantly affect the entity's operations, including direct supervisory activities.
- ◆ Taxation (corporate and other).
- ◆ Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- ◆ Environmental requirements affecting the industry and the entity's business.

A20. SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements"⁶, includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry.

A21. In case of the audits of certain entities, in addition to legislation or regulations, there may be government policy requirements and resolutions of the legislature that affect the entity's operations. Such elements are essential to consider when obtaining an understanding of the entity and its environment.

Other external factors

A22. Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

⁵ SA 220, "Quality Control for an Audit of Financial Statements", paragraph 14.

⁶ SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", paragraph 10.

Nature of the Entity (Ref: Para.11(b))

A23. An understanding of the nature of an entity enables the auditor to understand such matters as:

- ◆ Whether the entity has a complex structure, for example with subsidiaries or other components in multiple locations. Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately.
- ◆ The ownership, and relations between owners and other people or entities. This understanding assists in determining whether related party transactions have been identified and accounted for appropriately. SA 550, “Related Parties”⁷, establishes requirements and provides guidance on the auditor’s considerations relevant to related parties.

A24. Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include:

- ◆ Business operations – such as:
 - Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as internet sales and marketing activities.
 - Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
 - Alliances, joint ventures, and outsourcing activities.
 - Geographic dispersion and industry segmentation.
 - Location of production facilities, warehouses, and offices, and location and quantities of inventories.
 - Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).
 - Research and development activities and expenditures.
 - Transactions with related parties.
- ◆ Investments and investment activities – such as:
 - Planned or recently executed acquisitions or divestitures.
 - Investments and dispositions of securities and loans.
 - Capital investment activities.
 - Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.
- ◆ Financing and financing activities – such as:
 - Major subsidiaries and associated entities, including consolidated and non-consolidated structures.
 - Debt structure and related terms, including off-balance-sheet financing arrangements and leasing

⁷ SA 550, “Related Parties”. Reference may also be made to the Accounting Standard (AS) 18, “Related Party Disclosures” for definition of related party and related party transactions.

arrangements.

- Beneficial owners (local, foreign, business reputation and experience) and related parties.
- Use of derivative financial instruments.
- ◆ Financial reporting – such as:
 - Accounting principles and industry - specific practices, including industry - specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals).
 - Revenue recognition practices.
 - Accounting for fair values.
 - Foreign currency assets, liabilities and transactions.
 - Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

A25. Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.

Nature of Special-Purpose Entities

A26. A special-purpose entity (sometimes referred to as a special purpose vehicle) is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitisation of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which the special-purpose entity has been created may often transfer assets to the latter (e.g., as part of a de-recognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, while other parties may provide the funding to the latter. As SA 550 indicates, in some circumstances, a special-purpose entity may be a related party of the entity.⁸

A27. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control, or circumstances under which the special-purpose entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the special-purpose entity.

The Entity's Selection and Application of Accounting Policies (Ref: Para.11(c))

A28. An understanding of the entity's selection and application of accounting policies may encompass such matters as:

- ◆ The methods the entity uses to account for significant and unusual transactions.
- ◆ The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
- ◆ Changes in the entity's accounting policies.
- ◆ Financial reporting standards and laws and regulations that are new to the entity, and when and how the entity will adopt such requirements.

Objectives and Strategies and Related Business Risks (Ref. Para.11(d))

A29. The entity conducts its business in the context of industry, regulatory and other internal and external

⁸ SA 550, 'Related Parties', paragraph A7.

factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time.

A30. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognise the need for change may also give rise to business risk. Business risk may arise, for example, from:

- ◆ The development of new products or services that may fail;
- ◆ A market which, even if successfully developed, is inadequate to support a product or service; or
- ◆ Flaws in a product or service that may result in liabilities and reputational risk.

A31. An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

A32. Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:

- ◆ Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- ◆ New products and services (a potential related business risk might be, for example, that there is increased product liability).
- ◆ Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- ◆ New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
- ◆ Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
- ◆ Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
- ◆ Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).
- ◆ The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

A33. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which the auditor considers when assessing the appropriateness of the going concern assumption. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are indicated in the Appendix 2.

A34. Usually, management identifies business risks and develops approaches to address them. Such a risk

assessment process is part of internal control and is discussed in paragraph 15 and paragraphs A79-A80.

A35. In case of audits of certain entities, “management objectives” may be influenced by concerns regarding public accountability and may include objectives which have their source in legislation, regulations, and government directions.

Measurement and Review of the Entity's Financial Performance (Ref: Para. 11(e))

A36. Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud – See SA 240 for requirements and guidance in relation to the risks of fraud.

A37. The measurement and review of financial performance is not the same as the monitoring of controls (discussed as a component of internal control in paragraphs A98-A104), though their purposes may overlap:

- ◆ The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).
- ◆ Monitoring of controls is specifically concerned with the effective operation of internal control.

In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control.

A38. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the auditor may consider, include:

- ◆ Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.
- ◆ Period-on-period financial performance analyses.
- ◆ Budgets, forecasts, variance analyses, segment information and divisional, departmental or other level performance reports.
- ◆ Employee performance measures and incentive compensation policies.
- ◆ Comparisons of an entity's performance with that of competitors.

A39. External parties may also measure and review the entity's financial performance. For example, external information such as analysts' reports and credit rating agency reports may represent useful information for the auditor. Such reports can often be obtained from the entity being audited.

A40. Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor that risks of misstatement of related financial statement information do exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

Considerations specific to smaller entities

A41. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

The Entity's Internal Control

A42. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing, and extent of further audit procedures.

A43. The following application material on internal control is presented in four sections, as follows:

- ◆ General Nature and Characteristics of Internal Control.
- ◆ Controls Relevant to the Audit.
- ◆ Nature and Extent of the Understanding of Relevant Controls.
- ◆ Components of Internal Control.

General Nature and Characteristics of Internal Control (Ref: Para. 12)***Purpose of internal control***

A44. Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

- ◆ The reliability of the entity's financial reporting;
- ◆ The effectiveness and efficiency of its operations;
- ◆ Its compliance with applicable laws and regulations; and
- ◆ Safeguarding of assets.

The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

Considerations specific to smaller entities

A45. Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.

Limitations of internal control

A46. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control. Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

A47. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

A48. Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

Considerations specific to smaller entities

A49. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is

practicable. However, in a small owner-managed entity, the owner-manager⁹ may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

A50. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

Division of internal control into components

A51. The division of internal control into the following five components, for purposes of the SAs, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

- (a) The control environment;
- (b) The entity's risk assessment process;
- (c) The information system, including the related business processes, relevant to financial reporting, and communication;
- (d) Control activities; and
- (e) Monitoring of controls.

The division does not necessarily reflect how an entity designs, implements and maintains internal control, or how it may classify any particular component. Auditors may use different terminology or frameworks to describe the various aspects of internal control, and their effect on the audit than those used in this SA, provided all the components described in this SA are addressed.

A52. Application material relating to the five components of internal control as they relate to a financial statement audit is set out in paragraphs A69-A104 below. Appendix 1 provides further explanation of these components of internal control.

Characteristics of manual and automated elements of internal control relevant to the auditor's risk assessment

A53. An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.

A54. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

- ◆ Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.
- ◆ Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, record, process or report transactions, or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the

⁹ Owner-manager refers to the proprietor of an entity who is involved in running the entity on a day-to-day basis.

effective functioning of manual controls that depend on IT.

An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT.

A55. Generally, IT benefits an entity's internal control by enabling an entity to:

- ◆ Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- ◆ Enhance the timeliness, availability, and accuracy of information;
- ◆ Facilitate the additional analysis of information;
- ◆ Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- ◆ Reduce the risk that controls will be circumvented; and
- ◆ Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

A56. IT also poses specific risks to an entity's internal control, including, for example:

- ◆ Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- ◆ Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- ◆ The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- ◆ Unauthorised changes to data in master files.
- ◆ Unauthorised changes to systems or programs.
- ◆ Failure to make necessary changes to systems or programs.
- ◆ Inappropriate manual intervention.
- ◆ Potential loss of data or inability to access data as required.

A57. Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

- ◆ Large, unusual or non-recurring transactions.
- ◆ Circumstances where errors are difficult to define, anticipate or predict.
- ◆ In changing circumstances that require a control response outside the scope of an existing automated control.
- ◆ In monitoring the effectiveness of automated controls.

A58. Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements may be less suitable for the following circumstances:

- ◆ High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
- ◆ Control activities where the specific ways to perform the control can be adequately designed and

automated.

A59. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

Controls Relevant to the Audit

A60. There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.

A61. Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- ◆ Materiality.
- ◆ The significance of the related risk.
- ◆ The size of the entity.
- ◆ The nature of the entity's business, including its organisation and ownership characteristics.
- ◆ The diversity and complexity of the entity's operations.
- ◆ Applicable legal and regulatory requirements.
- ◆ The circumstances and the applicable component of internal control.
- ◆ The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.
- ◆ Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

A62. Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.

A63. Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

A64. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

A65. In certain circumstances, the statute or the regulation governing the entity may require the auditor to report on compliance with certain specific aspects of internal controls as a result, the auditor's review of internal control may be broader and more detailed.

Nature and Extent of the Understanding of Relevant Controls (Ref: Para. 13)

A66. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency in internal control.

A67. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:

- ◆ Inquiring of entity personnel.
- ◆ Observing the application of specific controls.
- ◆ Inspecting documents and reports.
- ◆ Tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes.

A68. Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing (see paragraph A55), performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes. Tests of the operating effectiveness of controls are further described in SA 330, "The Auditor's Responses to Assessed Risks".

Components of Internal Control—Control Environment (Ref: Para. 14)

A69. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people.

A70. Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- (a) *Communication and enforcement of integrity and ethical values* – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
- (b) *Commitment to competence* – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
- (c) *Participation by those charged with governance* – Attributes of those charged with governance such as:
 - ◆ Their independence from management.
 - ◆ Their experience and stature.

- ◆ The extent of their involvement and the information they receive, and the scrutiny of activities.
 - ◆ The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
- (d) Management's philosophy and operating style – Characteristics such as management's:
- ◆ Approach to taking and managing business risks.
 - ◆ Attitudes and actions toward financial reporting.
 - ◆ Attitudes toward information processing and accounting functions and personnel.
- (e) *Organisational structure* – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
- (f) *Assignment of authority and responsibility* - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.
- (g) *Human resource policies and practices* – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Audit evidence for elements of the control environment

- A71. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

Effect of the control environment on the assessment of the risks of material misstatement

- A72. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity's control consciousness is influenced significantly by those charged with governance, because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as:
- ◆ Their independence from management and their ability to evaluate the actions of management.
 - ◆ Whether they understand the entity's business transactions.
 - ◆ The extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework.
- A73. An active and independent board of directors may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings.
- A74. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect

internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures¹⁰.

- A75. The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

Considerations specific to smaller entities

- A76. The control environment within small entities is likely to differ from larger entities. For example, those charged with governance in small entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. The nature of the control environment may also influence the significance of other controls, or their absence. For example, the active involvement of an owner-manager may mitigate certain of the risks arising from a lack of segregation of duties in a small business; it may, however, increase other risks, for example, the risk of override of controls.
- A77. In addition, audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, yet effective. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.
- A78. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.

Components of Internal Control—The Entity's Risk Assessment Process (Ref: Para. 15)

- A79. The entity's risk assessment process forms the basis for how management determines the risks to be managed. If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

Considerations specific to smaller entities (Ref: Para. 17)

- A80. There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.

Components of Internal Control—The Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication

The information system, including related business processes, relevant to financial reporting (Ref: Para. 18)

- A81. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:
- ◆ Initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity;
 - ◆ Resolve incorrect processing of transactions, for example, automated suspense files and

¹⁰ SA 330, paragraphs A2-A3.

procedures followed to clear suspense items out on a timely basis;

- ◆ Process and account for system overrides or bypasses to controls;
- ◆ Transfer information from transaction processing systems to the general ledger;
- ◆ Capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortisation of assets and changes in the recoverability of accounts receivables; and
- ◆ Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarised and appropriately reported in the financial statements.

Journal entries

- A82. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases, and cash disbursements in the general ledger, or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.
- A83. An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of computer-assisted audit techniques.

Related business processes

- A84. An entity's business processes are the activities designed to:
- ◆ Develop, purchase, produce, sell and distribute an entity's products and services;
 - ◆ Ensure compliance with laws and regulations; and
 - ◆ Record information, including accounting and financial reporting information.

Business processes result in the transactions that are recorded, processed and reported by the information system. Obtaining an understanding of the entity's business processes, which include how transactions are originated, assists the auditor obtain an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

Considerations specific to smaller entities

- A85. Information systems and related business processes relevant to financial reporting in small entities are likely to be less sophisticated than in larger entities, but their role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's systems and processes may therefore be easier in an audit of smaller entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important.

Communication (Ref: Para. 19)

- A86. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes such matters as the extent to which

personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals. Open communication channels help ensure that exceptions are reported and acted on.

Considerations specific to smaller entities

A87. Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

Components of Internal Control—Control Activities (Ref: Para. 20)

A88. Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels. Examples of specific control activities include those relating to the following:

- ◆ Authorization.
- ◆ Performance reviews.
- ◆ Information processing.
- ◆ Physical controls.
- ◆ Segregation of duties.

A89. Control activities that are relevant to the audit are:

- ◆ Those that are required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs 29 and 30, respectively; or
- ◆ Those that are considered to be relevant in the judgment of the auditor.

A90. The auditor's judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.

A91. The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

A92. The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

Considerations specific to smaller entities

A93. The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A94. Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles

such as revenues, purchases and employment expenses.

Risks arising from IT (Ref: Para. 21)

- A95. The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective general IT-controls and application controls.
- A96. General IT-controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:
- ◆ Data center and network operations.
 - ◆ System software acquisition, change and maintenance.
 - ◆ Program change.
 - ◆ Access security.
 - ◆ Application system acquisition, development, and maintenance.

They are generally implemented to deal with the risks referred to in paragraph A56 above.

- A97. Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorised, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

Components of Internal Control—Monitoring of Controls (Ref: Para. 22)

- A98. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.
- A99. Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

Considerations specific to smaller entities

- A100. Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

Internal Audit Functions (Ref: Para 23)

- A101. The entity's internal audit function 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.

A102. The objectives of an internal audit function, and therefore the nature of its responsibilities and its status within the organisation, 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.

A103. If the nature of the internal audit function's responsibilities are related to the entity's financial reporting, 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.

Sources of information (Ref: Para. 24)

A104. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

- ◆ the sources of the information related to the entity's monitoring activities; and
- ◆ the basis upon which management considers the information to be sufficiently reliable for the purpose; is required as part of the auditor's understanding of the entity's monitoring activities as a component of internal control.

Identifying and Assessing the Risks of Material Misstatement

Assessment of Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 25 (a))

A105. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

A106. Risks at the financial statement level may derive in particular from deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

A107. The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

- ◆ Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.
- ◆ Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements.

A108. SA 705, "Modifications to the Opinion in the Independent Auditor's Report" establishes requirements and provides guidance in determining whether there is a need for the auditor to consider a qualification or

disclaimer of opinion or, as may be required in some cases, to withdraw from the engagement where this is legally possible.

Assessment of Risks of Material Misstatement at the Assertion Level (Ref: Para. 25(b))

A109. 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.

The Use of Assertions

A110. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

A111. 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:

- (a) 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.
- (b) 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.
- (c) 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.

A112. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.

A113. When making assertions about the financial statements of certain entities, especially, for example, where the Government is a major stakeholder, in addition to those assertions set out in paragraph A111, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

Process of Identifying Risks of Material Misstatement (Ref: Para. 26(a))

A114. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed.

A115. **Appendix 2** provides examples of conditions and events that may indicate the existence of risks of material misstatement.

Relating Controls to Assertions [Ref: Para. 26(c)]

A116. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

A117. Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.

A118. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Significant Risks

Identifying Significant Risks (Ref: Para. 28)

A119. Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.

A120. Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- ◆ Greater management intervention to specify the accounting treatment.
- ◆ Greater manual intervention for data collection and processing.

- ◆ Complex calculations or accounting principles.
- ◆ The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

A121. Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

- ◆ Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- ◆ Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

A122. SA 330 describes the consequences for further audit procedures of identifying a risk as significant.¹¹

Significant risks relating to the risks of material misstatement due to fraud

A123. SA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.¹²

Understanding Controls Related to Significant Risks (Ref: Para. 29)

A124. Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:

- ◆ Control activities such as a review of assumptions by senior management or experts.
- ◆ Documented processes for estimations.
- ◆ Approval by those charged with governance.

A125. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

A126. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure by management to implement such controls is an indicator of a significant deficiency in internal control.¹³

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence
(Ref: Para. 30)

A127. Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

¹¹ SA 330, paragraphs 15 and 21.

¹² SA 240, paragraph 25-27.

¹³ SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", Paragraph A7.

A128. Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an integrated system. In such cases:

- ◆ Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.
- ◆ The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

A129. The consequences for further audit procedures of identifying such risks are described in SA 330.¹⁴

Revision of Risk Assessment (Ref: Para. 31)

A130. During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements. See SA 330 for further guidance.

Documentation (Ref: Para. 32)

A131. The manner in which the requirements of paragraph 32 are documented is for the auditor to determine using professional judgment. For example, in audits of small entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan that is required by SA 300, "Planning an Audit of Financial Statements"¹⁵. Similarly, for example, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures (see SA 330)¹⁶. The form and extent of the documentation is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.

A132. For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple in form and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.

A133. The extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team. Provided the requirements of SA 230, "Audit Documentation" are always met, an audit undertaken by an engagement team comprising less experienced individuals may require more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.

¹⁴ SA 330, paragraph 8.

¹⁵ SA 300, paragraphs 7 and 9.

¹⁶ SA 330, paragraph 8.

A134. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

Material Modifications to ISA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment

Deletions

1. Paragraph A21 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the effect of ministerial directives, government policy requirements and resolutions of the legislature on the operations of the entity. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the operation of the entity may be affected by government policy requirements and resolutions of the legislature. Accordingly, the spirit of erstwhile A21, highlighting the fact that in some cases, the entity's operations may be affected by such requirements/resolutions, has been retained.

2. Paragraph A35 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the influence of concerns relating to public accountability, including objectives having source in legislation, regulations, government ordinances, etc., on 'management objectives'. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the management's objectives are influenced by such aspects. Accordingly, the spirit of erstwhile A35, highlighting the fact that in some cases, the management objectives may be influenced by the concerns relating to public accountability, including objectives having source in legislation, regulations, government directions, has been retained.

3. Paragraph A65 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the additional reporting responsibilities of the auditor with respect to internal control because of any code of practice or compliance with legislative authorities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the statute or regulations may require the auditor to report on compliance with certain specific aspects of internal control. Accordingly, the spirit of erstwhile A65, highlighting such additional reporting responsibilities of the auditor, has been retained.

4. Paragraph A113 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the relevance of management's assertions that transactions and events have been carried out in accordance with legislation or proper authority, for the financial statement audit. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, there may be similar assertions made by the management that may fall within the scope of the financial statement audit. Accordingly, the spirit of erstwhile A113, highlighting such fact, has been retained and an example has been added.

Appendix 1

(Ref: Paras. 4(c), 14-23 and A65-A97)

Internal Control Components

1. This appendix further explains the components of internal control, as set out in paragraphs 4(c), 14-24 and A69-A104, as they relate to a financial statement audit.

Control Environment

2. The control environment encompasses the following elements:
 - (a) *Communication and enforcement of integrity and ethical values.* The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.
 - (b) *Commitment to competence.* Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.
 - (c) *Participation by those charged with governance.* An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognised in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.
 - (d) *Management's philosophy and operating style.* Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.
 - (e) *Organizational structure.* Establishing a relevant organisational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities.
 - (f) *Assignment of authority and responsibility.* The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognise how and for what they will be held accountable.
 - (g) *Human resource policies and practices.* Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars

illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Entity's Risk Assessment Process

3. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyses significant estimates recorded in the financial statements.
4. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:
 - ◆ *Changes in operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
 - ◆ *New personnel.* New personnel may have a different focus on or understanding of internal control.
 - ◆ *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control.
 - ◆ *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
 - ◆ *New technology.* Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
 - ◆ *New business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
 - ◆ *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
 - ◆ *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
 - ◆ *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

Information System, Including the Related Business Processes, Relevant To Financial Reporting, And Communication

5. An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).
6. The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:
 - ◆ Identify and record all valid transactions.

- ◆ Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
 - ◆ Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
 - ◆ Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
 - ◆ Present properly the transactions and related disclosures in the financial statements.
7. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.
 8. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

Control Activities

9. Generally, control activities that may be relevant to an audit may be categorised as policies and procedures that pertain to the following:
 - ◆ *Performance reviews.* These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.
 - ◆ *Information processing.* The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT-controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT-controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.
 - ◆ *Physical controls.* Controls that encompass:
 - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
 - The authorisation for access to computer programs and data files.
 - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records).

The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.
 - ◆ *Segregation of duties.* Assigning different people the responsibilities of authorising transactions,

recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

10. Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorisation controls may be delegated under established guidelines, such as, investment criteria set by those charged with governance; alternatively, non-routine transactions such as, major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

Monitoring of Controls

11. An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as, management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.
12. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and deficiencies in internal control and recommendations for improving internal control.
13. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

Appendix 2

(Ref: Para. A29 and A108)

Conditions and Events that May Indicate Risks of Material Misstatement

The following are examples of conditions and events that may indicate the existence of risks of material misstatement. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

- ◆ Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- ◆ Operations exposed to volatile markets, for example, futures trading.
- ◆ Operations that are subject to a high degree of complex regulation.
- ◆ Going concern and liquidity issues including loss of significant customers.

- ◆ Constraints on the availability of capital and credit.
- ◆ Changes in the industry in which the entity operates.
- ◆ Changes in the supply chain.
- ◆ Developing or offering new products or services, or moving into new lines of business.
- ◆ Expanding into new locations.
- ◆ Changes in the entity such as large acquisitions or reorganisations or other unusual events.
- ◆ Entities or business segments likely to be sold.
- ◆ The existence of complex alliances and joint ventures.
- ◆ Use of off-balance-sheet finance, special-purpose entities, and other complex financing arrangements.
- ◆ Significant transactions with related parties.
- ◆ Lack of personnel with appropriate accounting and financial reporting skills.
- ◆ Changes in key personnel including departure of key executives.
- ◆ Deficiencies in internal control, especially those not addressed by management.
- ◆ Inconsistencies between the entity's IT strategy and its business strategies.
- ◆ Changes in the IT environment.
- ◆ Installation of significant new IT systems related to financial reporting.
- ◆ Inquiries into the entity's operations or financial results by regulatory or government bodies.
- ◆ Past misstatements, history of errors or a significant amount of adjustments at period end.
- ◆ Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.
- ◆ Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- ◆ Application of new accounting pronouncements.
- ◆ Accounting measurements that involve complex processes.
- ◆ Events or transactions that involve significant measurement uncertainty, including accounting estimates.
- ◆ Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.

SA 320***Materiality in Planning and Performing an Audit**
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)*

Introduction**Scope of this SA**

1. This Standard on Auditing (SA) deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. SA 450¹, explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

Materiality in the Context of an Audit

2. 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 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.² The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.
3. 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 to in paragraph 2 provide the auditor with such a frame of reference.
4. 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

* Published in August, 2009 issue of the Journal.

¹ SA 450, "Evaluation of Misstatements Identified during the Audit".

² For example, paragraph 10 of the "Framework for the Preparation and Presentation of Financial Statements," issued by the Institute of Chartered Accountants of India (ICAI) in July 2000, indicates for a profit-oriented entity that "as providers of risk capital to the enterprise, investor need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy".

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.
5. 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. (Ref: Para. A1)
 6. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:
 - (a) Determining the nature, timing and extent of risk assessment procedures;
 - (b) Identifying and assessing the risks of material misstatement; and
 - (c) Determining the nature, timing and extent of further audit procedures.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although, it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.³

Effective Date

7. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

8. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

Definition

9. For purposes of the SAs, performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Requirements

Determining Materiality and Performance Materiality when Planning the Audit

10. When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also

³ SA 450, paragraph A16.

determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A2-A11)

11. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)

Revision as the Audit Progresses

12. The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: Para. A13)
13. If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Documentation

14. The audit documentation shall include the following amounts and the factors considered in their determination:
 - (a) Materiality for the financial statements as a whole (see paragraph 10);
 - (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures (see paragraph 10);
 - (c) Performance materiality (see paragraph 11); and
 - (d) Any revision of (a)-(c) as the audit progressed (see paragraphs 12-13).

Application and Other Explanatory Material

Materiality and Audit Risk (Ref: Para. 5)

- A1. In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.⁴ The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level⁵. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk⁶. Materiality and audit risk are considered throughout the audit, in particular, when:
 - (a) Identifying and assessing the risks of material misstatement⁷;

⁴ SA 200, paragraph 11.

⁵ SA 200, paragraph 17.

⁶ SA 200, paragraph 13(c)

⁷ SA 315, "Identifying and Assessing the Risks of Material Misstatements Through Understanding the Entity and Its Environment".

- (b) Determining the nature, timing and extent of further audit procedures⁸; and
- (c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report⁹.

Determining Materiality and Performance Materiality when Planning the Audit (Ref: Para. 10)

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole

- A2. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:
- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
 - Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
 - The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
 - The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
 - The relative volatility of the benchmark.
- A3. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.
- A4. In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.
- A5. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period.
- A6. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional

⁸ SA 330, "The Auditor's Responses to Assessed Risks".

⁹ SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements".

judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in different circumstances.

Considerations Specific to Small Entities

- A7. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.
- A8. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the financial statements of those entities may therefore be influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public utility programs/projects, such as, Accelerated Irrigation Benefit Programme (AIBP), Pradhan Mantri Gram Sadak Yojana (PMGSY) undertaken by the Central/State governments or related government entities .
- A9. In an audit of the entities doing public utility programs/projects, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures
(Ref: Para. 10)

- A10. Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:
- Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, and the remuneration of management and those charged with governance).
 - The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
 - Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).
- A11. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

Performance Materiality (Ref: Para. 11)

- A12. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined,

is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

Revision as the Audit Progresses (Ref: Para. 12)

- A13. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

Material Modifications to ISA 320, "Materiality in Planning and Performing an Audit"

Deletions

1. Paragraph A2 of ISA 320 dealt with the determination of materiality for the financial statements as a whole or for particular assertion in an audit of financial statements of a public sector entity, which is influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public sector programs. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A2, highlighting such fact, has been retained and the paragraph has been re-numbered as A8.

2. Paragraph A9 of ISA 320 states that in an audit of the public sector entities, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program/project activities. Where a public sector entity has custody of assets, assets may be an appropriate benchmark. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A9, highlighting such fact, has been retained.

SA 500*
Audit Evidence
***(Effective for audits of financial statements
for periods beginning on or after April 1, 2009)***

Introduction

Scope of this SA

1. This Standard on Auditing (SA) explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.
2. This SA is applicable to all the audit evidence obtained during the course of the audit. Other SAs deal with specific aspects of the audit (for example, SA 315¹), the audit evidence to be obtained in relation to a particular topic (for example, SA 570²), specific procedures to obtain audit evidence (for example, SA 520³), and the evaluation of whether sufficient appropriate audit evidence has been obtained (SA 200 and SA 330⁴).

Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective

4. The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

Definitions

5. For purposes of the SAs, the following terms have the meanings attributed below:
 - (a) Accounting records – The records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
 - (b) Appropriateness (of audit evidence) – The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.
 - (c) Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records

* Published in April, 2009 issue of the Journal.

¹ SA 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

² SA 570, "Going Concern".

³ SA 520, "Analytical Procedures".

⁴ SA 330, "The Auditor's Responses to Assessed Risks".

underlying the financial statements and other information.

- (d) Management's expert – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.
- (e) Sufficiency (of audit evidence) – The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

Requirements

Sufficient Appropriate Audit Evidence

6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. (Ref: Para. A1-A25)

Information to Be Used as Audit Evidence

7. When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence. (Ref: Para. A26-A33)

8. When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes, (Ref: Para. A34-A36)

- (a) Evaluate the competence, capabilities and objectivity of that expert; (Ref: Para. A37-A43)
- (b) Obtain an understanding of the work of that expert; and (Ref: Para. A44-A47)
- (c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion. (Ref: Para. A48)

9. When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances:

- (a) Obtaining audit evidence about the accuracy and completeness of the information; and (Ref: Para. A49-A50)
- (b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes. (Ref: Para. A51)

Selecting Items for Testing to Obtain Audit Evidence

10. When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. (Ref: Para. A52-A56)

Inconsistency in, or Doubts over Reliability of, Audit Evidence

11. If:

- (a) audit evidence obtained from one source is inconsistent with that obtained from another; or
- (b) the auditor has doubts over the reliability of information to be used as audit evidence,

The auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit. (Ref: Para. A57)

Application and Other Explanatory Material

Sufficient Appropriate Audit Evidence (Ref: Para. 6)

A1. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also

include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit)⁵ or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

A2. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, reperformance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

A3. As explained in SA 200,⁶ reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

A4. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

A5. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

A6. SA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained.⁷ Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

Sources of Audit Evidence

A7. Some audit evidence is obtained by performing audit procedures to test the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.

⁵ SA 315, paragraph 9.

⁶ SA 200, paragraph 5.

⁷ SA 330, paragraph 26.

A8. More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.

A9. Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts' reports, and comparable data about competitors (benchmarking data).

Audit Procedures for Obtaining Audit Evidence

A10. As required by, and explained further in, SA 315 and SA 330, audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

- (a) Risk assessment procedures; and
- (b) Further audit procedures, which comprise:
 - (i) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and
 - (ii) Substantive procedures, including tests of details and substantive analytical procedures.

A11. The audit procedures described in paragraphs A14-A25 below may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor. As explained in SA 330, audit evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance⁸.

A12. The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

A13. Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

Inspection

A14. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

A15. Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

A16. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not

⁸ SA 330, paragraph A35.

necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

Observation

A17. Observation consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed. See SA 501 for further guidance on observation of the counting of inventory.⁹

External Confirmation

A18. An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition. See SA 505 for further guidance.¹⁰

Recalculation

A19. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Reperformance

A20. Repperformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

Analytical Procedures

A21. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. See SA 520 for further guidance.

Inquiry

A22. Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

A23. Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to

⁹ SA 501, "Audit Evidence—Specific Considerations for Selected Items".

¹⁰ SA 505, "External Confirmations".

modify or perform additional audit procedures.

A24. Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

A25. In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries. See SA 580 for further guidance.¹¹

Information to Be Used as Audit Evidence

Relevance and Reliability (Ref: Para. 7)

A26. As noted in paragraph A1, while audit evidence is primarily obtained from audit procedures performed during the course of the audit, it may also include information obtained from other sources such as, for example, previous audits, in certain circumstances, and a firm's quality control procedures for client acceptance and continuance. The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

Relevance

A27. Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing. For example, if the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

A28. A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off. Similarly, obtaining audit evidence regarding a particular assertion, for example, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to the same assertion.

A29. Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing tests of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation conditions which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

A30. Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

Reliability

A31. The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is

¹¹ SA 580, "Written Representations".

influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

A32. SA 520 provides further guidance regarding the reliability of data used for purposes of designing analytical procedures as substantive procedures.¹²

A33. SA 240 deals with circumstances where the auditor has reason to believe that a document may not be authentic, or may have been modified without that modification having been disclosed to the auditor.¹³

Reliability of Information Produced by a Management's Expert (Ref: Para. 8)

A34. The preparation of an entity's financial statements may require expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data. The entity may employ or engage experts in these fields to obtain the needed expertise to prepare the financial statements. Failure to do so when such expertise is necessary increases the risks of material misstatement.

A35. When information to be used as audit evidence has been prepared using the work of a management's expert, the requirement in paragraph 8 of this SA applies. For example, an individual or organisation may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organisation applies that expertise in making an estimate which the entity uses in preparing its financial statements, the individual or organisation is a management's expert and paragraph 8 applies. If, on the other hand, that individual or organization merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is subject to paragraph 7 of this SA, but is not the use of a management's expert by the entity.

A36. The nature, timing and extent of audit procedures in relation to the requirement in paragraph 8 of this

¹² SA 520, paragraph 5 (a).

¹³ SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph 13.

SA, may be affected by such matters as:

- The nature and complexity of the matter to which the management's expert relates.
- The risks of material misstatement in the matter.
- The availability of alternative sources of audit evidence.
- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- The nature and extent of any controls within the entity over the management's expert's work.
- The auditor's knowledge and experience of the management's expert's field of expertise.
- The auditor's previous experience of the work of that expert.

The Competence, Capabilities and Objectivity of a Management's Expert (Ref: Para. 8(a))

A37. Competence relates to the nature and level of expertise of the management's expert. Capability relates to the ability of the management's expert to exercise that competence in the circumstances. Factors that influence capability may include, for example, geographic location, and the availability of time and resources. Objectivity relates to the possible effects that bias, conflict of interest or the influence of others may have on the professional or business judgment of the management's expert. The competence, capabilities and objectivity of a management's expert, and any controls within the entity over that expert's work, are important factors in relation to the reliability of any information produced by a management's expert.

A38. Information regarding the competence, capabilities and objectivity of a management's expert may come from a variety of sources, such as:

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with others who are familiar with that expert's work.
- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.
- An auditor's expert, if any, who assists the auditor in obtaining sufficient appropriate audit evidence with respect to information produced by the management's expert.

A39. Matters relevant to evaluating the competence, capabilities and objectivity of a management's expert include whether that expert's work is subject to technical performance standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.

A40. Other matters that may be relevant include:

- The relevance of the management's expert's competence to the matter for which that expert's work will

be used, including any areas of specialty within that expert's field. For example, a particular actuary may specialise in property and casualty insurance, but have limited expertise regarding pension calculations.

- The management's expert's competence with respect to relevant accounting requirements, for example, knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework.
- Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the management's expert as the audit progresses.

A41. A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats and intimidation threats. Safeguards may reduce such threats, and may be created either by external structures (for example, the management's expert's profession, legislation or regulation), or by the management's expert's work environment (for example, quality control policies and procedures).

A42. Although safeguards cannot eliminate all threats to a management's expert's objectivity, threats such as intimidation threats may be of less significance to an expert engaged by the entity than to an expert employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be present, an expert employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.

A43. When evaluating the objectivity of an expert engaged by the entity, it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity, and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:

- Financial interests.
- Business and personal relationships.
- Provision of other services.

Obtaining an Understanding of the Work of the Management's Expert (Ref: Para. 8(b))

A44. An understanding of the work of the management's expert includes an understanding of the relevant field of expertise. An understanding of the relevant field of expertise may be obtained in conjunction with the auditor's determination of whether the auditor has the expertise to evaluate the work of the management's expert, or whether the auditor needs an auditor's expert for this purpose.¹⁴

A45. Aspects of the management's expert's field relevant to the auditor's understanding may include:

- Whether that expert's field has areas of specialty within it that are relevant to the audit.
- Whether any professional or other standards, and regulatory or legal requirements apply.
- What assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.
- The nature of internal and external data or information the auditor's expert uses.

A46. In the case of a management's expert engaged by the entity, there will ordinarily be an engagement letter or other written form of agreement between the entity and that expert. Evaluating that agreement when

¹⁴ SA 620, "Using the Work of an Auditor's Expert", paragraph 7.

obtaining an understanding of the work of the management's expert may assist the auditor in determining the appropriateness of the following for the auditor's purposes:

- The nature, scope and objectives of that expert's work;
- The respective roles and responsibilities of management and that expert; and
- The nature, timing and extent of communication between management and that expert, including the form of any report to be provided by that expert.

A47. In the case of a management's expert employed by the entity, it is less likely there will be a written agreement of this kind. Inquiry of the expert and other members of management may be the most appropriate way for the auditor to obtain the necessary understanding.

Evaluating the Appropriateness of the Management's Expert's Work (Ref: Para. 8(c))

A48. Considerations when evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion may include:

- The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
- If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
- If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

Information Produced by the Entity and Used for the Auditor's Purposes (Ref: Para. 9(a)-(b))

A49. In order for the auditor to obtain reliable audit evidence, information produced by the entity that is used for performing audit procedures needs to be sufficiently complete and accurate. For example, the effectiveness of auditing revenue by applying standard prices to records of sales volume is affected by the accuracy of the price information and the completeness and accuracy of the sales volume data. Similarly, if the auditor intends to test a population (for example, payments) for a certain characteristic (for example, authorisation), the results of the test will be less reliable if the population from which items are selected for testing is not complete.

A50. Obtaining audit evidence about the accuracy and completeness of such information may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the preparation and maintenance of the information. In some situations, however, the auditor may determine that additional audit procedures are needed.

A51. In some cases, the auditor may intend to use information produced by the entity for other audit purposes. For example, the auditor may intend to make use of the entity's performance measures for the purpose of analytical procedures, or to make use of the entity's information produced for monitoring activities, such as internal auditor's reports. In such cases, the appropriateness of the audit evidence obtained is affected by whether the information is sufficiently precise or detailed for the auditor's purposes. For example, performance measures used by management may not be precise enough to detect material misstatements.

Selecting Items for Testing to Obtain Audit Evidence (Ref: Para. 10)

A52. An effective test provides appropriate audit evidence to an extent that, taken with other audit evidence obtained or to be obtained, will be sufficient for the auditor's purposes. In selecting items for testing, the auditor is required by paragraph 7 to determine the relevance and reliability of information to be used as audit evidence;

the other aspect of effectiveness (sufficiency) is an important consideration in selecting items to test. The means available to the auditor for selecting items for testing are:

- (a) Selecting all items (100% examination);
- (b) Selecting specific items; and
- (c) Audit sampling.

The application of any one or combination of these means may be appropriate depending on the particular circumstances, for example, the risks of material misstatement related to the assertion being tested, and the practicality and efficiency of the different means.

Selecting All Items

A53. The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). 100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details. 100% examination may be appropriate when, for example:

- The population constitutes a small number of large value items;
- There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

Selecting Specific Items

A54. The auditor may decide to select specific items from a population. In making this decision, factors that may be relevant include the auditor's understanding of the entity, the assessed risks of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

- High value or key items. The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example, items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- All items over a certain amount. The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- Items to obtain information. The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

A55. While selective examination of specific items from a class of transactions or account balance will often be an efficient means of obtaining audit evidence, it does not constitute audit sampling. The results of audit procedures applied to items selected in this way cannot be projected to the entire population; accordingly, selective examination of specific items does not provide audit evidence concerning the remainder of the population.

Audit Sampling

A56. Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it. Audit sampling is discussed in SA 530.¹⁵

Inconsistency in, or Doubts over Reliability of, Audit Evidence (Ref: Para. 11)

¹⁵ SA 530, "Audit Sampling".

A57. Obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable, such as when audit evidence obtained from one source is inconsistent with that obtained from another. This may be the case when, for example, responses to inquiries of management, internal audit, and others are inconsistent, or when responses to inquiries of those charged with governance made to corroborate the responses to inquiries of management are inconsistent with the response by management. SA 230 includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter.¹⁶

Material Modifications *vis a vis* ISA 500, "Audit Evidence"

SA 500, "Audit Evidence" does not contain any material modifications *vis-a-vis* ISA 500.

¹⁶ SA 230, "Audit Documentation", paragraph 11.

SA 501*

**Audit Evidence—Specific Considerations for
Selected Items**
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with SA 330¹, SA 500² and other relevant SAs, with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

3. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:
- (a) Existence and condition of inventory;
 - (b) Completeness of litigation and claims involving the entity; and
 - (c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

Requirements

Inventory

4. When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:
- (a) Attendance at physical inventory counting, unless impracticable, to: (Ref: Para. A1-A3)
 - (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting; (Ref: Para. A4)
 - (ii) Observe the performance of management's count procedures; (Ref: Para. A5)
 - (iii) Inspect the inventory; and (Ref: Para. A6)
 - (iv) Perform test counts; and (Ref: Para. A7-A8)
 - (b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

* Published in March, 2010 issue of the Journal.

¹ SA 330, "The Auditor's Responses to Assessed Risks".

² SA 500, "Audit Evidence".

5. If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required by paragraph 4, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. (Ref: Para. A9-A11)

6. If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

7. If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with SA 705³. (Ref: Para. A12-A14)

8. When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

- (a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity. (Ref: Para. A15)
- (b) Perform inspection or other audit procedures appropriate in the circumstances. (Ref: Para. A16)

Litigation and Claims

9. The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including: (Ref: Para. A17-A19)

- (a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
- (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- (c) Reviewing legal expense accounts. (Ref: Para. A20)

10. If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor. If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures. (Ref: Para. A21-A25)

11. If:

- (a) management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding; and
- (b) the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

³ SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

Written Representations

12. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

Segment Information

13. The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by: (Ref: Para. A26)

- (a) Obtaining an understanding of the methods used by management in determining segment information, and: (Ref: Para. A27)
 - (i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and
 - (ii) Where appropriate, testing the application of such methods; and
- (b) Performing analytical procedures or other audit procedures appropriate in the circumstances.

Application and Other Explanatory Material**Inventory****Attendance at Physical Inventory Counting** (Ref: Para. 4(a))

A1. Management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity's perpetual inventory system.

A2. Attendance at physical inventory counting involves:

- Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
- Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
- Obtaining audit evidence as to the reliability of management's count procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

A3. Matters relevant in planning attendance at physical inventory counting (or in designing and performing audit procedures pursuant to paragraphs 4-8 of this SA) include, for example:

- Nature of inventory.
- Stages of completion of work in progress.
- The risks of material misstatement related to inventory.
- The nature of the internal control related to inventory.
- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- The timing of physical inventory counting.
- Whether the entity maintains a perpetual inventory system.
- The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate. SA 600,

“Using the Work of Another Auditor” deals with the involvement of other auditors and accordingly may be relevant if such involvement is with regards to attendance of physical inventory counting at a remote location.

- Whether the assistance of an auditor's expert is needed. SA 620⁴ deals with the use of an auditor's expert to assist the auditor to obtain sufficient appropriate audit evidence.

Evaluate Management's Instructions and Procedures (Ref: Para. 4(a)(i))

A4. Matters relevant in evaluating management's instructions and procedures for recording and controlling the physical inventory counting include whether they address, for example:

- The application of appropriate control activities, for example, collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures.
- The accurate identification of the stage of completion of work in progress, of slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment.
- The procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile.
- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cut off date.

Observe the Performance of Management's Count Procedures (Ref: Para. 4(a)(ii))

A5. Observing the performance of management's count procedures, for example those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management's instructions and count procedures are adequately designed and implemented. In addition, the auditor may obtain copies of cut off information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

Inspect the Inventory (Ref: Para. 4(a)(iii))

A6. Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or ageing inventory.

Perform Test Counts (Ref: Para. 4(a)(iv))

A7. Performing test counts, for example by tracing items selected from management's count records to the physical inventory and tracing items selected from the physical inventory to management's count records, provides audit evidence about the completeness and the accuracy of those records.

A8. In addition to recording the auditor's test counts, obtaining copies of management's completed physical inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

Physical Inventory Counting Conducted Other than At the Date of the Financial Statements (Ref: Para. 5)

A9. For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system. In either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory

⁴ SA 620, “Using the Work of an Auditor's Expert”.

determines whether the conduct of physical inventory counting at a date, or dates, other than the date of the financial statements is appropriate for audit purposes. SA 330 establishes requirements and provides guidance on substantive procedures performed at an interim date⁵.

A10. Where a perpetual inventory system is maintained, management may perform physical counts or other tests to ascertain the reliability of inventory quantity information included in the entity's perpetual inventory records. In some cases, management or the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively.

A11. Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

- Whether the perpetual inventory records are properly adjusted.
- Reliability of the entity's perpetual inventory records.
- Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

Attendance at Physical Inventory Counting Is Impracticable (Ref: Para. 7)

A12. In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200⁶, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

A13. In some cases where attendance is impracticable, alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

A14. In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation⁷.

Inventory under the Custody and Control of a Third Party

Confirmation (Ref: Para. 8(a))

A15. SA 505⁸ establishes requirements and provides guidance for performing external confirmation procedures.

Other Audit Procedures (Ref: Para. 8(b))

A16. Depending on the circumstances, for example where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures

⁵ SA 330, paragraphs 22-23.

⁶ SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph A48.

⁷ SA 705, paragraph 13.

⁸ SA 505, "External Confirmations".

include:

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral.

Litigation and Claims

Completeness of Litigations and Claims (Ref: Para. 9)

A17. Litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.

A18. In addition to the procedures identified in paragraph 9, other relevant procedures include, for example, using information obtained through risk assessment procedures carried out as part of obtaining an understanding of the entity and its environment to assist the auditor to become aware of litigation and claims involving the entity.

A19. Audit evidence obtained for purposes of identifying litigation and claims that may give rise to a risk of material misstatement also may provide audit evidence regarding other relevant considerations, such as valuation or measurement, regarding litigation and claims. SA 540⁹ establishes requirements and provides guidance relevant to the auditor's consideration of litigation and claims requiring accounting estimates or related disclosures in the financial statements.

Reviewing Legal Expense Accounts (Ref: Para. 9(c))

A20. Depending on the circumstances, the auditor may judge it appropriate to examine related source documents, such as invoices for legal expenses, as part of the auditor's review of legal expense accounts.

Communication with the Entity's External Legal Counsel (Ref: Para. 10-11)

A21. Direct communication with the entity's external legal counsel assists the auditor in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reasonable.

A22. In some cases, the auditor may seek direct communication with the entity's external legal counsel through a letter of general inquiry. For this purpose, a letter of general inquiry requests the entity's external legal counsel to inform the auditor of any litigation and claims that the counsel is aware of, together with an assessment of the outcome of the litigation and claims, and an estimate of the financial implications, including costs involved.

A23. If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:

- (a) A list of litigation and claims;
- (b) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
- (c) A request that the entity's external legal counsel confirm the reasonableness of management's

⁹ SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures".

assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

A24. In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, where:

- The auditor determines that the matter is a significant risk.
- The matter is complex.
- There is disagreement between management and the entity's external legal counsel. Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

A25. In accordance with Revised SA 700¹⁰, the auditor is required to date the auditor's report no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements. Audit evidence about the status of litigation and claims up to the date of the auditor's report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity's external legal counsel.

Segment Information (Ref: Para. 13)

A26. Depending on the applicable financial reporting framework, the entity may be required or permitted to disclose segment information in the financial statements. The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a stand alone basis.

Understanding of the Methods Used by Management (Ref: Para. 13(a))

A27. Depending on the circumstances, example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

- Sales, transfers and charges between segments, and elimination of inter-segment amounts.
- Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
- The allocation of assets and costs among segments.
- Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

Modifications vis-a-vis ISA 501, "Audit Evidence—Specific Considerations for Selected Items"

SA 501, "Audit Evidence—Specific Considerations for Selected Items" does not contain any modifications vis-à-vis ISA 501.

¹⁰ Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 41.

SA 505*

External Confirmations

*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 330¹ and SA 500². It does not address inquiries regarding litigation and claims. SA 501³ deals with obtaining sufficient appropriate audit evidence from such inquiries.

External Confirmation Procedures to Obtain Audit Evidence

2. SA 500 indicates that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained⁴. That SA also includes the following generalisations applicable to audit evidence⁵:

- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium.

Accordingly, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity. This SA is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

3. Other SAs recognise the importance of external confirmations as audit evidence, for example:

- SA 330 discusses the auditor's responsibility to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level, and to design and perform further audit procedures whose nature, timing and extent are based on, and are responsive to, the assessed risks of material misstatement at the assertion level⁶. In addition, SA 330 requires that,

* Published in March, 2010 issue of the Journal.

¹ SA 330, "The Auditor's Responses to Assessed Risks".

² SA 500, "Audit Evidence".

³ SA 501, "Audit Evidence—Specific Considerations for Selected Items".

⁴ SA 500, paragraph A5.

⁵ SA 500, paragraph A31.

⁶ SA 330, paragraphs 5-6.

irrespective of the assessed risks of material misstatement, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure. The auditor is also required to consider whether external confirmation procedures are to be performed as substantive audit procedures⁷.

- SA 330 requires that the auditor obtain more persuasive audit evidence the higher the auditor's assessment of risk⁸. To do this, the auditor may increase the quantity of the evidence or obtain evidence that is more relevant or reliable, or both. For example, the auditor may place more emphasis on obtaining evidence directly from third parties or obtaining corroborating evidence from a number of independent sources. SA 330 also indicates that external confirmation procedures may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error⁹.
- SA 240 indicates that the auditor may design confirmation requests to obtain additional corroborative information as a response to address the assessed risks of material misstatement, whether due to fraud at the assertion level¹⁰.
- SA 500 indicates that corroborating information obtained from a source independent of the entity, such as external confirmations, may increase the assurance the auditor obtains from evidence existing within the accounting records or from the representations made by the management¹¹.

Effective Date

4. This SA is effective for audit of financial statements for period beginning on or after April 1, 2010.

Objective

5. The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.

Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:
- a) External confirmation – Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.
 - b) Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.
 - c) Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
 - d) Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.
 - e) Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

⁷ SA 330, Paragraph 18 and 19.

⁸ SA 330, paragraph 7(b).

⁹ SA 330, paragraph A53.

¹⁰ SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph A37.

¹¹ SA 500, paragraph A8.

Requirements**External Confirmation Procedures**

7. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

- (a) Determining the information to be confirmed or requested; (Ref: Para. A1)
- (b) Selecting the appropriate confirming party; (Ref: Para. A2)
- (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and (Ref: Para. A3-A6)
- (d) Sending the requests, including follow-up requests when applicable, to the confirming party. (Ref: Para. A7)

Management's Refusal to Allow the Auditor to Send a Confirmation Request

8. If management refuses to allow the auditor to send a confirmation request, the auditor shall:

- (a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness; (Ref: Para. A8)
- (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and (Ref: Para. A9)
- (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence. (Ref: Para. A10)

9. If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260¹². The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705¹³.

Results of the External Confirmation Procedures**Reliability of Responses to Confirmation Requests**

10. If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts. (Ref: Para. A11-A16)

11. If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures. (Ref: Para. A17)

Non-Responses

12. In the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. (Ref: Para A18-A19)

¹² SA 260, "Communication with Those Charged with Governance", paragraph 12.

¹³ SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

When a Response to a Positive Confirmation Request is Necessary to Obtain Sufficient Appropriate Audit Evidence

13. If the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. If the auditor does not obtain such confirmation, the auditor shall determine the implications for the audit and the auditor's opinion in accordance with SA 705. (Ref: Para A20)

Exceptions

14. The auditor shall investigate exceptions to determine whether or not they are indicative of misstatements. (Ref: Para. A21-A22)

Negative Confirmations

15. Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present: (Ref: Para. A23)

- (a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
- (b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;
- (c) A very low exception rate is expected; and
- (d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

Evaluating the Evidence Obtained

16. The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether performing further audit procedures is necessary. (Ref: Para A24-A25)

Application and Other Explanatory Material***External Confirmation Procedures******Determining the Information to be Confirmed or Requested*** (Ref: Para. 7(a))

A1. External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a "side agreement".

Selecting the Appropriate Confirming Party (Ref: Para. 7(b))

A2. Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is knowledgeable about the information to be confirmed. For example, a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation.

Designing Confirmation Requests (Ref: Para. 7(c))

A3. The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

A4. Factors to consider when designing confirmation requests include:

- The assertions being addressed.
- Specific identified risks of material misstatement, including fraud risks.
- The layout and presentation of the confirmation request.
- Prior experience on the audit or similar engagements.
- The method of communication (for example, in paper form, or by electronic or other medium).
- Management's authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
- The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

A5. A positive external confirmation request asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party's agreement with the given information, or by asking the confirming party to provide information. A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence. There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, and ask the confirming party to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the confirming parties.

A6. Determining that requests are properly addressed includes testing the validity of some or all of the addresses on confirmation requests before they are sent out.

Follow-Up on Confirmation Requests (Ref: Para. 7(d))

A7. The auditor may send an additional confirmation request when a reply to a previous request has not been received within a reasonable time. For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request.

Management's Refusal to Allow the Auditor to Send a Confirmation Request

Reasonableness of Management's Refusal (Ref: Para. 8(a))

A8. A refusal by management to allow the auditor to send a confirmation request is a limitation on the audit evidence the auditor may wish to obtain. The auditor is therefore required to inquire as to the reasons for the limitation. A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. The auditor is required to seek audit evidence as to the validity and reasonableness of the reasons because of the risk that management may be attempting to deny the auditor access to audit evidence that may reveal fraud or error.

Implications for the Assessment of Risks of Material Misstatement (Ref: Para. 8(b))

A9. The auditor may conclude from the evaluation in paragraph 8(b) that it would be appropriate to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures in accordance with SA 315¹⁴. For example, if management's request to not confirm is unreasonable, this may indicate a fraud risk factor that requires evaluation in accordance with SA 240¹⁵.

¹⁴ SA 315, paragraph 31.

¹⁵ SA 240, paragraph 24.

Alternative Audit Procedures (Ref: Para. 8(c))

A10. The alternative audit procedures performed may be similar to those appropriate for a non-response as set out in paragraphs A18-A19 of this SA. Such procedures also would take account of the results of the auditor's evaluation in paragraph 8(b) of this SA.

Results of the External Confirmation Procedures**Reliability of Responses to Confirmation Requests** (Ref: Para. 10)

A11. SA 500 indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability¹⁶. All responses carry some risk of interception, alteration or fraud. Such risk exists regardless of whether a response is obtained in paper form, or by electronic or other medium. Factors that may indicate doubts about the reliability of a response include that it:

- Was received by the auditor indirectly; or
- Appeared not to come from the originally intended confirming party.

A12. Responses received electronically, for example by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of the respondent may be difficult to establish, and alterations may be difficult to detect. A process used by the auditor and the respondent that creates a secure environment for responses received electronically may mitigate these risks. If the auditor is satisfied that such a process is secure and properly controlled, the reliability of the related responses is enhanced. An electronic confirmation process might incorporate various techniques for validating the identity of a sender of information in electronic form, for example, through the use of encryption, electronic digital signatures, and procedures to verify website authenticity.

A13. If a confirming party uses a third party to coordinate and provide responses to confirmation requests, the auditor may perform procedures to address the risks that:

- (a) The response may not be from the proper source;
- (b) A respondent may not be authorised to respond; and
- (c) The integrity of the transmission may have been compromised.

A14. The auditor is required by SA 500 to determine whether to modify or add procedures to resolve doubts over the reliability of information to be used as audit evidence¹⁷. The auditor may choose to verify the source and contents of a response to a confirmation request by contacting the confirming party. For example, when a confirming party responds by electronic mail, the auditor may telephone the confirming party to determine whether the confirming party did, in fact, send the response. When a response has been returned to the auditor indirectly (for example, because the confirming party incorrectly addressed it to the entity rather than to the auditor), the auditor may request the confirming party to respond in writing directly to the auditor.

A15. On its own, an oral response to a confirmation request does not meet the definition of an external confirmation because it is not a direct written response to the auditor. However, upon obtaining an oral response to a confirmation request, the auditor may, depending on the circumstances, request the confirming party to respond in writing directly to the auditor. If no such response is received, in accordance with paragraph 12, the auditor seeks other audit evidence to support the information in the oral response.

A16. A response to a confirmation request may contain restrictive language regarding its use. Such restrictions do not necessarily invalidate the reliability of the response as audit evidence.

¹⁶ SA 500, paragraph A31.

¹⁷ SA 500, paragraph 11.

Unreliable Responses (Ref: Para. 11)

A17. When the auditor concludes that a response is unreliable, the auditor may need to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures accordingly, in accordance with SA 315¹⁸. For example, an unreliable response may indicate a fraud risk factor that requires evaluation in accordance with SA 240¹⁹.

Non-Responses (Ref: Para. 12)

A18. Examples of alternative audit procedures the auditor may perform include:

- For accounts receivable balances – examining specific subsequent cash receipts, shipping documentation, and sales near the period-end.
- For accounts payable balances – examining subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes.

A19. The nature and extent of alternative audit procedures are affected by the account and assertion in question. A non-response to a confirmation request may indicate a previously unidentified risk of material misstatement. In such situations, the auditor may need to revise the assessed risk of material misstatement at the assertion level, and modify planned audit procedures, in accordance with SA 315²⁰. For example, fewer responses to confirmation requests than anticipated, or a greater number of responses than anticipated, may indicate a previously unidentified fraud risk factor that requires evaluation in accordance with SA 240²¹.

When a Response to a Positive Confirmation Request is Necessary to Obtain Sufficient Appropriate Audit Evidence (Ref: Para. 13)

A20. In certain circumstances, the auditor may identify an assessed risk of material misstatement at the assertion level for which a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence. Such circumstances may include where:

- The information available to corroborate management's assertion(s) is only available outside the entity.
- Specific fraud risk factors, such as the risk of management override of controls, or the risk of collusion which can involve employee(s) and/or management, prevent the auditor from relying on evidence from the entity.

Exceptions (Ref: Para. 14)

A21. Exceptions noted in responses to confirmation requests may indicate misstatements or potential misstatements in the financial statements. When a misstatement is identified, the auditor is required by SA 240 to evaluate whether such misstatement is indicative of fraud²². Exceptions may provide a guide to the quality of responses from similar confirming parties or for similar accounts. Exceptions also may indicate a deficiency, or deficiencies, in the entity's internal control over financial reporting.

A22. Some exceptions do not represent misstatements. For example, the auditor may conclude that differences in responses to confirmation requests are due to timing, measurement, or clerical errors in the external confirmation procedures.

Negative Confirmations (Ref: Para. 15)

¹⁸ SA 315, paragraph 31.

¹⁹ SA 240, paragraph 24.

²⁰ SA 315, paragraph 31.

²¹ SA 240, paragraph 24.

²² SA 240, paragraph 35.

A23. The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request. Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise. For example, holders of bank deposit accounts may be more likely to respond if they believe that the balance in their account is understated in the confirmation request, but may be less likely to respond when they believe the balance is overstated. Therefore, sending negative confirmation requests to holders of bank deposit accounts may be a useful procedure in considering whether such balances may be understated, but is unlikely to be effective if the auditor is seeking evidence regarding overstatement.

Evaluating the Evidence Obtained (Ref: Para. 16)

A24. When evaluating the results of individual external confirmation requests, the auditor may categorise such results as follows:

- (a) A response by the appropriate confirming party indicating agreement with the information provided in the confirmation request, or providing requested information without exception;
- (b) A response deemed unreliable;
- (c) A non-response; or
- (d) A response indicating an exception.

A25. The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether performing further audit procedures is necessary, as required by SA 330²³.

Modifications *vis-a-vis* ISA 505, "External Confirmations"

SA 505, "External Confirmations" does not contain any modifications *vis-à-vis* ISA 505.

²³ SA 330, paragraphs 27-28.

SA 510*

Initial Audit Engagements—Opening Balances

(Effective for audits of financial statements for periods beginning on or after April 1, 2010)

Introduction**Scope of this SA**

1. This Standard on Auditing (SA) deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement. In addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments. When the financial statements include comparative financial information, the requirements and guidance in SA 710¹ also apply. SA 300² includes additional requirements and guidance regarding activities prior to starting an initial audit.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

3. 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:

- (a) Opening balances contain misstatements that materially affect the current period's financial statements; and
- (b) 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.

Definitions

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

- (a) Initial audit engagement – An engagement in which either:
 - (i) The financial statements for the prior period were not audited; or
 - (ii) The financial statements for the prior period were audited by a predecessor auditor.
- (b) Opening balances – Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.
- (c) Predecessor auditor – The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

* Published in March, 2009 issue of the Journal.

¹ SA 710, "Comparative Information- Corresponding Figures and Comparatives Financial Statements".

² SA 300, "Planning an Audit of Financial Statements".

Requirements**Audit Procedures*****Opening Balances***

5. The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

6. The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

- (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss³;
- (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
- (c) Performing one or more of the following: (Ref: Para. A1–A4)
 - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
 - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
 - (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

7. If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance in accordance with SA 450⁴.

Consistency of Accounting Policies

8. The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the accounting policies have been properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Relevant Information in the Predecessor Auditor's Report

9. If the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion, the auditor shall evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements in accordance with SA 315.⁵

Audit Conclusions and Reporting

³ Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived.

⁴ SA 450, "Evaluation of Misstatements Identified During the Audit", paragraphs 8 and 12.

⁵ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

Opening Balances

10. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.⁶ (Ref: Para. A5)

11. If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with SA 705.

Consistency of Accounting Policies

12. If the auditor concludes that:

- (a) the current period's accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework; or
- (b) a change in accounting policies is not properly accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework,

the auditor shall express a qualified opinion or an adverse opinion as appropriate in accordance with SA 705.

Modification to the Opinion in the Predecessor Auditor's Report

13. If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements in accordance with SA 705 and SA 710. (Ref: Para. A6)

Application and Other Explanatory Material**Audit Procedures** (Ref: Para. 6)**Opening Balances** (Ref: Para. 6(c))

A1. The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depend on such matters as:

- The accounting policies followed by the entity.
- The nature of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period's financial statements.
- The significance of the opening balances relative to the current period's financial statements.
- Whether the prior period's financial statements were audited and, if so, whether the predecessor auditor's opinion was modified.

A2. If the prior period's financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the 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.

⁶ SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

A3. For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures. For example, the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period. In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- Performing audit procedures on the valuation of the opening inventory items.
- Performing audit procedures on gross profit and cut-off.

A4. For non-current assets and liabilities, such as property plant and equipment, investments and long-term debt, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

Audit Conclusions and Reporting

Opening Balances (Ref: Para. 10)

A5. SA 705 establishes requirements and provides guidance on circumstances that may result in a modification to the auditor's opinion on the financial statements, the type of opinion appropriate in the circumstances, and the content of the auditor's report when the auditor's opinion is modified. The inability of the auditor to obtain sufficient appropriate audit evidence regarding opening balances may result in one of the following modifications to the opinion in the auditor's report:

- (a) A qualified opinion or a disclaimer of opinion, as is appropriate in the circumstances; or
- (b) Unless prohibited by law or regulation, an opinion which is qualified or disclaimed, as appropriate, regarding the results of operations*, and cash flows, where relevant, and unmodified regarding State of Affairs*.

The Appendix includes illustrative auditor's reports.

Modification to the Opinion in the Predecessor Auditor's Report (Ref: Para. 13)

A6. In some situations, a modification to the predecessor auditor's opinion may not be relevant and material to the opinion on the current period's financial statements. This may be the case where, for example, there was a scope limitation in the prior period, but the matter giving rise to the scope limitation has been resolved in the current period.

Material Modifications vis a vis ISA 510, "Initial Audit Engagements - Opening Balances"

Deletions

1. Paragraph 6 (a) of ISA 510 dealt with the procedure for obtaining sufficient appropriate audit evidence about the opening balances which contain misstatements that materially affect the current period's financial statements by determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated. Since in India Accounting Standard (AS) 5, "Net

* Profit & Loss Account.

* Balance Sheet.

Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies” requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived, the restatement of the prior period financial statements does not exist in the Indian scenario. Hence, to align with the requirements of AS 5, the requirement of restatement of prior period items has been replaced with the requirement to disclose the prior period items in the current year’s Statement of Profit & Loss.

2. Paragraph 6 (c) (i) of ISA 510 dealt with the procedure for obtaining sufficient appropriate audit evidence about the opening balances which contain misstatements that materially affect the current period’s financial statements by reviewing the predecessor auditor’s working papers, where the prior year financial statements were audited. Since in India Clause 1 of Part I of the Second Schedule to the Code of Ethics provides that a Chartered Accountant in Practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, an auditor cannot provide access to his working paper to the another auditor. Therefore, keeping in view the requirements of Code of Ethics, the requirement of reviewing the predecessor auditor’s working papers has been replaced with the requirement of perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements. Corresponding change has also been made in the paragraph A4 of ISA 510 and Paragraphs A1 and A5 have been deleted.

3. Paragraph A2 of ISA 510 dealt with the outsourcing of an audit of a public sector entity by the statutorily appointed auditor to a private sector audit firm. Since in the Indian context such situation does not exist, the paragraph A2 of the application part has been deleted completely.

Appendix

(Ref: Para. A5)

Illustrations of Auditors’ Reports with Modified Opinions*

Illustration 1:

Circumstances described in paragraph A5 (a) include the following:

- The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.
- The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity’s results of operations and cash flows.⁷
- The State of Affairs at year end gives a true and fair view.
- In this particular jurisdiction, law and regulation prohibit the auditor from giving an opinion which is qualified regarding the results of operations and cash flows and unmodified regarding State of Affairs.

* The Reporting Standards may give rise to conforming amendments to the illustrations of auditors’ reports.

⁷ If the possible effects, in the auditor’s judgment, are considered to be material and pervasive to the entity’s results of operations and cash flows, the auditor would disclaim an opinion on the results of operations and cash flows.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁸

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at March 31, 20X1, and the Statement of Profit and Loss, and the cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation of financial statements that give a true and fair view in accordance with applicable Accounting Standards.⁹ This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation¹⁰ of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.¹¹ An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

⁸ The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

⁹ Depending on the circumstances, this sentence may read: "Management is responsible for the preparation and fair presentation of these financial statements in accordance with applicable accounting standards".

¹⁰ Depending on the circumstances, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control".

¹¹ In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances". In the case of footnote 13, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances".

Basis for Qualified Opinion

We were appointed as auditors of the company on June 30, 20X0 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at March 31, 20X0. Since opening inventories enter into the determination of the results of operations and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the Statement of Profit and Loss and the net cash flows from operating activities reported in the cash flow statement.

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the State of Affairs of ABC Company as of March 31, 20X1, and of its Results of Operations and its cash flows for the year then ended in accordance with applicable Accounting Standards.

Other Matters

The financial statements of the Company for the year ended March 31, 20X0, were audited by another auditor whose report dated July 1, 20X0 expressed an unmodified opinion on those statements.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities].

For ABC and Co.
Chartered Accountants
Firm's Registration Number
Signature
(Name of the Member Signing the Audit Report)
(Designation¹²)
Membership Number

Place of Signature

Date

Illustration 2:

Circumstances described in paragraph A5 (b) include the following:

- The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.
- The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity's results of operations and cash flows.¹³
- The State of Affairs at year end gives a true and fair view.
- An opinion that is qualified regarding the results of operations and cash flows and unmodified regarding State of Affairs is considered appropriate in the circumstances.

¹² Partner or Proprietor, as the case may be.

¹³ If the possible effects, in the auditor's judgment, are considered to be material and pervasive to the entity's results of operations and cash flows, the auditor would disclaim the opinion on the results of operations and cash flows.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements¹⁴

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at March 31, 20X1, and the Statement of Profit and Loss, and the cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation¹⁵ of financial statements that give a true and fair view in accordance with applicable Accounting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation¹⁶ of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.¹⁷ An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our unmodified opinion on the State of Affairs and our qualified audit opinion on the results of operations and cash flows.

¹⁴ The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

¹⁵ Depending on the circumstances, this sentence may read: "Management is responsible for the preparation and fair presentation of these financial statements in accordance with applicable accounting standards".

¹⁶ Depending on the circumstances, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control".

¹⁷ In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances". In the case of footnote 19, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances".

Basis for Qualified Opinion on the results of operations and Cash Flows

We were appointed as auditors of the company on June 30, 20X0 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at March 31, 20X0. Since opening inventories enter into the determination of the results of operations and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the Statement of Profit and Loss and the net cash flows from operating activities reported in the cash flow statement.

Qualified Opinion on the results of operations and Cash Flows

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the Statement of Profit and Loss and Cash Flow Statement give a true and fair view of the results of operations and cash flows of ABC Company for the year ended March 31, 20X1 in accordance with applicable Accounting Standards.

Opinion on the State of Affairs

In our opinion, the balance sheet gives a true and fair view of the State of Affairs of ABC Company as of March 31, 20X1 in accordance with applicable Accounting Standards.

Other Matters

The financial statements of the Company for the year ended March 31, 20X0, were audited by another auditor whose report dated July 1, 20X0 expressed an unmodified opinion on those statements.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

For ABC and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁸)
Membership Number

Place of Signature

Date

¹⁸ Partner or Proprietor, as the case may be.

SA 520*

Analytical Procedures
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2010)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements. The use of analytical procedures as risk assessment procedures is dealt with in SA 315¹. SA 330 includes requirements and guidance regarding the nature, timing and extent of audit procedures in response to assessed risks; these audit procedures may include substantive analytical procedures².

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

3. The objectives of the auditor are:

- (a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
- (b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

Definition

4. For the purposes of the SAs, the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. The auditor's choice of procedures, methods and level of application is a matter of professional judgement. (Ref: Para. A1-A3)

Requirements

Substantive Analytical Procedures

5. When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330³, the auditor shall: (Ref: Para. A4-A5)

- (a) Determine the suitability of particular substantive analytical procedures for given assertions, taking

*Published in March, 2010 issue of the Journal.

¹ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraphs 6 (b) and A7-A10.

² SA 330, "The Auditor's Responses to Assessed Risks", paragraphs 6 and 18.

³ SA 330, paragraph 18.

account of the assessed risks of material misstatement and tests of details, if any, for these assertions; (Ref: Para. A6-A11)

- (b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation; (Ref: Para. A12-A14)
- (c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and (Ref: Para. A15)
- (d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph 7. (Ref: Para. A16)

Analytical Procedures that Assist When Forming an Overall Conclusion

6. The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. (Ref: Para. A17-A19)

Investigating Results of Analytical Procedures

7. If analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- (a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and
- (b) Performing other audit procedures as necessary in the circumstances. (Ref: Para. A20-A21)

Application and Other Explanatory Material

Nature of Analytical Procedures (Ref: Para. 4)

A1. Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

A2. Analytical procedures also include consideration of relationships, for example:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

A3. Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Substantive Analytical Procedures (Ref: Para. 5)

A4. The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

A5. The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

Suitability of Particular Analytical Procedures for Given Assertions (Ref: Para. 5(a))

A6. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

A7. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

A8. Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

A9. The determination of the suitability of particular substantive analytical procedures is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.

A10. Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

Considerations Specific to Public Sector Entities

A11. The relationships between individual financial statement items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities; for example, in many public sector entities there may be little direct relationship between revenue and

expenditure. In addition, because expenditure on the acquisition of assets may not be capitalised, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. Also, industry data or statistics for comparative purposes may not be available in the public sector. However, other relationships may be relevant, for example, variations in the cost per kilometer of road construction or the number of vehicles acquired compared with vehicles retired.

The Reliability of the Data (Ref: Para. 5(b))

A12. The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

- (a) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity⁴;
- (b) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
- (c) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (d) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

A13. The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures⁵.

A14. The matters discussed in paragraphs A12(a)-A12(d) are relevant irrespective of whether the auditor performs substantive analytical procedures on the entity's period end financial statements, or at an interim date and plans to perform substantive analytical procedures for the remaining period. SA 330 establishes requirements and provides guidance on substantive procedures performed at an interim date⁶.

Evaluation of Whether the Expectation Is Sufficiently Precise (Ref: Para. 5(c))

A15. Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

- The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

⁴ SA 500, "Audit Evidence", paragraph A31.

⁵ SA 500, paragraph 10.

⁶ SA 330, paragraphs 22-23.

- The degree to which information can be disaggregated. For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
- The availability of the information, both financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information as discussed in paragraphs A12 - A13 above.

Amount of Difference of Recorded Amounts from Expected Values that Is Acceptable (Ref: Para. 5(d))

A16. The auditor's determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by materiality⁷ and the consistency with the desired level of assurance, taking account of the possibility that a misstatement, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated. SA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk⁸. Accordingly, as the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence⁹.

Analytical Procedures that Assist When Forming an Overall Conclusion (Ref: Para. 6)

A17. The conclusions drawn from the results of analytical procedures designed and performed in accordance with paragraph 6 are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion.

A18. The results of such analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances, SA 315 requires the auditor to revise the auditor's assessment of the risks of material misstatement and modify the further planned audit procedures accordingly¹⁰.

A19. The analytical procedures performed in accordance with paragraph 6 may be similar to those that would be used as risk assessment procedures.

Investigating Results of Analytical Procedures (Ref: Para. 7)

A20. Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

A21. The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

Modifications vis-a-vis ISA 520, "Analytical Procedures"

SA 520, "Analytical Procedures" does not contain any modifications vis-à-vis ISA 520.

Appendix

⁷ SA 320, "Materiality in Planning and Performing an Audit", paragraph A13.

⁸ SA 330, paragraph 7(b).

⁹ SA 330, paragraph A19.

¹⁰ SA 315, paragraph 31.

Analytical Procedures**Trends**

Analysing account fluctuations by comparing current year to prior year information and, also, to information derived over several years.

Reasonableness

Tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts. Examples of accounts that may be reasonably tested are:

- Interest expense against interest bearing obligations
- Raw Material Consumption to Production (quantity)
- Wastage & Scrap % against production & raw material consumption (quantity)
- Work-in-Progress based on issued of materials & Sales (quantity)
- Sales discounts and commissions against sales volume
- Rental revenues based on occupancy of premises

Ratios

Analysis by computation of ratios includes the study of relationships between financial statement amounts. Commonly used ratios include:

- Elements of income or loss as a percentage of sales
- Gross profit turnover
- Accounts receivable turnover
- Inventory turnover
- Profitability, leverage, and liquidity

Sources of information

- Interim financial information
- Budgets
- Management accounts
- Non-financial information
- Bank and cash records
- VAT returns
- Board minutes
- Discussion or correspondence with the client at the year-end

SA 530*
Audit Sampling
***(Effective for audits of financial statements
for periods beginning on or after April 1, 2009)***

Introduction

Scope of this SA

1. This Standard on Auditing (SA) applies when the auditor has decided to use audit sampling in performing audit procedures. It deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample.
2. This SA complements SA 500¹, which deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. SA 500 provides guidance on the means available to the auditor for selecting items for testing, of which audit sampling is one means.

Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective

4. The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

Definitions

5. For purposes of the SAs, the following terms have the meanings attributed below:
 - (a) Audit sampling (sampling) – The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.
 - (b) Population – The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.
 - (c) Sampling risk – 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 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.

* Published in February, 2009 issue of the Journal.

¹ SA 500, "Audit Evidence".

- (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a 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.
- (d) Non-sampling risk – The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. (*Ref: Para A1*)
- (e) Anomaly – A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.
- (f) Sampling unit – The individual items constituting a population. (*Ref: Para A2*)
- (g) Statistical sampling – An approach to sampling that has the following characteristics:
 - (i) Random selection of the sample items; and
 - (ii) The use of probability theory to evaluate sample results, including measurement of sampling risk.
 A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling.
- (h) Stratification – The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).
- (i) Tolerable misstatement – A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population. (*Ref: Para. A3*)
- (j) Tolerable rate of deviation – A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Requirements

Sample Design, Size and Selection of Items for Testing

6. When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. (*Ref: Para. A4-A9*)
7. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. (*Ref: Para. A10-A11*)
8. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. (*Ref: Para. A12-A13*)

Performing Audit Procedures

9. The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.
10. If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. (*Ref: Para. A14*)
11. If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details. (*Ref: Para. A15-A16*)

Nature and Cause of Deviations and Misstatements

12. The auditor shall investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. (Ref: Para. A17)

13. In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

Projecting Misstatements

14. For tests of details, the auditor shall project misstatements found in the sample to the population. (Ref: Para. A18-A20)

Evaluating Results of Audit Sampling

15. The auditor shall evaluate:

- (a) The results of the sample; and (Ref: Para. A21-A22)
- (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. (Ref: Para. A23)

Application and Other Explanatory Material

Definitions

Non-Sampling Risk (Ref: Para. 5(d))

A1. Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognise a misstatement or deviation.

Sampling Unit (Ref: Para. 5(f))

A2. The sampling units might be physical items (for example, cheques listed on deposit slips, credit entries on bank statements, sales invoices or debtors' balances) or monetary units.

Tolerable Misstatement (Ref: Para. 5(i))

A3. 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. Tolerable misstatement is the application of performance materiality, as defined in SA 320², to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

Sample Design, Size and Selection of Items for Testing

Sample Design (Ref: Para. 6)

A4. 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.

A5. When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose. Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other

² SA 320, "Materiality in Planning and Performing an Audit", paragraph 9.

characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling. In fulfilling the requirement of paragraph 8 of SA 500, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

A6. The auditor's consideration of the purpose of the audit procedure, as required by paragraph 6, includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements. For example, in a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement. Also, a misposting between customer accounts does not affect the total accounts receivable balance. Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

A7. In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size. For example, if the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls. Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

A8. In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate. Appendix 1 provides further discussion on stratification and value-weighted selection.

A9. The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Sample Size (Ref: Para. 7)

A10. The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

A11. The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. Appendices 2 and 3 indicate the influences that various factors typically have on the determination of sample size. When circumstances are similar, the effect on sample size of factors such as those identified in Appendices 2 and 3 will be similar regardless of whether a statistical or non-statistical approach is chosen.

Selection of Items for Testing (Ref: Para. 8)

A12. With statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected. With non-statistical sampling, judgment is used to select sample items. Because the purpose of sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected, it is important that the auditor selects a representative sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population.

A13. The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection. Each of these methods is discussed in Appendix 4.

Performing Audit Procedures (Ref: Para. 10-11)

A14. An example of when it is necessary to perform the procedure on a replacement item is when a cancelled cheque is selected while testing for evidence of payment authorisation. If the auditor is satisfied that the cheque has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined.

A15. An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost.

A16. An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.

Nature and Cause of Deviations and Misstatements (Ref: Para. 12)

A17. In analysing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

Projecting Misstatements (Ref: Para. 14)

A18. The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

A19. When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

A20. For tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole. SA 330³ provides guidance when deviations from controls upon which the auditor intends to rely are detected.

Evaluating Results of Audit Sampling (Ref: Para. 15)

A21. For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

A22. In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

³ SA 330, "The Auditor's Responses to Assessed Risks", paragraphs 17 and A41.

A23. If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

- Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or
- Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

Material Modifications *vis à vis* ISA 530, “Audit Sampling”

SA 530, “Audit Sampling” does not contain any material modifications *vis à vis* ISA 530.

Appendix 1

(Ref: Para. A8)

Stratification and Value-Weighted Selection

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate. This Appendix provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.

Stratification

1. Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.
2. When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.
3. The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population. For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).
4. If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

Value-Weighted Selection

5. When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units. One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes. This approach may be used in conjunction with the systematic method of sample selection (described in Appendix 4) and is most efficient when selecting items using random selection.

Appendix 2

(Ref: Para. A11)

Examples of Factors Influencing Sample Size for Tests of Controls

The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

FACTOR	EFFECT ON SAMPLE SIZE	
1. An increase in the extent to which the auditor's risk assessment takes into account relevant controls	Increase	The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased).
2. An increase in the tolerable rate of deviation	Decrease	The lower the tolerable rate of deviation, the larger the sample size needs to be.
3. An increase in the expected rate of deviation of the population to be tested	Increase	The higher the expected rate of deviation, the larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures

		undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.
4. An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population	Increase	The greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.
5. An increase in the number of sampling units in the population	Negligible effect	For large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence.

Appendix 3

(Ref: Para. A11)

Examples of Factors Influencing Sample Size for Tests of Details

The following are factors that the auditor may consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.

FACTOR	EFFECT ON SAMPLE SIZE	
1. An increase in the auditor's assessment of the risk of material misstatement	Increase	The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the auditor does not perform tests of controls, the auditor's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.

2. An increase in the use of other substantive procedures directed at the same assertion	Decrease	The more the auditor is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be.
3. An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population	Increase	The greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.
4. An increase in tolerable misstatement	Decrease	The lower the tolerable misstatement, the larger the sample size needs to be.
5. An increase in the amount of misstatement the auditor expects to find in the population	Increase	The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of misstatement in the population. Factors relevant to the auditor's consideration of the expected misstatement amount include the extent to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures.
6. Stratification of the population when appropriate	Decrease	When there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.
7. The number of sampling units in the population	Negligible effect	For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures).

Appendix 4

(Ref: Para. A13)

Sample Selection Methods

There are many methods of selecting samples. The principal methods are as follows:

- (a) Random selection (applied through random number generators, for example, random number tables).
- (b) Systematic selection, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.
- (c) Monetary Unit Sampling is a type of value-weighted selection (as described in Appendix 1) in which sample size, selection and evaluation results in a conclusion in monetary amounts.
- (d) Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.
- (e) Block selection involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

SA 550*
RELATED PARTIES
***(Effective for audits of financial statements
for periods beginning on or after April 1, 2010)***

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it expands on how SA 315¹, SA 330² and SA 240³ are to be applied in relation to risks of material misstatement associated with related party relationships and transactions.

Nature of Related Party Relationships and Transactions

2. Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. For example:

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

Responsibilities of the Auditor

3. Because related parties are not independent of each other, many financial reporting frameworks establish specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and actual or potential effects on the financial statements. Where the applicable financial reporting framework establishes such requirements, the auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances in accordance with the requirements of the framework.

4. Even if the applicable financial reporting framework establishes minimal or no related party requirements, the auditor nevertheless needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by

* Published in March, 2009 issue of the Journal.

¹ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

² SA 330, "The Auditor's Responses to Assessed Risks".

³ SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

those relationships and transactions: (Ref: Para. A1)

- (a) Achieve a true and fair presentation (for fair presentation frameworks); or (Ref: Para. A2)
- (b) Are not misleading (for compliance frameworks). (Ref: Para. A3)

5. In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether one or more fraud risk factors are present as required by SA 240⁴ because fraud may be more easily committed through related parties.

6. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs⁵. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- Management may be unaware of the existence of all related party relationships and transactions, particularly if the applicable financial reporting framework does not establish related party requirements.
- Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

7. Planning and performing the audit with professional skepticism as required by SA 200⁶ is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

Effective Date

8. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

9. The objectives of the auditor are:

- (a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:
 - (i) To recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
 - (ii) To conclude whether the financial statements, insofar as they are affected by those relationships and transactions:
 - a. Achieve a true and fair presentation (for fair presentation frameworks); or
 - b. Are not misleading (for compliance frameworks); and
- (b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

⁴ SA 240, paragraph 24.

⁵ SA 200, paragraph A52.

⁶ SA 200, paragraph 15.

Definitions

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

- (a) Arm's length transaction—A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.
- (b) Related party – A party that is either: (*Ref: Para. A4-A7*)
 - (i) A related party as defined in the applicable financial reporting framework⁷; or
 - (ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
 - b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
 - c. Another entity that is under common control with the reporting entity through having:
 - i. Common controlling ownership;
 - ii. Owners who are close family members; or
 - iii. Common key management.

However, entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

Requirements**Risk Assessment Procedures and Related Activities**

11. As part of the risk assessment procedures and related activities that SA 315 and SA 240 require the auditor to perform during the audit,⁸ the auditor shall perform the audit procedures and related activities set out in paragraphs 12-17 to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions. (*Ref: Para. A8*)

Understanding the Entity's Related Party Relationships and Transactions

12. The engagement team discussion that SA 315 and SA 240 require⁹ shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions. (*Ref: Para. A9-A10*)

13. The auditor shall inquire of management regarding:

- (a) The identity of the entity's related parties, including changes from the prior period; (*Ref: Para. A11-A14*)
- (b) The nature of the relationships between the entity and these related parties; and
- (c) Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

14. The auditor shall inquire of management and others within the entity, and perform other risk assessment

⁷ In Indian context, definitions of "Related Party" and "Related Party Transactions" as given in Accounting Standard (AS) 18, "Related Party Disclosures", issued by the Institute of Chartered Accountants of India, will be applicable for the purposes of this SA, and the said definitions also meet the tests laid down in paragraph 10(b)(ii) of this SA.

⁸ SA 315, paragraph 5; and SA 240, paragraph 16.

⁹ SA 315, paragraph 10; and SA 240, paragraph 15.

procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to: (Ref: Para. A15-A20)

- (a) Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;
- (b) Authorise and approve significant transactions and arrangements with related parties; and (Ref: Para. A21)
- (c) Authorise and approve significant transactions and arrangements outside the normal course of business.

Maintaining Alertness for Related Party Information When Reviewing Records or Documents

15. During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. (Ref: Para. A22-A23)

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

- (a) Bank, legal and third party confirmations obtained as part of the auditor's procedures;
- (b) Minutes of meetings of shareholders and of those charged with governance; and
- (c) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

16. If the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures required by paragraph 15 or through other audit procedures, the auditor shall inquire of management about: (Ref: Para. A24-A25)

- (a) The nature of these transactions; and (Ref: Para. A26)
- (b) Whether related parties could be involved. (Ref: Para. A27)

Sharing Related Party Information with the Engagement Team

17. The auditor shall share relevant information obtained about the entity's related parties with the other members of the engagement team. (Ref: Para. A28)

Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

18. In meeting the SA 315 requirement to identify and assess the risks of material misstatement,¹⁰ the auditor shall identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. In making this determination, the auditor shall treat identified significant related party transactions outside the entity's normal course of business as giving rise to significant risks.

19. If the auditor identifies fraud risk factors (including circumstances relating to the existence of a related party with dominant influence) when performing the risk assessment procedures and related activities in connection with related parties, the auditor shall consider such information when identifying and assessing the risks of material misstatement due to fraud in accordance with SA 240. (Ref: Para. A6 and A29-A30)

Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

20. As part of the SA 330 requirement that the auditor respond to assessed risks,¹¹ the auditor designs and

¹⁰ SA 315, paragraph 25.

¹¹ SA 330, paragraphs 5-6.

performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions. These audit procedures shall include those required by paragraphs 21-24. (Ref: Para. A31-A34)

Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

21. If the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships or transactions.

22. If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:

- (a) Promptly communicate the relevant information to the other members of the engagement team; (Ref: Para. A35)
- (b) Where the applicable financial reporting framework establishes related party requirements:
 - (i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and
 - (ii) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
- (c) Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions; (Ref: Para. A36)
- (d) Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary; and
- (e) If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit. (Ref: Para. A37)

Identified Significant Related Party Transactions outside the Entity's Normal Course of Business

23. For identified significant related party transactions outside the entity's normal course of business, the auditor shall:

- (a) Inspect the underlying contracts or agreements, if any, and evaluate whether:
 - (i) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;¹² (Ref: Para. A38-A39)
 - (ii) The terms of the transactions are consistent with management's explanations; and
 - (iii) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- (b) Obtain audit evidence that the transactions have been appropriately authorised and approved. (Ref: Para. A40-A41)

Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm's Length Transaction

¹² SA 240, paragraph 32(c).

24. When management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion. (Ref: Para. A42-A45)

Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions

25. In forming an opinion on the financial statements in accordance with SA 700,¹³ the auditor shall evaluate: (Ref: Para. A46)

- (a) Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and (Ref: Para. A47)
- (b) Whether the effects of the related party relationships and transactions:
 - (i) Prevent the financial statements from achieving true and fair presentation (for fair presentation frameworks); or
 - (ii) Cause the financial statements to be misleading (for compliance frameworks).

Written Representations

26. Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance that: (Ref: Para. A48-A49)

- (a) They have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and
- (b) They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

Communication with Those Charged with Governance

27. Unless all of those charged with governance are involved in managing the entity¹⁴, the auditor shall communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties. (Ref: Para. A50)

Documentation

28. In meeting the documentation requirements of SA 230¹⁵ and other SAs, the auditor shall include in the audit documentation the names of the identified related parties and the nature of the related party relationships.

¹³ Revised SA 700, "Forming an Opinion and Reporting on Financial Statements"; paragraphs 10-15.

¹⁴ SA 260, paragraph 12 (c).

¹⁵ SA 230, "Audit Documentation".

Application and Other Explanatory Material**Responsibilities of the Auditor*****Financial Reporting Frameworks That Establish Minimal Related Party Requirements*** (Ref: Para. 4)

A1. An applicable financial reporting framework that establishes minimal related party requirements is one that defines the meaning of a related party but that definition has a substantially narrower scope than the definition set out in paragraph 10(b)(ii) of this SA, so that a requirement in the framework to disclose related party relationships and transactions would apply to substantially fewer related party relationships and transactions.

Fair Presentation Frameworks (Ref: Para. 4(a))

A2. In the context of a fair presentation framework,¹⁶ related party relationships and transactions may cause the financial statements to fail to achieve true and fair presentation if, for example, the economic reality of such relationships and transactions is not appropriately reflected in the financial statements. For instance, true and fair presentation may not be achieved if the sale of a property by the entity to a controlling shareholder at a price above or below fair market value has been accounted for as a transaction involving a profit or loss for the entity when it may constitute a contribution or return of capital or the payment of a dividend.

Compliance Frameworks (Ref: Para. 4(b))

A3. In the context of a compliance framework, whether related party relationships and transactions cause the financial statements to be misleading as discussed in SA 700 depends upon the particular circumstances of the engagement. For example, even if non-disclosure of related party transactions in the financial statements is in compliance with the framework and applicable law or regulation, the financial statements could be misleading if the entity derives a very substantial portion of its revenue from transactions with related parties, and that fact is not disclosed. However, it will be extremely rare for the auditor to consider financial statements that are prepared and presented in accordance with a compliance framework to be misleading if in accordance with SA 210¹⁷ the auditor determined that the framework is acceptable¹⁸.

Definition of a Related Party (Ref: Para. 10(b))

A4. Many financial reporting frameworks discuss the concepts of control and significant influence. Although they may discuss these concepts using different terms, they generally explain that:

- (a) Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities; and
- (b) Significant influence (which may be gained by share ownership, statute or agreement) is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies.

A5. The existence of the following relationships may indicate the presence of control or significant influence:

- (a) Direct or indirect equity holdings or other financial interests in the entity.
- (b) The entity's holdings of direct or indirect equity or other financial interests in other entities.
- (c) Being part of those charged with governance or key management (i.e., those members of management who have the authority and responsibility for planning, directing and controlling the activities of the entity).
- (d) Being a close family member of any person referred to in subparagraph (c).

¹⁶ SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph 13 (a), defines the meaning of fair presentation and compliance frameworks.

¹⁷ SA 210, "Agreeing the Terms of Audit Engagements," paragraph 4(a).

¹⁸ SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph A12.

- (e) Having a significant business relationship with any person referred to in subparagraph (c).

Related Parties with Dominant Influence

A6. Related parties, by virtue of their ability to exert control or significant influence, may be in a position to exert dominant influence over the entity or its management. Consideration of such behavior is relevant when identifying and assessing the risks of material misstatement due to fraud, as further explained in paragraphs A29-A30.

Special-Purpose Entities as Related Parties

A7. In some circumstances, a special-purpose entity¹⁹ may be a related party of the entity because the entity may in substance control it, even if the entity owns little or none of the special-purpose entity's equity.

Risk Assessment Procedures and Related Activities

Risks of Material Misstatement Associated with Related Party Relationships and Transactions (Ref: Para. 11)

A8. In case of certain entities, auditor's responsibilities regarding related party relationships and transactions may be affected by the audit mandate, or by obligations on those entities arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature. Consequently, in such cases the auditor's responsibilities may not be limited to addressing the risks of material misstatement associated with related party relationships and transactions, but may also include a broader responsibility to address the risks of non-compliance with laws and regulations governing such entities that lay down specific requirements in the conduct of business with related parties. Further, in such cases the auditor may need to have regard to any specific financial reporting requirements for related party relationships and transactions that may differ from other entities.

Understanding the Entity's Related Party Relationships and Transactions

Discussion among the Engagement Team (Ref: Para. 12)

A9. Matters that may be addressed in the discussion among the engagement team include:

- The nature and extent of the entity's relationships and transactions with related parties (using, for example, the auditor's record of identified related parties updated after each audit).
- An emphasis on the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
- The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (e.g., a complex organisational structure, use of special-purpose entities for off-balance sheet transactions, or an inadequate information system).
- The records or documents that may indicate the existence of related party relationships or transactions.
- The importance that management and those charged with governance attach to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirements), and the related risk of management override of relevant controls.

A10. In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:

¹⁹ SA 315, paragraphs A26-A27, provides guidance regarding the nature of a special-purpose entity.

- How special-purpose entities controlled by management might be used to facilitate earnings management.
- How transactions between the entity and a known business partner of a key member of management could be arranged to facilitate misappropriation of the entity's assets.

The Identity of the Entity's Related Parties (Ref: Para. 13(a))

A11. Where the applicable financial reporting framework establishes related party requirements, information regarding the identity of the entity's related parties is likely to be readily available to management because the entity's information systems will need to record, process and summarise related party relationships and transactions to enable the entity to meet the accounting and disclosure requirements of the framework. Management is therefore likely to have a comprehensive list of related parties and changes from the prior period. For recurring engagements, making the inquiries provides a basis for comparing the information supplied by management with the auditor's record of related parties noted in previous audits.

A12. However, where the framework does not establish related party requirements, the entity may not have such information systems in place. Under such circumstances, it is possible that management may not be aware of the existence of all related parties. Nevertheless, the requirement to make the inquiries specified by paragraph 13 still applies because management may be aware of parties that meet the related party definition set out in this SA.

In such a case, however, the auditor's inquiries regarding the identity of the entity's related parties are likely to form part of the auditor's risk assessment procedures and related activities performed in accordance with SA 315 to obtain information regarding:

- The entity's ownership and governance structures;
- The types of investments that the entity is making and plans to make; and
- The way the entity is structured and how it is financed.

In the particular case of common control relationships, as management is more likely to be aware of such relationships if they have economic significance to the entity, the auditor's inquiries are likely to be more effective if they are focused on whether parties with which the entity engages in significant transactions, or shares resources to a significant degree, are related parties.

A13. In the context of a group audit, SA 600 requires the group engagement team to provide each component auditor with a list of related parties prepared by group management and any other related parties of which the group engagement team is aware²⁰. Where the entity is a component within a group, this information provides a useful basis for the auditor's inquiries of management regarding the identity of the entity's related parties.

A14. The auditor may also obtain some information regarding the identity of the entity's related parties through inquiries of management during the engagement acceptance or continuance process.

The Entity's Controls over Related Party Relationships and Transactions (Ref: Para. 14)

A15. Others within the entity are those considered likely to have knowledge of the entity's related party relationships and transactions, and the entity's controls over such relationships and transactions. These may include, to the extent that they do not form part of management:

- Those charged with governance;
- Personnel in a position to initiate, process, or record transactions that are both significant and outside

²⁰ Currently, SA 600, 'Using the Work of Another Auditor' is in force. The standard is being revised in light of the corresponding international standard.

the entity's normal course of business, and those who supervise or monitor such personnel;

- Internal auditors;
- In-house legal counsel; and
- The chief ethics officer or equivalent person.

A16. The audit is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged and understand that they have responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, and for such internal control as management and, where appropriate, those charged with governance, determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.²¹ Accordingly, where the framework establishes related party requirements, management, with oversight from those charged with governance, is responsible for the design, implementation and maintenance of adequate controls over related party relationships and transactions so that these are identified and appropriately accounted for and disclosed in accordance with the framework. In their oversight role, those charged with governance are responsible for monitoring how management is discharging its responsibility for such controls. Regardless of any related party requirements the framework may establish, those charged with governance may, in order to fulfill their oversight responsibilities, obtain information from management to enable them to understand the nature and business rationale of the entity's related party relationships and transactions.

A17. In meeting the SA 315 requirement to obtain an understanding of the control environment,²² the auditor may consider features of the control environment relevant to mitigating the risks of material misstatement associated with related party relationships and transactions, such as:

- Internal ethical codes, appropriately communicated to the entity's personnel and enforced, governing the circumstances in which the entity may enter into specific types of related party transactions.
- Policies and procedures for open and timely disclosure of the interests that management and those charged with governance have in related party transactions.
- The assignment of responsibilities within the entity for identifying, recording, summarising, and disclosing related party transactions.
- Timely disclosure and discussion between management and those charged with governance of significant related party transactions outside the entity's normal course of business, including whether those charged with governance have appropriately challenged the business rationale of such transactions (for example, by seeking advice from external professional advisors).
- Clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest, such as approval by a subcommittee of those charged with governance comprising individuals independent of management.
- Periodic reviews by internal auditors, where applicable.
- Proactive action taken by management to resolve related party disclosure issues, such as by seeking advice from the auditor or external legal counsel.
- The existence of whistle-blowing policies and procedures, where applicable.

A18. Controls over related party relationships and transactions within some entities may be deficient or non-

²¹ SA 200, paragraph A2.

²² SA 315, paragraph 14.

existent for a number of reasons, such as:

- The low importance attached by management to identifying and disclosing related party relationships and transactions.
- The lack of appropriate oversight by those charged with governance.
- An intentional disregard for such controls because related party disclosures may reveal information that management considers sensitive, for example, the existence of transactions involving family members of management.
- An insufficient understanding by management of the related party requirements of the applicable financial reporting framework.
- The absence of disclosure requirements under the applicable financial reporting framework.

Where such controls are ineffective or non-existent, the auditor may be unable to obtain sufficient appropriate audit evidence about related party relationships and transactions. If this were the case, the auditor would, in accordance with SA 705²³, consider the implications for the audit, including the auditor's report.

A19. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.²⁴ The risk of management override of controls is higher if management has relationships that involve control or significant influence with parties with which the entity does business because these relationships may present management with greater incentives and opportunities to perpetrate fraud. For example, management's financial interests in certain related parties may provide incentives for management to override controls by (a) directing the entity, against its interests, to conclude transactions for the benefit of these parties, or (b) colluding with such parties or controlling their actions. Examples of possible fraud include:

- Creating fictitious terms of transactions with related parties designed to misrepresent the business rationale of these transactions.
- Fraudulently organizing the transfer of assets from or to management or others at amounts significantly above or below market value.
- Engaging in complex transactions with related parties, such as special-purpose entities, that are structured to misrepresent the financial position or financial performance of the entity.

Considerations specific to smaller entities

A20. Control environment in smaller entities is likely to be different from larger entities. In particular those charged with governance may not include an outside member, and the role of governance may be undertaken directly by the owner-manager where no other owner exists. Control activities in smaller entities are likely to be less formal and smaller entities may have no documented processes for dealing with related party relationships and transactions. An owner-manager may mitigate some of the risks arising from related party transactions, or potentially increase those risks, through active involvement in all the main aspects of the transactions. For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management's oversight and review activities, and inspection of available relevant documentation.

Authorisation and approval of significant transactions and arrangements (Ref: Para. 14(b))

A21. Authorisation involves the granting of permission by a party or parties with the appropriate authority

²³SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

²⁴ SA 240, paragraphs 31 and A4.

(whether management, those charged with governance or the entity's shareholders) for the entity to enter into specific transactions in accordance with pre-determined criteria, whether judgmental or not. Approval involves those parties' acceptance of the transactions the entity has entered into as having satisfied the criteria on which authorisation was granted. Examples of controls the entity may have established to authorise and approve significant transactions and arrangements with related parties or significant transactions and arrangements outside the normal course of business include:

- Monitoring controls to identify such transactions and arrangements for authorisation and approval.
- Approval of the terms and conditions of the transactions and arrangements by management, those charged with governance or, where applicable, shareholders.

Maintaining Alertness for Related Party Information When Reviewing Records or Documents

Records or Documents That the Auditor May Inspect (Ref: Para. 15)

A22. During the audit, the auditor may inspect records or documents that may provide information about related party relationships and transactions, for example:

- Entity income tax returns.
- Information supplied by the entity to regulatory authorities.
- Shareholder registers to identify the entity's principal shareholders.
- Statements of conflicts of interest from management and those charged with governance.
- Records of the entity's investments and those of its pension plans.
- Contracts and agreements with key management or those charged with governance.
- Significant contracts and agreements not in the entity's ordinary course of business.
- Specific invoices and correspondence from the entity's professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated by the entity during the period.
- Internal auditors' reports.
- Documents associated with the entity's filings with a securities regulator (e.g., prospectuses).

Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions

A23. An arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as:

- The establishment of a business relationship through appropriate vehicles or structures.
- The conduct of certain types of transactions under specific terms and conditions.
- The provision of designated services or financial support.

Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include:

- Participation in unincorporated partnerships with other parties.
- Agreements for the provision of services to certain parties under terms and conditions that are outside the entity's normal course of business.
- Guarantees and guarantor relationships.

Identification of Significant Transactions outside the Normal Course of Business (Ref: Para. 16)

A24. Obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement.

A25. Examples of transactions outside the entity's normal course of business may include:

- Complex equity transactions, such as corporate restructurings or acquisitions.
- Transactions with offshore entities in jurisdictions with weak corporate laws.
- The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
- Sales transactions with unusually large discounts or returns.
- Transactions with circular arrangements, for example, sales with a commitment to repurchase.
- Transactions under contracts whose terms are changed before expiry.

Understanding the nature of significant transactions outside the normal course of business (Ref: Para. 16(a))

A26. Inquiring into the nature of the significant transactions outside the entity's normal course of business involves obtaining an understanding of the business rationale of the transactions, and the terms and conditions under which these have been entered into.

Inquiring into whether related parties could be involved (Ref: Para. 16(b))

A27. A related party could be involved in a significant transaction outside the entity's normal course of business not only by directly influencing the transaction through being a party to the transaction, but also by indirectly influencing it through an intermediary. Such influence may indicate the presence of a fraud risk factor.

Sharing Related Party Information with the Engagement Team (Ref: Para. 17)

A28. Relevant related party information that may be shared among the engagement team members includes, for example:

- The identity of the entity's related parties.
- The nature of the related party relationships and transactions.
- Significant or complex related party relationships or transactions that may require special audit consideration, in particular transactions in which management or those charged with governance are financially involved.

Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions***Fraud Risk Factors Associated with a Related Party with Dominant Influence*** (Ref: Para. 19)

A29. Domination of management by a single person or small group of persons without compensating controls is a fraud risk factor.²⁵ Indicators of dominant influence exerted by a related party include:

- The related party has vetoed significant business decisions taken by management or those charged with governance.
- Significant transactions are referred to the related party for final approval.
- There is little or no debate among management and those charged with governance regarding

²⁵ SA 240, Appendix 1.

business proposals initiated by the related party.

- Transactions involving the related party (or a close family member of the related party) are rarely independently reviewed and approved.

Dominant influence may also exist in some cases if the related party has played a leading role in founding the entity and continues to play a leading role in managing the entity.

A30. In the presence of other risk factors, the existence of a related party with dominant influence may indicate significant risks of material misstatement due to fraud. For example:

- An unusually high turnover of senior management or professional advisors may suggest unethical or fraudulent business practices that serve the related party's purposes.
- The use of business intermediaries for significant transactions for which there appears to be no clear business justification may suggest that the related party could have an interest in such transactions through control of such intermediaries for fraudulent purposes.
- Evidence of the related party's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates may suggest the possibility of fraudulent financial reporting.

Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions (Ref: Para. 20)

A31. The nature, timing and extent of the further audit procedures that the auditor may select to respond to the assessed risks of material misstatement associated with related party relationships and transactions depend upon the nature of those risks and the circumstances of the entity.²⁶

A32. Examples of substantive audit procedures that the auditor may perform when the auditor has assessed a significant risk that management has not appropriately accounted for or disclosed specific related party transactions in accordance with the applicable financial reporting framework (whether due to fraud or error) include:

- Confirming or discussing specific aspects of the transactions with intermediaries such as banks, law firms, guarantors, or agents, where practicable and not prohibited by law, regulation or ethical rules.
- Confirming the purposes, specific terms or amounts of the transactions with the related parties (this audit procedure may be less effective where the auditor judges that the entity is likely to influence the related parties in their responses to the auditor).
- Where applicable, reading the financial statements or other relevant financial information, if available, of the related parties for evidence of the accounting of the transactions in the related parties' accounting records.

A33. If the auditor has assessed a significant risk of material misstatement due to fraud as a result of the presence of a related party with dominant influence, the auditor may, in addition to the general requirements of SA 240, perform audit procedures such as the following to obtain an understanding of the business relationships that such a related party may have established directly or indirectly with the entity and to determine the need for further appropriate substantive audit procedures:

- Inquiries of, and discussion with, management and those charged with governance.

²⁶ SA 330 provides further guidance on considering the nature, timing and extent of further audit procedures. SA 240 establishes requirements and provides guidance on appropriate responses to assessed risks of material misstatement due to fraud.

- Inquiries of the related party.
- Inspection of significant contracts with the related party.
- Appropriate background research, such as through the Internet or specific external business information databases.
- Review of employee whistle-blowing reports where these are retained.

A34. Depending upon the results of the auditor's risk assessment procedures, the auditor may consider it appropriate to obtain audit evidence without testing the entity's controls over related party relationships and transactions. In some circumstances, however, it may not be possible to obtain sufficient appropriate audit evidence from substantive audit procedures alone in relation to the risks of material misstatement associated with related party relationships and transactions. For example, where intra-group transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, recorded, processed or reported electronically in an integrated system, the auditor may determine that it is not possible to design effective substantive audit procedures that by themselves would reduce the risks of material misstatement associated with these transactions to an acceptably low level. In such a case, in meeting the SA 330 requirement to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls,²⁷ the auditor is required to test the entity's controls over the completeness and accuracy of the recording of the related party relationships and transactions.

Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

Communicating Newly Identified Related Party Information to the Engagement Team (Ref: Para. 22(a))

A35. Communicating promptly any newly identified related parties to the other members of the engagement team assists them in determining whether this information affects the results of, and conclusions drawn from, risk assessment procedures already performed, including whether the risks of material misstatement need to be reassessed.

Substantive Procedures Relating to Newly Identified Related Parties or Significant Related Party Transactions (Ref: Para. 22(c))

A36. Examples of substantive audit procedures that the auditor may perform relating to newly identified related parties or significant related party transactions include:

- Making inquiries regarding the nature of the entity's relationships with the newly identified related parties, including (where appropriate and not prohibited by law, regulation or ethical rules) inquiring of parties outside the entity who are presumed to have significant knowledge of the entity and its business, such as legal counsel, principal agents, major representatives, consultants, guarantors, or other close business partners.
- Conducting an analysis of accounting records for transactions with the newly identified related parties. Such an analysis may be facilitated using computer-assisted audit techniques.
- Verifying the terms and conditions of the newly identified related party transactions, and evaluating whether the transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

Intentional Non-Disclosure by Management (Ref: Para. 22(e))

A37. The requirements and guidance in SA 240 regarding the auditor's responsibilities relating to fraud in an audit of financial statements are relevant where management appears to have intentionally failed to disclose

²⁷ SA 330, paragraph 8(b).

related parties or significant related party transactions to the auditor. The auditor may also consider whether it is necessary to re-evaluate the reliability of management's responses to the auditor's inquiries and management's representations to the auditor.

Identified Significant Related Party Transactions outside the Entity's Normal Course of Business

Evaluating the Business Rationale of Significant Related Party Transactions (Ref: Para. 23)

A38. In evaluating the business rationale of a significant related party transaction outside the entity's normal course of business, the auditor may consider the following:

- Whether the transaction:
 - o Is overly complex (e.g., it may involve multiple related parties within a consolidated group).
 - o Has unusual terms of trade, such as unusual prices, interest rates, guarantees and repayment terms.
 - o Lacks an apparent logical business reason for its occurrence.
 - o Involves previously unidentified related parties.
 - o Is processed in an unusual manner.
- Whether management has discussed the nature of, and accounting for, such a transaction with those charged with governance.
- Whether management is placing more emphasis on a particular accounting treatment rather than giving due regard to the underlying economics of the transaction.

If management's explanations are materially inconsistent with the terms of the related party transaction, the auditor is required, in accordance with SA 500,²⁸ to consider the reliability of management's explanations and representations on other significant matters.

A39. The auditor may also seek to understand the business rationale of such a transaction from the related party's perspective, as this may help the auditor to better understand the economic reality of the transaction and why it was carried out. A business rationale from the related party's perspective that appears inconsistent with the nature of its business may represent a fraud risk factor.

Authorization and Approval of Significant Related Party Transactions (Ref: Para. 23(b))

A40. Authorisation and approval by management, those charged with governance, or, where applicable, the shareholders of significant related party transactions outside the entity's normal course of business may provide audit evidence that these have been duly considered at the appropriate levels within the entity and that their terms and conditions have been appropriately reflected in the financial statements. The existence of transactions of this nature that were not subject to such authorisation and approval, in the absence of rational explanations based on discussion with management or those charged with governance, may indicate risks of material misstatement due to error or fraud. In these circumstances, the auditor may need to be alert for other transactions of a similar nature. Authorisation and approval alone, however, may not be sufficient in concluding whether risks of material misstatement due to fraud are absent because authorisation and approval may be ineffective if there has been collusion between the related parties or if the entity is subject to the dominant influence of a related party.

Considerations specific to smaller entities

A41. A smaller entity may not have the same controls provided by different levels of authority and approval that may exist in a larger entity. Accordingly, when auditing a smaller entity, the auditor may rely to a lesser

²⁸ SA 500, "Audit Evidence", paragraph 11.

degree on authorization and approval for audit evidence regarding the validity of significant related party transactions outside the entity's normal course of business. Instead, the auditor may consider performing other audit procedures such as inspecting relevant documents, confirming specific aspects of the transactions with relevant parties, or observing the owner-manager's involvement with the transactions.

Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm's Length Transaction (Ref: Para. 24)

A42. Although audit evidence may be readily available regarding how the price of a related party transaction compares to that of a similar arm's length transaction, there are ordinarily practical difficulties that limit the auditor's ability to obtain audit evidence that all other aspects of the transaction are equivalent to those of the arm's length transaction. For example, although the auditor may be able to confirm that a related party transaction has been conducted at a market price, it may be impracticable to confirm whether other terms and conditions of the transaction (such as credit terms, contingencies and specific charges) are equivalent to those that would ordinarily be agreed between independent parties. Accordingly, there may be a risk that management's assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction may be materially misstated.

A43. Management is responsible for the substantiation of an assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction. Management's support for the assertion may include:

- Comparing the terms of the related party transaction to those of an identical or similar transaction with one or more unrelated parties.
- Engaging an external expert to determine a market value and to confirm market terms and conditions for the transaction.
- Comparing the terms of the transaction to known market terms for broadly similar transactions on an open market.

A44. Evaluating management's support for this assertion may involve one or more of the following:

- Considering the appropriateness of management's process for supporting the assertion.
- Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
- Evaluating the reasonableness of any significant assumptions on which the assertion is based.

A45. Some financial reporting frameworks require the disclosure of related party transactions not conducted on terms equivalent to those prevailing in arm's length transactions. In these circumstances, if management has not disclosed a related party transaction in the financial statements, there may be an implicit assertion that the transaction was conducted on terms equivalent to those prevailing in an arm's length transaction.

Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions

Materiality Considerations in Evaluating Misstatements (Ref: Para. 25)

A46. SA 450 requires the auditor to consider both the size and the nature of a misstatement, and the particular circumstances of its occurrence, when evaluating whether the misstatement is material.²⁹ The significance of the transaction to the financial statement users may not depend solely on the recorded amount of the

²⁹ SA 450, "Evaluation of Misstatements Identified during the Audit," paragraph 11(a). Paragraph A16 of SA 450 provides guidance on the circumstances that may affect the evaluation of a misstatement.

transaction but also on other specific relevant factors, such as the nature of the related party relationship.

Evaluation of Related Party Disclosures (Ref: Para. 25(a))

A47. Evaluating the related party disclosures in the context of the disclosure requirements of the applicable financial reporting framework means considering whether the facts and circumstances of the entity's related party relationships and transactions have been appropriately summarized and presented so that the disclosures are understandable. Disclosures of related party transactions may not be understandable if:

- (a) The business rationale and the effects of the transactions on the financial statements are unclear or misstated; or
- (b) Key terms, conditions, or other important elements of the transactions necessary for understanding them are not appropriately disclosed.

Written Representations (Ref: Para. 26)

A48. Circumstances in which it may be appropriate to obtain written representations from those charged with governance include:

- When they have approved specific related party transactions that (a) materially affect the financial statements, or (b) involve management.
- When they have made specific oral representations to the auditor on details of certain related party transactions.
- When they have financial or other interests in the related parties or the related party transactions.
- Management's assertion of responsibility that related party transactions were conducted on terms equivalent to those prevailing in an arm's length transaction.

A49. The auditor may also decide to obtain written representations regarding specific assertions that management may have made, such as a representation that specific related party transactions do not involve undisclosed side agreements.

Communication with Those Charged with Governance (Ref: Para. 27)

A50. Communicating significant matters arising during the audit³⁰ in connection with the entity's related parties helps the auditor to establish a common understanding with those charged with governance of the nature and resolution of these matters. Examples of significant related party matters include:

- Non-disclosure (whether intentional or not) by management to the auditor of related parties or significant related party transactions, which may alert those charged with governance to significant related party relationships and transactions of which they may not have been previously aware.
- The identification of significant related party transactions that have not been appropriately authorised and approved, which may give rise to suspected fraud.
- Disagreement with management regarding the accounting for and disclosure of significant related party transactions in accordance with the applicable financial reporting framework.
- Non-compliance with applicable law or regulations prohibiting or restricting specific types of related party transactions.
- Difficulties in identifying the party that ultimately controls the entity.

Material Modifications *vis a vis* ISA 550, "Related Parties"

³⁰ SA230, "Audit Documentation", paragraph A8 provides further guidance on the nature of significant matters arising during the audit.

Additions

1. In paragraph A20 of the Application Section, the lines, "Control environment in smaller entities is likely to be different from larger entities. In particular those charged with governance may not include an outside member, and the role of governance may be undertaken directly by the owner-manager where no other owner exists" have been added so to explain the difference between the control environment in the larger entities and smaller entities.

2. In paragraph A48 of the Application Section, it has been added that a written representation may be obtained by the auditor regarding management's assertion of responsibility that related party transactions were conducted on terms equivalent to those prevailing in an arm's length transaction.

Deletions

1. Paragraph A8 of the Application Section of ISA 550 deals with the application of the requirement of ISA 550 to the audits of public sector entities regarding the effect of laws and regulations governing the public sector bodies on the auditor's responsibilities with regard to related party relationships and transactions. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of certain entities, the laws and regulations may also include a broader responsibility to address the risks of non-compliance with laws and regulations that lay down specific requirements in the conduct of business with related parties. Accordingly, the spirit of erstwhile A8, highlighting such additional responsibilities of the auditor, has been retained.

SA 560*

Subsequent Events

***(Effective for audits of financial statements
for periods beginning on or after April 1, 2009)***

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. (Ref: Para. A1)
2. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks¹ specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:
 - (a) Those that provide evidence of conditions that existed at the date of the financial statements; and
 - (b) Those that provide evidence of conditions that arose after the date of the financial statements.

SA 700 explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.²

Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objectives

4. The objectives of the auditor are to:
 - (a) Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements; and
 - (b) Respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

Definitions

5. For purposes of the SAs, the following terms have the meanings attributed below:
 - (a) Date of the financial statements – The date of the end of the latest period covered by the financial statements.
 - (b) Date of approval of the financial statements – The date on which all the statements that comprise the financial statements, including the related notes, have been prepared and those with the recognised

* Published in January, 2009 issue of the Journal.

¹ SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing", Paragraph 13 (a).

² Revised SA 700, "Forming an Opinion and Reporting on Financial Statements"; paragraph A37.

authority have asserted that they have taken responsibility for those financial statements. (Ref: Para. A2)

- (c) Date of the auditor's report – The date the auditor dates the report on the financial statements in accordance with SA 700. (Ref: Para. A3)
- (d) Date the financial statements are issued – The date that the auditor's report and audited financial statements are made available to third parties. (Ref: Para. A4-A5)
- (e) Subsequent events – Events occurring between the date of the 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.

Requirements

Events Occurring Between the Date of the Financial Statements and the Date of the Auditor's Report

6. The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. (Ref: Para. A6)

7. The auditor shall perform the procedures required by paragraph 6 so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following: (Ref: Para. A7-A8)

- (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- (b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements. (Ref: Para. A9)
- (c) Reading 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. (Ref: Para. A10)
- (d) Reading the entity's latest subsequent interim financial statements, if any.

8. When, as a result of the procedures performed as required by paragraphs 6 and 7, 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.

Written Representations

9. The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580, "Written Representations" that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued

10. The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall: (Ref: Para. A11)

- (a) Discuss the matter with management and, where appropriate, those charged with governance.

- (b) Determine whether the financial statements need amendment and, if so,
- (c) Inquire how management intends to address the matter in the financial statements.
- 11. If management amends the financial statements, the auditor shall:
 - (a) Carry out the audit procedures necessary in the circumstances on the amendment.
 - (b) Unless the circumstances in paragraph 12 apply:
 - (i) Extend the audit procedures referred to in paragraphs 6 and 7 to the date of the new auditor's report; and
 - (ii) Provide a new auditor's report on the amended financial statements. The new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.
- 12. When law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent events or events causing that amendments and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, the auditor is permitted to restrict the audit procedures on subsequent events required in paragraph 11(b)(i) to that amendment. In such cases, the auditor shall either:
 - (a) Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements; or (*Ref: Para. A12*)
 - (b) Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph or Other Matter(s) paragraph³ that conveys that auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.
- 13. In some entities, management may not be required by the applicable law, regulation or the financial reporting framework to issue amended financial statements and, accordingly, the auditor need not provide an amended or new auditor's report. However, when management does not amend the financial statements in circumstances where the auditor believes they need to be amended, then: (*Ref: Para. A13-A14*)
 - (a) If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion as required by SA 705⁴ and then provide the auditor's report; or
 - (b) If the auditor's report has already been provided to the entity, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action, to seek to prevent reliance on the auditor's report. (*Ref: Para. A15-A16*)

Facts Which Become Known to the Auditor After the Financial Statements have been Issued

- 14. After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, when, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:
 - (a) Discuss the matter with management and, where appropriate, those charged with governance.

³ SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report".

⁴ SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

- (b) Determine whether the financial statements need amendment and, if so,
- (c) Inquire how management intends to address the matter in the financial statements.
- 15. If the management amends the financial statements, the auditor shall: (*Ref: Para. A17*)
 - (a) Carry out the audit procedures necessary in the circumstances on the amendment.
 - (b) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.
 - (c) Unless the circumstances in paragraph 12 apply:
 - (i) Extend the audit procedures referred to in paragraphs 6 and 7 to the date of the new auditor's report, and the date the new auditor's report no earlier than the date of approval of the amended financial statements; and
 - (ii) Provide a new auditor's report on the amended financial statements.
 - (d) When the circumstances in paragraph 12 apply, amend the auditor's report, or provide a new auditor's report as required by paragraph 12.
- 16. The auditor shall include in the new or amended auditor's report an Emphasis of Matter paragraph or Other Matter(s) paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.
- 17. If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management and, unless all of those charged with governance⁵ are involved in managing the entity, those charged with governance, that the auditor will seek to prevent future reliance on the auditor's report. If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report. (*Ref: Para. A18*)

Application and Other Explanatory Material

Introduction (*Ref: Para. 1*)

A1. When the audited financial statements are included in other documents subsequent to the issuance of the financial statements, the auditor may have additional responsibilities relating to subsequent events that the auditor may need to consider, such as legal or regulatory requirements involving the offering of securities to the public in jurisdictions in which the securities are being offered. For example, the auditor may be required to perform additional audit procedures to the date of the final offering document. These procedures may include those referred to in paragraphs 6 and 7 performed up to a date at or near the effective date of the final offering document, and reading the offering document to assess whether the other information in the offering document is consistent with the financial information with which the auditor is associated.

Definitions

Date of Approval of the Financial Statements (*Ref: Para. 5(b)*)

A2. In some entities, the applicable law or regulation identifies the individuals or bodies (for example, management or those charged with governance) that are responsible for concluding that all the statements that comprise the financial statements, including the related notes, have been prepared, and specifies the necessary approval process. In some other entities, the approval process is not prescribed in law or regulation

⁵ SA 260, paragraph 12(c).

and the entity follows its own procedures in preparing and finalising its financial statements in view of its management and governance structures. In some cases, final approval of the financial statements by shareholders is required. In such cases, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements has been obtained. The date of approval of the financial statements for purposes of the SAs is the earlier date on which those with the recognised authority determine that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognised authority have asserted that they have taken responsibility for those financial statements.

Date of the Auditor's Report (Ref: Para. 5(c))

A3. The auditor's report cannot be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements, including evidence that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognised authority have asserted that they have taken responsibility for those financial statements.⁶ Consequently, the date of the auditor's report cannot be earlier than the date of approval of the financial statements as defined in paragraph 5(b). A time period may elapse due to administrative issues between the date of the auditor's report as defined in paragraph 5(c) and the date the auditor's report is provided to the entity.

Date the Financial Statements are Issued (Ref: Para. 5(d))

A4. The date the financial statements are issued generally depends on the regulatory environment of the entity. In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority. Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report, but must also be at or later than the date the auditor's report is provided to the entity.

A5. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the date the financial statements are issued may be the date the audited financial statements and the auditor's report thereon are presented to the legislature or otherwise made public.

Events Occurring Between the Date of the Financial Statements and the Date of the Auditor's Report (Ref: Para. 6-9)

A6. Depending on the auditor's risk assessment, the audit procedures required by paragraph 6 may include procedures, necessary to obtain sufficient appropriate audit evidence, involving the review or testing of accounting records or transactions occurring between the date of the financial statements and the date of the auditor's report. The audit procedures required by paragraphs 6 and 7 are in addition to procedures that the auditor may perform for other purposes that, nevertheless, may provide evidence about subsequent events (for example, to obtain audit evidence for account balances as at the date of the financial statements, such as cut-off procedures or procedures in relation to subsequent receipts of accounts receivable).

A7. Paragraph 7 stipulates certain audit procedures in this context that the auditor is required to perform pursuant to paragraph 6. The subsequent events procedures that the auditor performs may, however, depend on the information that is available and, in particular, the extent to which the accounting records have been prepared since the date of the financial statements. When the accounting records are not up-to-date, and accordingly no interim financial statements (whether for internal or external purposes) have been prepared, or minutes of meetings of management or those charged with governance have not been prepared, relevant audit

⁶ SA 700, paragraph 41.

procedures may take the form of inspection of available books and records, including bank statements. Paragraph A8 gives examples of some of the additional matters that the auditor may consider in the course of these inquiries.

A8. In addition to the audit procedures required by paragraph 7, the auditor may consider it necessary and appropriate to:

- Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements;
- Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims; or
- Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

Inquiry (Ref: Para. 7(b))

A9. In inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters:

- 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 any assets have been appropriated by government or destroyed, for example, by fire or flood.
- Whether there have been any developments regarding contingencies.
- Whether any unusual accounting adjustments have been made or are contemplated.
- Whether any events have occurred or are likely to occur that 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.

Reading Minutes (Ref: Para. 7(c))

A10. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the auditor may read the official records of relevant proceedings of the legislature and inquire about matters addressed in proceedings for which official records are not yet available.

Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued

Management Responsibility Towards Auditor (Ref: Para. 10)

A11. As explained in SA 210, the terms of the audit engagement include the agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware

during the period from the date of the auditor's report to the date the financial statements are issued.⁷

Dual Dating (Ref: Para. 12(a))

A12. When, in the circumstances described in paragraph 12(a), the auditor amends the auditor's report to include an additional date restricted to that amendment, the date of the auditor's report on the financial statements prior to their subsequent amendment by management remains unchanged because this date informs the reader as to when the audit work on those financial statements was completed. However, an additional date is included in the auditor's report to inform users that the auditor's procedures subsequent to that date were restricted to the subsequent amendment of the financial statements. The following is an illustration of such an additional date:

“(Date of auditor's report), except as to Note Y, which is as of (date of completion of audit procedures restricted to amendment described in Note Y)”.

No Amendment of Financial Statements by Management (Ref: Para. 13)

A13. In some entities, management may not be required by the applicable law, regulation or the financial reporting framework to issue amended financial statements. This is often the case when issuance of the financial statements for the following period is imminent, provided appropriate disclosures are made in such statements.

A14. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the actions taken in accordance with paragraph 13 when management does not amend the financial statements may also include reporting separately to the legislature, or other relevant body in the reporting hierarchy, on the implications of the subsequent event for the financial statements and the auditor's report.

Auditor Action to Seek to Prevent Reliance on Auditor's Report (Ref: Para. 13(b))

A15. The auditor may need to fulfill additional legal obligations even when the auditor has notified management not to issue the financial statements and management has agreed to this request.

A16. When management has issued the financial statements despite the auditor's notification not to issue the financial statements to third parties, the auditor's course of action to prevent reliance on the auditor's report on the financial statements depends upon the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

Facts Which Become Known to the Auditor After the Financial Statements have been Issued

No Amendment of Financial Statements by Management (Ref: Para. 15)

A17. In some circumstances, the entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions) may be prevented from issuing amended financial statements by law or regulation. In such circumstances, the appropriate course of action for the auditor may be to report to the appropriate statutory body.

Auditor Action to Seek to Prevent Reliance on Auditor's Report (Ref: Para. 17)

A18. When the auditor believes that management, or those charged with governance, have failed to take the necessary steps to prevent reliance on the auditor's report on financial statements previously issued by the entity despite the auditor's prior notification that the auditor will take action to seek to prevent such reliance, the auditor's course of action depends upon the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

⁷ SA 210, “Agreeing the Terms of Audit Engagements”, paragraph A23.

Material Modifications to ISA 560, “Subsequent Events”**Deletion**

1. Paragraph A5 of ISA 560 provides that in the case of public sector entities, the date the financial statements are issued may be the date the audited financial statements and the auditor's report thereon are presented to the legislature or otherwise made public. Paragraph A10 of ISA 560 provides that in the case of public sector, the auditor may read the official records of relevant proceedings of the legislature and inquire about matters addressed in proceedings for which official records are not yet available. Paragraph A14 of ISA 560 provides that in the case of public sector, the actions taken in accordance with paragraph 13 of ISA when management does not amend the financial statements may also include reporting separately to the legislature, or other relevant body in the reporting hierarchy, on the implications of the subsequent event for the financial statements and the auditor's report. Paragraph A17 of ISA 560 provides that in some circumstances, the entities in the public sector may be prevented from issuing amended financial statements by law or regulation. In such circumstances, the appropriate course of action for the auditor may be to report to the appropriate statutory body. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such situations may also exist in case of certain entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A5, A10, A14 and A17, highlighting such fact, has been retained though a specific reference to public sector entities has been deleted.

SA 570

Going Concern

***(Effective for audits of financial statements
for periods beginning on or after April 1, 2017)***

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 200,¹ 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 315,² 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 a going concern and, if so, management's plans to address them; or

¹ SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, paragraphs A51–A52

² SA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 5

- (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 560,³ 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 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.

³ SA 560, *Subsequent Events*, paragraph 5(a)

- (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)⁴; 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.

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,⁵ 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 701⁶ 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

⁴ SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*.

⁵ SA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13.

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

significant doubt on the entity's ability to continue as a going concern is, by its nature, a key audit matter.⁷

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 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.

⁷ See paragraphs 15 and A41 of SA 701.

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.⁸ 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 of the auditor's further procedures in response to the assessed risks. SA 330⁹ 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

⁸ SA 315, paragraph 31

⁹ SA 330, *The Auditor's Responses to Assessed Risks*

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 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.¹⁰ 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)¹¹ 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' 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;¹² 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)

¹⁰ SA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 14

¹¹ SA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

¹² SA 706(Revised), paragraph A2

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 (Revised) provides guidance on this issue.¹³

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.

¹³ SA 705(Revised), paragraph 10

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 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 210.14
- 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 Statements¹⁵**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*)¹⁶ 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)]¹⁷.

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 generally accepted in India, of the state of affairs of the Company as at March 31, 20XX, and profit/loss, (*changes in equity*)¹⁸ and its cash flows for the year ended on that date.

Basis for Opinion

¹⁴ SA 210, *Agreeing the Terms of Audit Engagements*

¹⁵ 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.

¹⁶ Where applicable.

¹⁷ Where applicable.

¹⁸ Where applicable

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).¹⁹]

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)
(Designation²⁰)
(Membership No. XXXXX)

Place of Signature:

Date:

¹⁹ 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.

²⁰ Partner or Proprietor, as the case may be

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 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 Statements²¹**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*)²² 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)]²³.

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

²¹ 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.

²² Where applicable.

²³ Where applicable.

state of affairs of the Company as at March 31, 20XX, and profit/loss, (*changes in equity*)²⁴ 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 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).²⁵]

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)
(Designation²⁶)
(Membership No. XXXXX)

Place of Signature:

Date:

²⁴ Where applicable

²⁵ 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.

²⁶ Partner or Proprietor, as the case may be

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

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 Statements²⁷**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)*²⁸ 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 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

²⁷ 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.

²⁸ Where applicable.

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 Statements²⁹

[Reporting in accordance with SA 700 (Revised) – see Illustration 4 in SA 700 (Revised).³⁰]

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)
(Designation³¹)
(Membership No. XXXXX)

Place of Signature:

Date:

²⁹ Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction.

³⁰ 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.

³¹ Partner or Proprietor, as the case may be

SA 580*

Written Representations
(Effective for audits of financial statements
for periods beginning on or after April 1, 2009)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance.

Written Representations as Audit Evidence

2. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based.¹ Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. (Ref: Para. A1)
3. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after 1st April, 2009.

Objectives

5. The objectives of the auditor are:
 - (a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
 - (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and
 - (c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

Definition

6. For purposes of the SAs, the following term has the meaning attributed below:

* Published in October, 2008 issue of the Journal.

¹ SA 500, "Audit Evidence", paragraph 5 (c).

Written representations – A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

7. For purposes of this SA, references to “management” should be read as “management and, where appropriate, those charged with governance.” Furthermore, in the case of a fair presentation framework, management is responsible for the preparation and *fair* presentation of the financial statements in accordance with the applicable financial reporting framework; or the preparation of financial statements *that give a true and fair view* in accordance with the applicable financial reporting framework.

Requirements

Management from Whom Written Representations Requested

8. The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. (Ref: Para. A2-A6)

Written Representations about Management's Responsibilities

Preparation of the Financial Statements

9. The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement.² (Ref: Para. A7-A9, A14, A22)

Information Provided and Completeness of Transactions

10. The auditor shall request management to provide a written representation that:
- (a) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement,³ and
 - (b) All transactions have been recorded and are reflected in the financial statements. (Ref: Para. A7-A9, A14, A22)

Description of Management's Responsibilities in the Written Representations

11. Management's responsibilities shall be described in the written representations required by paragraphs 9 and 10 in the manner in which these responsibilities are described in the terms of the audit engagement.

Other Written Representations

12. Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. (Ref: Para. A10-A13, A14, A22)

Date of and Period(s) Covered by Written Representations

13. The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report. (Ref: Para. A15-A18)

Form of Written Representations

² SA 210, “Agreeing the Terms of Audit Engagements,” paragraph 6(b)(i)

³ SA 210, “Agreeing the Terms of Audit Engagements,” paragraph 6(b)(iii).

14. The written representations shall be in the form of a representation letter addressed to the auditor. If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations required by paragraphs 9 or 10, the relevant matters covered by such statements need not be included in the representation letter. (Ref: Para. A19-A21)

Doubt as to the Reliability of Written Representations and Requested Written Representations Not Provided

Doubt as to the Reliability of Written Representations

15. If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A24-A25)
16. In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A23)
17. If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705⁴, having regard to the requirement in paragraph 19 of this SA.

Requested Written Representations Not Provided

18. If management does not provide one or more of the requested written representations, the auditor shall:
- Discuss the matter with management;
 - Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
 - Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705, having regard to the requirement in paragraph 19 of this SA.

Written Representations about Management's Responsibilities

19. The auditor shall disclaim an opinion on the financial statements in accordance with SA 705 if: (Ref: Para. A26-A27)
- The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations required by paragraphs 9 and 10 are not reliable; or
 - Management does not provide the written representations required by paragraphs 9 and 10.

Application and Other Explanatory Material

Written Representations as Audit Evidence (Ref: Para. 2)

- A1. Written representations are an important source of audit evidence. If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist. Further, a request for written, rather than oral, representations in many cases

⁴ SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

Management from Whom Written Representations Requested (Ref: Para. 8)

- A2. Written representations are requested from those responsible for the preparation and presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation; however, management (rather than those charged with governance) is often the responsible party. Written representations may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation and presentation of the financial statements.
- A3. Due to its responsibility for the preparation and presentation of the financial statements, and its responsibilities for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.
- A4. In some cases, however, management may decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein, including individuals who have specialized knowledge relating to the matters about which written representations are requested. Such individuals may include:
- An actuary responsible for actuarially determined accounting measurements.
 - Staff engineers who may have responsibility for and specialized knowledge about environmental liability measurements.
 - Internal counsel who may provide information essential to provisions for legal claims.
- A5. In some cases, management may include in the written representations qualifying language to the effect that representations are made to the best of its knowledge and belief. It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.
- A6. To reinforce the need for management to make informed representations, the auditor may request that management include in the written representations, confirmation that it has made such inquiries as it considered appropriate to place it in the position to be able to make the requested written representations. It is not expected that such inquiries would usually require a formal internal process beyond those already established by the entity.

Written Representations about Management's Responsibilities (Ref: Para. 9-10)

- A7. Audit evidence obtained during the audit that management has fulfilled the responsibilities referred to in paragraphs 10 and 11 is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities. For example, the auditor could not conclude that management has provided the auditor with all relevant information agreed in the terms of the audit engagement without asking it whether, and receiving confirmation that, such information has been provided.
- A8. The written representations required by paragraphs 9 and 10 draw on the agreed acknowledgement and understanding of management of its responsibilities in the terms of the audit engagement by requesting confirmation that it has fulfilled them. The auditor may also ask management to reconfirm its

acknowledgement and understanding of those responsibilities in written representations. This is particularly appropriate when:

- Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
- The terms of the audit engagement were prepared in a previous year;
- There is any indication that management misunderstands those responsibilities; or
- Changes in circumstances make it appropriate to do so.

Consistent with the requirement of SA 210,⁵ such reconfirmation of management's acknowledgement and understanding of its responsibilities is not made subject to the best of management's knowledge and belief (as discussed in paragraph A5 of this SA).

- A9. The mandates for audits of the financial statements of certain entities may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of such an entity is conducted may give rise to additional written representations. These may include written representations confirming that transactions and events have been carried out in accordance with legislation or proper authority.

Other Written Representations (Ref: Para. 12)

Additional Written Representations about the Financial Statements

- A10. In addition to the written representation required by paragraph 9, the auditor may consider it necessary to request other written representations about the financial statements. Such written representations may supplement, but do not form part of, the written representation required by paragraph 9. They may include representations about the following:

- Whether the selection and application of accounting policies are appropriate; and
- Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognized, measured, presented or disclosed in accordance with that framework:
 - o Plans or intentions that may affect the carrying value or classification of assets and liabilities;
 - o Liabilities, both actual and contingent;
 - o Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral; and
 - o Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.

Additional Written Representations about Information Provided to the Auditor

- A11. In addition to the written representation required by paragraph 10, the auditor may consider it necessary to request management to provide a written representation that it has communicated to the auditor all deficiencies in internal control of which management is aware.

Written Representations about Specific Assertions

⁵ SA 210, "Agreeing the Terms of Audit Engagements," paragraph 6(b).

A12. When obtaining evidence about, or evaluating, judgments and intentions, the auditor may consider one or more of the following:

- The entity's past history in carrying out its stated intentions.
- The entity's reasons for choosing a particular course of action.
- The entity's ability to pursue a specific course of action.
- The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent.

A13. In addition, the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements; in particular, to support an understanding that the auditor has obtained from other audit evidence of management's judgment or intent in relation to, or the completeness of, a specific assertion. For example, if the intent of management is important to the valuation basis for investments, it may not be possible to obtain sufficient appropriate audit evidence without a written representation from management about its intentions. Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.

Communicating a Threshold Amount (Ref: Para. 9-10, 12)

A14. SA 450⁶ requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial. The auditor may determine a threshold above which misstatements cannot be regarded as clearly trivial. In the same way, the auditor may consider communicating to management a threshold for purposes of the requested written representations.

Date of and Period(s) Covered by Written Representations (Ref: Para. 13)

A15. Because written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated, before the date of the written representations. Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

A16. In some circumstances it may be appropriate for the auditor to obtain a written representation about a specific assertion in the financial statements during the course of the audit. Where this is the case, it may be necessary to request an updated written representation.

A17. The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The auditor and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

A18. Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

⁶ SA 450, "Evaluation of Misstatements Identified during the Audit", paragraph 5.

Form of Written Representations (Ref: Para. 14)

A19. Written representations are required to be included in a representation letter addressed to the auditor. Some laws or regulations may, however, require management to make a written public statement about its responsibilities. Although such statement is a representation to the users of the financial statements, or to relevant authorities, the auditor may determine that it is an appropriate form of written representation in respect of some or all of the representations required by paragraph 9 or 10. Consequently, the relevant matters covered by such statement need not be included in the representation letter. Factors that may affect the auditor's determination include:

- Whether the statement includes confirmation of the fulfillment of the responsibilities referred to in paragraphs 10 and 11.
- Whether the statement has been given or approved by those from whom the auditor requests the relevant written representations.
- Whether a copy of the statement is provided to the auditor as near as practicable to, but not after, the date of the auditor's report on the financial statements (see paragraph 13).

A20. A formal statement of compliance with law or regulation, or of approval of the financial statements, would not contain sufficient information for the auditor to be satisfied that all necessary representations have been consciously made. The expression of management's responsibilities in law or regulation is also not a substitute for the requested written representations.

A21. The Appendix to this Standard provides an illustrative example of a representation letter.

Communication with Those Charged with Governance (Ref: Para. 9-10, 12)

A22. SA 260⁷ requires the auditor to communicate with those charged with governance the written representations which the auditor has requested from management.

Doubt as to the Reliability of Written Representations and Requested Written Representations Not Provided***Doubt as to the Reliability of Written Representations*** (Ref: Para. 15-16)

A23. In the case of identified inconsistencies between one or more written representations and audit evidence obtained from another source, the auditor may consider whether the risk assessment remains appropriate and, if not, revise the risk assessment and determine the nature, timing and extent of further audit procedures to respond to the assessed risks.

A24. Concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, may cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. In such a case, the auditor may consider, where possible, withdrawing from the engagement, unless those charged with governance put in place appropriate corrective measures. Such measures, however, may not be sufficient to enable the auditor to issue an unmodified audit opinion.

A25. SA 230⁸ requires the auditor to document significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. The auditor may have identified significant issues relating to the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, but concluded that the written

⁷ SA 260, "Communication with Those Charged with Governance", paragraph 12(c)(ii).

⁸ SA 230, "Audit Documentation", refer paragraph 8 and 10.

representations are nevertheless reliable. In such a case, this significant matter is documented in accordance with SA 230.

Written Representations about Management's Responsibilities (Ref: Para. 19)

A26. As explained in paragraph A7, the auditor is not able to judge solely on other audit evidence whether management has fulfilled the responsibilities referred to in paragraphs 10 and 11. Therefore, if, as described in paragraph 19(a), the auditor concludes that the written representations about these matters are unreliable, or if management does not provide those written representations, the auditor is unable to obtain sufficient appropriate audit evidence. The possible effects on the financial statements of such inability are not confined to specific elements, accounts or items of the financial statements and are hence pervasive. SA 705 requires the auditor to disclaim an opinion on the financial statements in such circumstances.⁹

A27. A written representation that has been modified from that requested by the auditor does not necessarily mean that management did not provide the written representation. However, the underlying reason for such modification may affect the opinion in the auditor's report. For example:

- The written representation about management's fulfillment of its responsibility for the preparation and presentation of the financial statements may state that management believes that, except for material non-compliance with a particular requirement of the applicable financial reporting framework, the financial statements are prepared and presented in accordance with that framework. The requirement in paragraph 19 does not apply because the auditor concluded that management has provided reliable written representations. However, the auditor is required to consider the effect of the non-compliance on the opinion in the auditor's report in accordance with SA 705.
- The written representation about the responsibility of management to provide the auditor with all relevant information agreed in the terms of the audit engagement may state that management believes that, except for information destroyed in a fire, it has provided the auditor with such information. The requirement in paragraph 19 does not apply because the auditor concluded that management has provided reliable written representations. However, the auditor is required to consider the effects of the pervasiveness of the information destroyed in the fire on the financial statements and the effect thereof on the opinion in the auditor's report in accordance with SA 705.

Material Modifications to ISA 580, "Written Representations"

Deletions

Paragraph A9 of the Application Section of ISA 580 deals with the application of the requirements of ISA 580 to the audits of public sector entities regarding the premise, relating to management's responsibilities which may give rise to additional written representations. Since as mentioned in the *"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"*, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Since it is also possible that even in case of non public sector entities, management responsibilities may give rise to additional representations, accordingly, the spirit of erstwhile A9, highlighting the fact that in case of certain entities, the need of additional representations may arise, has been retained.

⁹ SA 705, paragraph 9.

Appendix

(Ref: Para. A23)

Illustrative Representation Letter

The following illustrative letter includes written representations that are required by this and other SAs in effect for audits of financial statements for period beginning on or after as at [date]. It is assumed in this illustration that the applicable financial reporting framework is applicable accounting standards in India; the requirement of SA 570¹⁰ to obtain a written representation is not relevant; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

(Entity Letterhead)

(To Auditor)

(Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended March 31, 20XX¹¹ for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or *give a true and fair view*) in accordance with the applicable accounting standards in India.

We confirm that (,to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves):

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation of the financial statements in accordance with Financial Reporting Standards; in particular the financial statements are fairly presented (or *give a true and fair view*) in accordance with the applicable accounting standards in India.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable. (SA 540)
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of applicable accounting standards in India. (SA 550)¹²
- All events subsequent to the date of the financial statements and for which applicable accounting standards in India require adjustment or disclosure have been adjusted or disclosed. (SA 560)
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter.(SA 450)
- [Any other matters that the auditor may consider appropriate (see paragraph A10 of this SA).]

Information Provided

- We have provided you with:

¹⁰ SA 570, "Going Concern".

¹¹ Where the auditor reports on more than one period, the auditor adjusts the date so that the letter pertains to all periods covered by the auditor's report.

¹² SA 550, "Related Parties".

- o Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - o Additional information that you have requested from us for the purpose of the audit; and
 - o Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (SA 240).
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
 - o Management;
 - o Employees who have significant roles in internal control; or
 - o Others where the fraud could have a material effect on the financial statements. (SA 240)
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (SA 240)
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements. (SA 250)¹³
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (SA 550)¹⁴
- [Any other matters that the auditor may consider necessary (see paragraph A11 of this SA).]

Management

Management

¹³ SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements".

¹⁴ SA 550, "Related Parties".

SA 610

Using the Work of Internal Auditors

*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2016)*

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 315,¹ 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.² Such prohibitions or restrictions will therefore not prevent the external auditor from complying with the SAs. (Ref: Para. A31)

¹ 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.

² SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, paragraph A55.

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.

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 315³ 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 obtained⁴. 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 330⁵.

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 200⁶. 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 evidence that the work of the internal audit function, or internal auditors providing direct assistance, is adequate for the purposes of the audit.

³ 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)

⁴ See paragraphs 15–25

⁵ SA 330, The Auditor's Responses to Assessed Risks.

⁶ SA 200, paragraph 14.

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 260⁷, communicate how the external auditor has planned to use the work of the internal audit function. (Ref: Para. A23)

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:

⁷ SA 260, Communication with Those Charged with Governance, paragraph 11.

- (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;⁸ (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)

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:

⁸ See paragraph 18.

- (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 260,⁹ 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 220¹⁰. 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

⁹ SA 260, paragraph 11.

¹⁰ SA 220, Quality Control for an Audit of Financial Statements.

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:

- (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 230¹¹;
- (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:

¹¹ SA 230, Audit Documentation.

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.

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 330¹². 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 315¹³ 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 auditor¹⁴.

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)¹⁵.

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.

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

¹² See paragraph 10.

¹³ 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)

¹⁴ See paragraphs 15–25.

¹⁵ See paragraphs 26–35

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 oblige 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.

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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 1¹⁶ 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 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 threat¹⁷ 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)

¹⁶ 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.

¹⁷ 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.

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 300¹⁸.

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.
- 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)¹⁹.

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))

¹⁸ SA 300, Planning an Audit of Financial Statements.

¹⁹ SA 600, Using the Work of Another Auditor.

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 function in obtaining sufficient appropriate audit evidence. Furthermore, as explained in SA 200²⁰, 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 315²¹, 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 reevaluate 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^{22,22} 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.
- Review and reporting procedures.

A25. Coordination between the external auditor and the internal audit function is effective when, for example:

²⁰ SA 200, paragraph A29.

²¹ SA 315, paragraph 4(e).

²² SA 260, paragraph 11.

- 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 200²³ 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.²⁴ 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 240²⁵.

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.

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)

²³ SA 200, paragraphs 15 and A18.

²⁴ 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).

²⁵ 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.

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 auditors²⁶.
- Family and personal relationships with an individual working in, or responsible for, the aspect of the entity to which the work relates.
- 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

²⁶ See paragraph A7.

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 315²⁷.
- Determination of unannounced audit procedures as addressed in SA 240.

A37. Similarly, since in accordance with SA 505²⁸ 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. 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.

²⁷ SA 315, paragraph 6(a).

²⁸ SA 505, External Confirmations, paragraphs 7 and 16.

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)²⁹.

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)³⁰.

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

²⁹ 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.

³⁰ 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.

direct assistance³¹.

- 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 function³², 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:~~
 - ~~(a) The nature of the internal audit function's responsibilities, and how the internal audit function fits in the entity's organisational structure, status, and~~
 - ~~(b) The activities performed, or to be performed, by the internal audit function. (Ref: Para. A401-109 - A403-116)~~

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, the~~ 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:

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☐ ~~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.~~

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³¹ SA 610 (Revised), paragraphs 20 and 31.

³² 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.

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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 performed³³. 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.

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 240³⁴, 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 auditor's identification 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 (Ref: Para 23)

³³ The relevant requirements are contained in SA 610 (Revised).

³⁴ SA 240, paragraph 19.

~~A109104. If the entity 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.~~

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.

SA 700 (Revised)

Forming an Opinion and Reporting on Financial Statements

(Effective for all audits relating to accounting periods beginning on or after April 1, 2017)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.
2. SA 701¹ deals with the auditor's responsibility to communicate key audit matters in the auditor's report. SA 705² (Revised) and SA 706³ (Revised) deal with how the form and content of the auditor's report are affected when the auditor expresses a modified opinion or includes an Emphasis of Matter paragraph or an Other Matter paragraph in the auditor's report. Other SAs also contain reporting requirements that are applicable when issuing an auditor's report.
3. This SA applies to an audit of a complete set of general purpose financial statements and is written in that context. SA 800⁴ deals with special considerations when financial statements are prepared in accordance with a special purpose framework. SA 805⁵ deals with special considerations relevant to an audit of a single financial statement or of a specific element, account or item of a financial statement. This SA also applies to audits for which SA 800 or SA 805 apply.
4. The requirements of this SA are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users. This SA promotes consistency in the auditor's report, but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions. Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

Effective Date

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

¹ SA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

² SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*.

³ SA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

⁴ SA 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*.

⁵ SA 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*.

Objectives

6. The objectives of the auditor are:
- (a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and
 - (b) To express clearly that opinion through a written report.

Definitions

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

- (a) General purpose financial statements – Financial statements prepared in accordance with a general purpose framework.
- (b) General purpose framework – A financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.

The term “fair presentation framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.⁶

- (c) Unmodified opinion – The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.⁷

8. Reference to “financial statements” in this SA means “a complete set of general purpose financial statements, including the related notes.” The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information and any other information required to be included as part of the financial statements by the laws and regulations governing the entity. The requirements of the applicable financial reporting framework determine the form and content of the financial statements, and what constitutes a complete set of financial statements.

9. Reference to “Accounting Standards” in this SA includes :

- The Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI)⁸; or
- The Standards of Accounting notified by the Central Government in pursuance of section 133 of the

⁶ SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, paragraph 13(a).

⁷ Paragraphs 25–26 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

⁸ For example, the Accounting Standards for Local Bodies issued by the Institute of Chartered Accountants of India.

Companies Act, 2013 and the Rules thereunder; or

- The International Financial Reporting Standards (IFRSs); or
- The International Public Sector Accounting Standards (IPSASs) issued by the International Public Sector Accounting Standards Board;

as may be applicable to the entity.

Requirements

Forming an Opinion on the Financial Statements

10. The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.^{9&10}

11. In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

- (a) The auditor's conclusion, in accordance with SA 330, whether sufficient appropriate audit evidence has been obtained;¹¹
- (b) The auditor's conclusion, in accordance with SA 450, whether uncorrected misstatements are material, individually or in aggregate;¹² and
- (c) The evaluations required by paragraphs 12–15.

12. The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. (Ref: Para. A1–A3)

13. In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:

- (a) The financial statements adequately disclose the significant accounting policies selected and applied;
- (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- (c) The accounting estimates made by management are reasonable;
- (d) The information presented in the financial statements is relevant, reliable, comparable, and understandable;
- (e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and (Ref: Para. A4)
- (f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

⁹ SA 200, paragraph 11

¹⁰ Paragraphs 25–26 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

¹¹ SA 330, *The Auditor's Responses to Assessed Risks*, paragraph 26

¹² SA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 11

14. When the financial statements are prepared in accordance with a fair presentation framework, the evaluation required by paragraphs 12–13 shall also include whether the financial statements achieve fair presentation. The auditor's evaluation as to whether the financial statements achieve fair presentation shall include consideration of:

- (a) The overall presentation, structure and content of the financial statements; and
- (b) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

15. The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. (Ref: Para. A5–A10)

Form of Opinion

16. 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.

17. If the auditor:

- (a) concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- (b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement,

the auditor shall modify the opinion in the auditor's report in accordance with SA 705 (Revised).

18. If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with SA 705 (Revised). (Ref: Para. A11)

19. When the financial statements are prepared in accordance with a compliance framework, the auditor is not required to evaluate whether the financial statements achieve fair presentation. However, if in extremely rare circumstances the auditor concludes that such financial statements are misleading, the auditor shall discuss the matter with management and, depending on how it is resolved, shall determine whether, and how, to communicate it in the auditor's report. (Ref: Para. A12)

Auditor's Report

20. The auditor's report shall be in writing. (Ref: Para. A13–A14)

Auditor's Report for Audits Conducted in Accordance with Standards on Auditing

Title

21. The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor. (Ref: Para. A15)

Addressee

22. The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. (Ref: Para. A16)

Auditor's Opinion

23. The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

24. The Opinion section of the auditor's report shall also:

- (a) Identify the entity whose financial statements have been audited;
- (b) State that the financial statements have been audited;
- (c) Identify the title of each statement comprising the financial statements;
- (d) Refer to the notes, including the summary of significant accounting policies; and
- (e) Specify the date of, or period covered by, each financial statement comprising the financial statements. (Ref: Para. A17–A18)

25. When expressing an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

- (a) In our opinion, the accompanying financial statements present fairly, in all material respects, [...] in accordance with [the applicable financial reporting framework]; or
- (b) In our opinion, the accompanying financial statements give a true and fair view of [...] in accordance with [the applicable financial reporting framework]. (Ref: Para. A19–A26)

26. When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor's opinion shall be that the accompanying financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework]. (Ref: Para. A21–A26)

27. If the reference to the applicable financial reporting framework in the auditor's opinion is not to Accounting Standards referred to in paragraph 9, the auditor's opinion shall identify the origin of such other framework.

Basis for Opinion

28. The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that: (Ref: Para. A27)

- (a) States that the audit was conducted in accordance with Standards on Auditing; (Ref: Para. A28)
- (b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
- (c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the *Code of Ethics issued by ICAI* (Ref: Para. A29–A34)
- (d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Going Concern

29. Where applicable, the auditor shall report in accordance with SA 570 (Revised).¹³

Key Audit Matters

30. For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with SA 701.

31. When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with SA 701. (Ref: Para. A35–A38)

Responsibilities for the Financial Statements

¹³ SA 570 (Revised), *Going Concern*, paragraphs 21–23

32. The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." The auditor's report shall use the term that is appropriate in the context of the legal framework applicable to the entity and need not refer specifically to "management". In some entities, the appropriate reference may be to those charged with governance. (Ref: Para. A39)

33. This section of the auditor's report shall describe management's responsibility for: (Ref: Para. A40–A43)

- (a) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (b) Assessing the entity's ability to continue as a going concern¹⁴ and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate. (Ref: Para. A43)

34. This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from those who fulfill the responsibilities described in paragraph 33 above. In this case, the heading of this section shall also refer to "Those Charged with Governance" or such term that is appropriate in the context of the legal framework applicable to entity. (Ref: Para. A44)

35. When the financial statements are prepared in accordance with a fair presentation framework, the description of responsibilities for the financial statements in the auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view," as appropriate in the circumstances.

Auditor's Responsibilities for the Audit of the Financial Statements

36. The auditor's report shall include a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements."

37. This section of the auditor's report shall: (Ref: Para. A45)

- (a) State that the objectives of the auditor are to:
 - (i) Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
 - (ii) Issue an auditor's report that includes the auditor's opinion. (Ref: Para. A46)
- (b) State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists; and
- (c) State that misstatements can arise from fraud or error, and either:
 - (i) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or¹⁵
 - (ii) Provide a definition or description of materiality in accordance with the applicable financial reporting framework. (Ref: Para. A47)

38. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further: (Ref: Para. A45)

¹⁴ SA 570 (Revised), paragraph 2

¹⁵ SA 320, Materiality in Planning and Performing an Audit, paragraph 2

- (a) State that, as part of an audit in accordance with SAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and
- (b) Describe an audit by stating that the auditor's responsibilities are:
 - (i) To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
 - (ii) To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.
 - (iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
 - (iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, 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. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the opinion. The auditor's conclusions are based on the audit evidence obtained up to the date of the auditor's report. However, future events or conditions may cause an entity to cease to continue as a going concern.
 - (v) When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- (c) When SA 600¹⁶ applies, further describe the auditor's responsibilities in a group audit engagement by stating:

The division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components is audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors

39. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall: (Ref: Para. A45)

- (a) State that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;
- (b) State that the auditor provides those charged with governance with a statement that the auditor has

¹⁶ SA 600, Using the Work of Another Auditor.

complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and

- (c) For audits of financial statements of all such entities for which key audit matters are communicated in accordance with SA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. In accordance with the requirements of SA 701, the auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, the auditor determines that a matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication. (Ref: Para. A48)

Location of the description of the auditor's responsibilities for the audit of the financial statements

40. The description of the auditor's responsibilities for the audit of the financial statements required by paragraphs 38–39 shall be included: (Ref: Para. A49)

- (a) Within the body of the auditor's report;
- (b) Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix; or (Ref: Para. A49–A50)
- (c) By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or the auditing standards expressly permit the auditor to do so. (Ref: Para. A49, A51–A52)

41. When the auditor refers to a description of the auditor's responsibilities on a website of an appropriate authority, the auditor shall determine that such description addresses, and is not inconsistent with, the requirements in paragraphs 38–39 of this SA. (Ref: Para. A51)

Other Reporting Responsibilities

42. If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the SAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the SAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the SAs. (Ref: Para. A53–A55)

43. If other reporting responsibilities are presented in the same section as the related report elements required by the SAs, the auditor's report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the SAs. (Ref: Para. A55)

44. If the auditor's report contains a separate section that addresses other reporting responsibilities, the requirements of paragraphs 20–39 of this SA shall be included under a section with a heading "Report on the Audit of the Financial Statements." The "Report on Other Legal and Regulatory Requirements" shall follow the "Report on the Audit of the Financial Statements." (Ref: Para. A55)

Signature of the Auditor

45. The auditor's report shall be signed. The report is signed by the auditor (i.e. the engagement partner) in his personal name. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the audit report also needs to mention

the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them¹⁷. (Ref: Para. A56-A57)

Place of Signature

46. The auditor's report shall name specific location, which is ordinarily the city where the audit report is signed.

Date of the Auditor's Report

47. The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that: (Ref: Para. A58–A61)

- (a) All the statements that comprise the financial statements, including the related notes, have been prepared; and
- (b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Auditor's Report Prescribed by Law or Regulation

48. If the auditor is required by law or regulation applicable to the entity to use a specific layout, or wording of the auditor's report, the auditor's report shall refer to Standards on Auditing only if the auditor's report includes, at a minimum, each of the following elements: (Ref: Para. A62– A63)

- (a) A title.
- (b) An addressee, as required by the circumstances of the engagement.
- (c) An Opinion section containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements (see paragraph 27).
- (d) An identification of the entity's financial statements that have been audited.
- (e) A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI.
- (f) Where applicable, a section that addresses, and is not inconsistent with, the reporting requirements in paragraph 22 of SA 570 (Revised).
- (g) Where applicable, a Basis for Qualified (or Adverse) Opinion section that addresses, and is not inconsistent with, the reporting requirements in paragraph 23 of SA 570 (Revised).
- (h) Where applicable, a section that includes the information required by SA 701, or additional information

¹⁷ The Council of the ICAI, at its 292nd meeting held in January 2010, decided to require the members of the ICAI to include, in addition to the other requirements relating to signature on the audit report, as prescribed under the relevant Standard on Auditing, the registration number of the firm as allotted by ICAI, in the audit reports signed by them, and ensure that the resolution passed by the company regarding appointment of the statutory auditor of the company under section 224 of the Companies Act, 1956, also contain the registration number of the firm of the auditor(s) with the ICAI. These requirements came into effect from April 1, 2010. Subsequently, the Council of the ICAI, at its 296th meeting held in June 2010, decided to extend the requirement to mention the firm registration number to all reports issued pursuant to any attestation engagement, including certificates, issued by the members as proprietor or/ partner in the said firm. The requirement applies where such firm registration number has been allotted by the ICAI. The Council further decided to make this requirement effective for all attestation reports/ certificates issued on or after 1st October, 2010.

about the audit that is prescribed by law or regulation and that addresses, and is not inconsistent with, the reporting requirements in that SA.¹⁸ (Ref: Para. A63–A64)

- (i) A description of management's responsibilities for the preparation of the financial statements and an identification of those responsible for the oversight of the financial reporting process that addresses, and is not inconsistent with, the requirements in paragraphs 32–35.
- (j) A reference to Standards on Auditing and the law or regulation, and a description of the auditor's responsibilities for an audit of the financial statements that addresses, and is not inconsistent with, the requirements in paragraphs 36–39. (Ref: Para. A49–A50)
- (k) The auditor's signature.
- (l) The Place of signature
- (m) The date of the auditor's report.

Auditor's Report for Audits Conducted in Accordance with Both Standards on Auditing Issued by ICAI and International Standards on Auditing or Auditing Standards of Any Other Jurisdiction

49. An auditor may be required to conduct an audit in accordance with, in addition to the Standards on Auditing issued by ICAI, the International Standards on Auditing or auditing standards of any other jurisdiction. If this is the case, the auditor's report may refer to Standards on Auditing in addition to the International Standards on Auditing or auditing standards of such other jurisdiction, but the auditor shall do so only if: (Ref: Para. A68–A69)

- (a) There is no conflict between the requirements in the ISAs or such auditing standards of other jurisdiction and those in SAs that would lead the auditor (i) to form a different opinion, or (ii) not to include an Emphasis of Matter paragraph or Other Matter paragraph that, in the particular circumstances, is required by SAs; and
- (b) The auditor's report includes, at a minimum, each of the elements set out in paragraphs 48(a)–(m) above when the auditor uses the layout or wording specified by the Standards on Auditing. However, reference to "law or regulation" in paragraph 48(j) shall be read as reference to the Standards on Auditing. The auditor's report shall thereby identify such Standards on Auditing.

50. When the auditor's report refers to both the ISAs or the auditing standards of a specific jurisdiction and the Standards on Auditing issued by ICAI, the auditor's report shall clearly identify the same including the jurisdiction of origin of the other auditing standards.

Supplementary Information Presented with the Financial Statements (Ref: Para. A70–A76)

51. If supplementary information that is not required by the applicable financial reporting framework is presented with the audited financial statements, the auditor shall evaluate whether, in the auditor's professional judgment, supplementary information is nevertheless an integral part of the financial statements due to its nature or how it is presented. When it is an integral part of the financial statements, the supplementary information shall be covered by the auditor's opinion.

52. If supplementary information that is not required by the applicable financial reporting framework is not considered an integral part of the audited financial statements, the auditor shall evaluate whether such supplementary information is presented in a way that sufficiently and clearly differentiates it from the audited financial statements. If this is not the case, then the auditor shall ask management to change how the unaudited supplementary information is presented. If management refuses to do so, the auditor shall identify the unaudited supplementary information and explain in the auditor's report that such supplementary information

¹⁸ SA 701, paragraphs 11–16

has not been audited.

Application and Other Explanatory Material

Qualitative Aspects of the Entity's Accounting Practices (Ref: Para. 12)

A1. Management makes a number of judgments about the amounts and disclosures in the financial statements.

A2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices¹⁹. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that the cumulative effect of a lack of neutrality, together with the effect of uncorrected misstatements, causes the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality that may affect the auditor's evaluation of whether the financial statements as a whole are materially misstated include the following:

- The selective correction of misstatements brought to management's attention during the audit (e.g., correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings).
- Possible management bias in the making of accounting estimates.

A3. SA 540 addresses possible management bias in making accounting estimates.²⁰ Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

Disclosures of the Effect of Material Transactions and Events on the Information Conveyed in the Financial Statements (Ref: Para. 13(e))

A4. It is common for financial statements prepared in accordance with a general purpose framework to present an entity's financial position, financial performance and cash flows. In such circumstances, the auditor evaluates whether the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the entity's financial position, financial performance and cash flows.

Description of the Applicable Financial Reporting Framework (Ref: Para. 15)

A5. As explained in SA 200, the preparation of the financial statements by management and, where appropriate, those charged with governance requires the inclusion of an adequate description of the applicable financial reporting framework in the financial statements.²¹ That description advises users of the financial statements of the framework on which the financial statements are based.

A6. A description that the financial statements are prepared in accordance with a particular applicable financial reporting framework is appropriate only if the financial statements comply with all the requirements of that framework that are effective during the period covered by the financial statements.

A7. A description of the applicable financial reporting framework that contains imprecise qualifying or limiting language (e.g., "the financial statements are in substantial compliance with Accounting Standards") is not an adequate description of that framework as it may mislead users of the financial statements.

¹⁹ SA 260 (Revised), *Communication with Those Charged with Governance*, Appendix 2

²⁰ SA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, paragraph 21

²¹ SA 200, paragraphs A2–A3

Reference to More than One Financial Reporting Framework

A8. In some cases, the financial statements may represent that they are prepared in accordance with two financial reporting frameworks (e.g., Accounting Standards referred to in section 133 of the Companies Act, 2013 and the IFRSs). This may be because management is required, or has chosen, to prepare the financial statements in accordance with both frameworks, in which case both are applicable financial reporting frameworks. Such description is appropriate only if the financial statements comply with each of the frameworks individually. To be regarded as being prepared in accordance with both frameworks, the financial statements need to comply with both frameworks simultaneously and without any need for reconciling statements. In practice, simultaneous compliance is unlikely unless the other framework (e.g., IFRSs) has been adopted as the framework applicable to that entity, or has eliminated all barriers to compliance with it.

A9. Financial statements that are prepared in accordance with one financial reporting framework and that contain a note or supplementary statement reconciling the results to those that would be shown under another framework are not prepared in accordance with that other framework. This is because the financial statements do not include all the information in the manner required by that other framework.

A10. The financial statements may, however, be prepared in accordance with one applicable financial reporting framework and, in addition, describe in the notes to the financial statements the extent to which the financial statements comply with another framework (e.g., financial statements prepared in accordance with the Accounting Standards that also describe the extent to which they comply with IFRSs). Such description may constitute supplementary financial information as discussed in paragraph 52 and is covered by the auditor's opinion if it cannot be clearly differentiated from the financial statements.

Form of Opinion (Ref: Para. 18–19)

A11. There may be cases where the financial statements, although prepared in accordance with the requirements of a fair presentation framework, do not achieve fair presentation. Where this is the case, it may be possible for management to include additional disclosures in the financial statements beyond those specifically required by the framework or, in extremely rare circumstances, to depart from a requirement in the framework in order to achieve fair presentation of the financial statements.

A12. It will be extremely rare for the auditor to consider financial statements that are prepared in accordance with a compliance framework to be misleading if, in accordance with SA 210, the auditor determined that the framework is acceptable.²²

Auditor's Report (Ref: Para. 20)

A13. A written report encompasses reports issued in hard copy and those using an electronic medium.

A14. The Appendix to this SA contains illustrations of auditor's reports on financial statements, incorporating the elements set out in paragraphs 20–47. With the exception of the Opinion and Basis for Opinion sections, this SA does not establish requirements for ordering the elements of the auditor's report. However, this SA requires the use of specific headings, which are intended to assist in making auditor's reports that refer to audits that have been conducted in accordance with SAs more recognizable, particularly in situations where the elements of the auditor's report are presented in an order that differs from the illustrative auditor's reports in the Appendix to this SA.

Auditor's Report for Audits Conducted in Accordance with Standards on Auditing

Title (Ref: Para. 21)

A15. A title indicating the report is the report of an independent auditor, for example, "Independent Auditor's

²² SA 210, *Agreeing the Terms of Audit Engagements*, paragraph 6(a)

Report,” distinguishes the independent auditor’s report from reports issued by others.

Addressee (Ref: Para. 22)

A16. Law, regulation or the terms of the engagement may specify to whom the auditor’s report is to be addressed in that particular jurisdiction. The auditor’s report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

Auditor’s Opinion (Ref. Para. 24–26)

Reference to the financial statements that have been audited

A17. The auditor’s report states, for example, that the auditor has audited the financial statements of the entity, which comprise [state the title of each financial statement comprising the complete set of financial statements required by the applicable financial reporting framework, specifying the date or period covered by each financial statement] and notes to the financial statements, including a summary of significant accounting policies.

A18. When the auditor is aware that the audited financial statements will be included in a document that contains other information, such as an annual report, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the audited financial statements are presented. This helps users to identify the financial statements to which the auditor’s report relates.

“Present fairly, in all material respects” or “give a true and fair view”

A19. The phrases “present fairly, in all material respects,” and “give a true and fair view” are regarded as being equivalent. Whether the phrase “present fairly, in all material respects,” or the phrase “give a true and fair view” is used in any particular jurisdiction is determined by the law or regulation governing the audit of financial statements in that jurisdiction, or by generally accepted practice in that jurisdiction. Where law or regulation requires the use of different wording, this does not affect the requirement in paragraph 14 of this SA for the auditor to evaluate the fair presentation of financial statements prepared in accordance with a fair presentation framework.

A20. When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as “with the foregoing explanation” or “subject to” in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

Description of the financial statements and the matters they present

A21. The auditor’s opinion covers the complete set of financial statements as defined by the applicable financial reporting framework. For example, in the case of many general purpose frameworks, the financial statements may include: Balance sheet, Profit and Loss Accounts, a statement of changes in equity, a statement of cash flows, and related notes, which ordinarily comprise a summary of significant accounting policies and other explanatory information. In some entities, additional information may also be considered to be an integral part of the financial statements.

A22. In the case of financial statements prepared in accordance with a fair presentation framework, the auditor’s opinion states that the financial statements present fairly, in all material respects, or give a true and fair view of, the matters that the financial statements are designed to present. For example, in the case of companies under the Companies Act, 2013, the financial statements for financial year 2014-15, prepared in accordance with the Companies (Accounting Standards) Rules, 2006, these matters are present *true and fair view of the state of the company’s affairs as at the end of its financial year and profit or loss or cash flow for the year*. Consequently, the [...] in paragraph 25 and elsewhere in this SA is intended to be replaced by the words in italics in the preceding sentence when the applicable financial reporting framework is Ind AS/ Accounting Standard or, in the case of other applicable financial reporting frameworks, be replaced with words

that describe the matters that the financial statements are designed to present.

Description of the applicable financial reporting framework and how it may affect the auditor's opinion

A23. The identification of the applicable financial reporting framework in the auditor's opinion is intended to advise users of the auditor's report of the context in which the auditor's opinion is expressed; it is not intended to limit the evaluation required in paragraph 14. The applicable financial reporting framework is identified in such terms as:

"...In accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013"
or

"...In accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India"

"... in accordance with International Financial Reporting Standards"

A24. When the applicable financial reporting framework encompasses financial reporting standards and legal or regulatory requirements, the framework is identified in such terms as "...in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013". SA 210 deals with circumstances where there are conflicts between the financial reporting standards and the legislative or regulatory requirements.²³

A25. As indicated in paragraph A8, the financial statements may be prepared in accordance with two financial reporting frameworks, which are therefore both applicable financial reporting frameworks. Accordingly, each framework is considered separately when forming the auditor's opinion on the financial statements, and the auditor's opinion in accordance with paragraphs 25–27 refers to both frameworks as follows:

- (a) If the financial statements comply with each of the frameworks individually, two opinions are expressed: that is, that the financial statements are prepared in accordance with one of the applicable financial reporting frameworks (e.g., in case of a company incorporated in India, the Accounting Standards issued pursuant to section 133 of the Companies Act, 2013) and an opinion that the financial statements are prepared in accordance with the other applicable financial reporting framework (e.g., IFRSs). These opinions may be expressed separately or in a single sentence (e.g., the financial statements are presented fairly, in all material respects [...], in accordance with accounting principles generally accepted in India and with IFRSs).
- (b) If the financial statements comply with one of the frameworks but fail to comply with the other framework, an unmodified opinion can be given that the financial statements are prepared in accordance with the one framework (e.g., in case of a company incorporated in India, the Accounting Standards issued pursuant to section 133 of the Companies Act, 2013) but a modified opinion given with regard to the other framework (e.g., IFRSs) in accordance with SA 705 (Revised).

A26. As indicated in paragraph A10, the financial statements may represent compliance with the applicable financial reporting framework and, in addition, disclose the extent of compliance with another financial reporting framework. Such supplementary information is covered by the auditor's opinion if it cannot be clearly differentiated from the financial statements (see paragraphs 51–52 and related application material in paragraphs A70–A76). Accordingly,

- (a) If the disclosure as to the compliance with the other framework is misleading, a modified opinion is expressed in accordance with SA 705 (Revised).
- (b) If the disclosure is not misleading, but the auditor judges it to be of such importance that it is fundamental to the users' understanding of the financial statements, an Emphasis of Matter paragraph is added in accordance with SA 706 (Revised), drawing attention to the disclosure.

²³ SA 210, paragraph 18

Basis for Opinion (Ref: Para. 28)

A27. The Basis for Opinion section provides important context about the auditor's opinion. Accordingly, this SA requires the Basis for Opinion section to directly follow the Opinion section in the auditor's report.

A28. The reference to the standards used conveys to the users of the auditor's report that the audit has been conducted in accordance with established standards.

Relevant ethical requirements

A29. The identification of the applicable relevant ethical requirements increases transparency about those requirements relating to the particular audit engagement. SA 200 explains that relevant ethical requirements ordinarily comprise of Code of Ethics issued by the Institute of Chartered Accountants of India²⁴. When the relevant ethical requirements include those of the Code of Ethics, the statement may also make reference to the Code of Ethics. If the Code of Ethics related to an audit of financial statements constitutes all of the ethical requirements relevant to the audit, the statement need not identify a jurisdiction of origin.

A30. Relevant ethical requirements may exist in several different sources, such as the ethical code(s) and additional rules and requirements within law and regulation. When the independence and other relevant ethical requirements are contained in a limited number of sources, the auditor may choose to name the relevant source(s) (e.g., the name of the code, rule or regulation applicable in the jurisdiction), or may refer to a term that is commonly understood and that appropriately summarizes those sources (e.g., independence requirements for audits of private entities in Jurisdiction X).

A31. Law or regulation, applicable auditing standards or the terms of an audit engagement may require the auditor to provide in the auditor's report more specific information about the sources of the relevant ethical requirements, including those pertaining to independence that applied to the audit of the financial statements.

A32. In determining the appropriate amount of information to include in the auditor's report when there are multiple sources of relevant ethical requirements relating to the audit of the financial statements, an important consideration is balancing transparency against the risk of obscuring other useful information in the auditor's report.

Considerations specific to group audits

A33. In group audits when there are multiple sources of relevant ethical requirements, including those pertaining to independence, the reference in the auditor's report to the relevant ethical requirements refers to those that are applicable to the principal auditor.

A34. The SAs do not establish specific independence or ethical requirements for auditors, including component auditors, and thus do not extend, or otherwise override, the independence requirements of the ICAI Code of Ethics to which the principal auditor is subject, nor do the SAs require that the component auditor in all cases to be subject to the same specific independence requirements that are applicable to the principal auditor.

Key Audit Matters (Ref: Para. 30)

A35. Law or regulation may require communication of key audit matters for audits of entities other than listed entities, for example, entities characterized in such law or regulation as public interest entities.

A36. The auditor may also decide to communicate key audit matters for 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

²⁴ SA 200, paragraph A14

charities.

A37. SA 210 requires the auditor to agree the terms of the audit engagement with management and those charged with governance, as appropriate, and explains that the roles of management and those charged with governance in agreeing the terms of the audit engagement for the entity depend on the governance arrangements of the entity and relevant law or regulation²⁵. SA 210 also requires the audit engagement letter or other suitable form of written agreement to include reference to the expected form and content of any reports to be issued by the auditor.²⁶ When the auditor is not otherwise required to communicate key audit matters, SA 210²⁷ explains that it may be helpful for the auditor to make reference in the terms of the audit engagement to the possibility of communicating key audit matters in the auditor's report and, in certain jurisdictions, it may be necessary for the auditor to include a reference to such possibility in order to retain the ability to do so.

Considerations specific to public sector entities

A38. Public sector entities, even where not listed, may be significant due to size, complexity or public interest aspects. In such cases, an auditor of a public sector entity may be required by law or regulation or may otherwise decide to communicate key audit matters in the auditor's report.

Responsibilities for the Financial Statements (Ref: Para. 32–33)

A39. SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted.²⁸ Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted. SA 260 (Revised) uses the term those charged with governance to describe the person(s) or organization(s) with responsibility for overseeing the entity, and provides a discussion about the diversity of governance structures across jurisdictions and by entity.

A40. There may be circumstances when it is appropriate for the auditor to add to the descriptions of the responsibilities of management and those charged with governance in paragraphs 33–34 to reflect additional responsibilities that are relevant to the preparation of the financial statements in the context of the particular jurisdiction or the nature of the entity.

A41. SA 210 requires the auditor to agree management's responsibilities in an engagement letter or other suitable form of written agreement.²⁹ SA 210 provides some flexibility in doing so, by explaining that, if law or regulation prescribes the responsibilities of management and, where appropriate, those charged with governance in relation to financial reporting, the auditor may determine that the law or regulation includes responsibilities that, in the auditor's judgment, are equivalent in effect to those set out in SA 210. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the engagement letter or other suitable form of written agreement. In such cases, this wording may also be used in the auditor's report to describe the responsibilities as required by paragraph 33(a) of this SA. In other

²⁵ SA 210, paragraphs 9 and A 20

²⁶ SA 210, paragraph 10

²⁷ SA 210, paragraph A23a

²⁸ SA 200, paragraph 13(j)

²⁹ SA 210, paragraph 6(b)(i)–(ii)

circumstances, including where the auditor decides not to use the wording of law or regulation as incorporated in the engagement letter, the wording in paragraph 33(a) of this SA is used. In addition to including the description of management's responsibilities in the auditor's report as required by paragraph 33, the auditor may refer to a more detailed description of these responsibilities by including a reference to where such information may be obtained (e.g., in the annual report of the entity or a website of an appropriate authority).

A42. In some entities, law or regulation prescribing management's responsibilities may specifically refer to a responsibility for the adequacy of accounting books and records, or accounting system. As books, records and systems are an integral part of internal control (as defined in SA 315³⁰), the descriptions in SA 210 and in paragraph 33 do not make specific reference to them.

A43. The Appendix to this SA provides illustrations of how the requirement in paragraph 33(b) would be applied when Accounting Standards is the applicable financial reporting framework. If an applicable financial reporting framework other than Accounting Standards is used, the illustrative statements featured in the Appendix to this SA may need to be adapted to reflect the application of the other financial reporting framework in the circumstances.

Oversight of the financial reporting process (Ref: Para. 34)

A44. When some, but not all, of the individuals involved in the oversight of the financial reporting process are also involved in preparing the financial statements, the description as required by paragraph 34 of this SA may need to be modified to appropriately reflect the particular circumstances of the entity. When individuals responsible for the oversight of the financial reporting process are the same as those responsible for the preparation of the financial statements, no reference to oversight responsibilities is required.

Auditor's Responsibilities for the Audit of the Financial Statements (Ref: Para. 36–39)

A45. The description of the auditor's responsibilities as required by paragraphs 36–39 of this SA may be tailored to reflect the specific nature of the entity, for example, when the auditor's report addresses consolidated financial statements. Illustration 2 in the Appendix to this SA includes an example of how this may be done.

Objectives of the auditor (Ref: Para. 37(a))

A46. The auditor's report explains that the objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes the auditor's opinion. These are in contrast to management's responsibilities for the preparation for the financial statements.

Description of materiality (Ref: Para. 37(c))

A47. The Appendix to this SA provides illustrations of how the requirement in paragraph 37(c), to provide a description of materiality, would be applied when Accounting Standards is the applicable financial reporting framework. If an applicable financial reporting framework other than Accounting Standards 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.

Auditor's responsibilities relating to SA 701 (Ref: Para. 39(c))

A48. The auditor may also consider it useful to provide additional information in the description of the auditor's responsibilities beyond what is required by paragraph 39(c). For example, the auditor may make reference to the requirement in paragraph 9 of SA 701 to determine the matters that required significant auditor attention

³⁰ SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment, paragraph 4(c)

in performing the audit, taking into account areas of higher assessed risk of material misstatement or significant risks identified in accordance with SA 315 ; significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty; and the effects on the audit of significant events or transactions that occurred during the period.

Location of the description of the auditor's responsibilities for the audit of the financial statements (Ref: Para. 40, 48(j))

A49. Including the information required by paragraphs 38–39 of this SA in an appendix to the auditor's report or, when law, regulation or national auditing standards expressly permit, referring to a website of an appropriate authority containing such information may be a useful way of streamlining the content of the auditor's report. However, because the description of the auditor's responsibilities contains information that is necessary to inform users' expectations of an audit conducted in accordance with SAs, a reference is required to be included in the auditor's report indicating where such information can be accessed.

Location in an appendix (Ref: Para. 40(b), 48(j))

A50. Paragraph 40 permits the auditor to include the statements required by paragraphs 38–39 describing the auditor's responsibilities for the audit of the financial statements in an appendix to the auditor's report, provided that appropriate reference is made within the body of the auditor's report to the location of the appendix. The following is an illustration of how such a reference to an appendix could be made in the auditor's report:

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is included in appendix X of this auditor's report. This description, which is located at *[indicate page number or other specific reference to the location of the description]*, forms part of our auditor's report.

Reference to a website of an appropriate authority (Ref: Para. 40(c), 41)

A51. Paragraph 40 explains that the auditor may refer to a description of the auditor's responsibilities located on a website of an appropriate authority, only if expressly permitted by law, regulation or the applicable auditing standards. The information on the website that is incorporated in the auditor's report by way of a specific reference to the website location where such information can be found may describe the auditor's work, or the audit in accordance with SAs more broadly, but it cannot be inconsistent with the description required in paragraphs 38–39 of this SA. This means that the wording of the description of the auditor's responsibilities on the website may be more detailed, or may address other matters relating to an audit of financial statements, provided that such wording reflects and does not contradict the matters addressed in paragraphs 38–39.

A52. An appropriate authority could be a national auditing standard setter, regulator, or an audit oversight body. Such organizations are well-placed to ensure the accuracy, completeness and continued availability of the standardized information. It would not be appropriate for the auditor to maintain such a website. The following is an illustration of how such a reference to a website could be made in the auditor's report:

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from

material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located at [Organization's] website at: [website address]. This description forms part of our auditor's report.

Other Reporting Responsibilities (Ref: Para. 42–44)

A53. In case of some entities, the auditor may have additional responsibilities to report on other matters that are supplementary to the auditor's responsibilities under the SAs. For example, the auditor may be asked to report certain matters if they come to the auditor's attention during the course of the audit of the financial statements. Alternatively, the auditor may be asked to perform and report on additional specified procedures, or to express an opinion on specific matters, such as the adequacy of accounting books and records, internal control over financial reporting or other information. Standards on Auditing and/or other relevant pronouncements of the ICAI often provide guidance on the auditor's responsibilities with respect to specific additional reporting responsibilities.

A54. In some cases, the relevant law or regulation may require or permit the auditor to report on these other responsibilities as part of their auditor's report on the financial statements. In other cases, the auditor may be required or permitted to report on them in a separate report.

A55. Paragraphs 42–44 of this SA permit combined presentation of other reporting responsibilities and the auditor's responsibilities under the SAs only when they address the same topics and the wording of the auditor's report clearly differentiates the other reporting responsibilities from those under the SAs. Such clear differentiation may make it necessary for the auditor's report to refer to the source of the other reporting responsibilities and to state that such responsibilities are beyond those required under the SAs. Otherwise, other reporting responsibilities are required to be addressed in a separate section in the auditor's report with a heading "Report on Other Legal and Regulatory Requirements," or otherwise as appropriate to the content of the section. In such cases, paragraph 44 requires the auditor to include reporting responsibilities under the SAs under a heading titled "Report on the Audit of the Financial Statements."

Signature of the Auditor (Ref: Para 45)

A56. SQC 1³¹ requires that the firm establish policies and procedures to provide reasonable assurance that engagements are performed in accordance with professional standards and applicable legal and regulatory requirements. Notwithstanding these SQC 1 requirements, naming the engagement partner in the auditor's report is intended to provide further transparency to the users of the auditor's report of a complete set of general purpose financial statements of an entity.

A57. In some cases, law or regulation may allow for the use of electronic signatures in the auditor's report.

Date of the Auditor's Report (Ref: Para. 47)

A58. The date of the auditor's report informs the user of the auditor's report that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor's responsibility for events and transactions after the date of the auditor's report is addressed in SA 560.³²

A59. Since the auditor's opinion is provided on the financial statements and the financial statements are the

³¹ SQC 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*, paragraph 3

³² SA 560, *Subsequent Events*, paragraphs 10–17

responsibility of management, the auditor is not in a position to conclude that sufficient appropriate audit evidence has been obtained until evidence is obtained that all the statements that comprise the financial statements, including the related notes, have been prepared and management has accepted responsibility for them.

A60. In the case of some entities, the applicable law or regulation identifies the individuals or bodies (e.g., the directors) that are responsible for concluding that all the statements that comprise the financial statements, including the related notes, have been prepared, and specifies the necessary approval process. In such cases, evidence is obtained of that approval before dating the report on the financial statements. In case of some entities, however, the approval process may not be prescribed in the applicable law or regulation. In such cases, the procedures the entity follows in preparing and finalizing its financial statements in view of its management and governance structures are considered in order to identify the individuals or body with the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared. In some cases, law or regulation identifies the point in the financial statement reporting process at which the audit is expected to be complete.

A61. In the case of some entities, the Final approval of the financial statements by shareholders is required before the financial statements are issued publicly. Final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence has been obtained. The date of approval of the financial statements for purposes of SAs is the earlier date on which those with the recognized authority determine that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.

Auditor's Report Prescribed by Law or Regulation (Ref: Para 48)

A62. SA 200 explains that the auditor may be required to comply with legal or regulatory requirements in addition to SAs.³³ When the differences between the legal or regulatory requirements and SAs relate only to the layout and wording of the auditor's report, the requirements in paragraph 48(a)–(m) set out the minimum elements to be included in the auditor's report to enable a reference to the Standards on Auditing. In those circumstances, the requirements in paragraphs 21–47 that are not included in paragraph 48(a)–(n) do not need to be applied including, for example, the required ordering of the Opinion and Basis for Opinion sections.

A63. Where specific requirements in a particular law or regulation do not conflict with SAs, the layout and wording required by paragraphs 21–47 of this SA assist users of the auditor's report in more readily recognizing the auditor's report as a report of an audit conducted in accordance with SAs.

Information Required by SA 701 (Ref: Para. 48(h))

A64. Law or regulation may require the auditor to provide additional information about the audit that was performed, which may include information that is consistent with the objectives of SA 701, or may prescribe the nature and extent of communication about such matters.

A65. The SAs do not override law or regulation that governs an audit of financial statements. When SA 701 is applicable, reference can only be made to SAs in the auditor's report if, in applying the law or regulation, the section required by paragraph 48(h) of this SA is not inconsistent with the reporting requirements in SA 701. In such circumstances, the auditor may need to tailor certain aspects of the communication of key audit matters in the auditor's report required by SA 701, for example by:

- Modifying the heading "Key Audit Matters", if law or regulation prescribes a specific heading;
- Explaining why the information required by law or regulation is being provided in the auditor's report, for example by making a reference to the relevant law or regulation and describing how that information relates to the key audit matters;

³³ SA 200, paragraph A55

- Where law or regulation prescribes the nature and extent of the description, supplementing the prescribed information to achieve an overall description of each key audit matter that is consistent with the requirement in paragraph 13 of SA 701.

A66. SA 210 deals with circumstances where law or regulation applicable to the entity prescribes the layout or wording of the auditor's report in terms that are significantly different from the requirements of SAs, which in particular includes the auditor's opinion. In these circumstances, SA 210 requires the auditor to evaluate:

- (a) Whether users might misunderstand the assurance obtained from the audit of the financial statements and, if so,
- (b) Whether additional explanation in the auditor's report can mitigate possible misunderstanding.

If the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, SA 210 requires the auditor not to accept the audit engagement, unless required by law or regulation to do so. In accordance with SA 210, an audit conducted in accordance with such law or regulation does not comply with SAs. Accordingly, the auditor does not include any reference in the auditor's report to the audit having been conducted in accordance with Standards on Auditing.³⁴

Considerations specific to public sector entities

A67. Auditors of public sector entities may also have the ability pursuant to law or regulation to report publicly on certain matters, either in the auditor's report or in a supplementary report, which may include information that is consistent with the objectives of SA 701. In such circumstances, the auditor may need to tailor certain aspects of the communication of key audit matters in the auditor's report required by SA 701 or include a reference in the auditor's report to a description of the matter in the supplementary report.

Auditor's Report for Audits Conducted in Accordance with Both Standards on Auditing issued by ICAI and International Standards on Auditing/ Auditing Standards of Another Jurisdiction (Ref: Para. 49)

A68. The auditor may refer in the auditor's report to the audit having been conducted in accordance with both the Standards on Auditing issued by ICAI as well as the International Standards on Auditing/auditing standards of another jurisdiction when, in addition to complying with the ISAs/ auditing standards of such other jurisdiction, the auditor complies with each of the SAs relevant to the audit.

A69. A reference to both Standards on Auditing issued by ICAI and the International Standards on Auditing/auditing standards of another jurisdiction is not appropriate if there is a conflict between the requirements in SAs and those ISAs/ auditing standards of such other jurisdiction that would lead the auditor to form a different opinion or not to include an Emphasis of Matter or Other Matter paragraph that, in the particular circumstances, is required by SAs. In such a case, the auditor's report refers only to the auditing standards (either Standards on Auditing issued by ICAI or ISAs/the auditing standards of such other jurisdiction) in accordance with which the auditor's report has been prepared.

Supplementary Information Presented with the Financial Statements (Ref: Para. 51-52)

A70. In some circumstances, the entity may be required by law, regulation or standards, or may voluntarily choose, to present together with the financial statements supplementary information that is not required by the applicable financial reporting framework. For example, supplementary information might be presented to enhance a user's understanding of the applicable financial reporting framework or to provide further explanation of specific financial statement items. Such information is normally presented in either supplementary schedules or as additional notes.

A71. Paragraph 51 of this SA explains that the auditor's opinion covers supplementary information that is an integral part of the financial statements because of its nature or how it is presented. This evaluation is a matter

³⁴ SA 210, paragraph 21

of professional judgment. To illustrate:

- When the notes to the financial statements include an explanation or the reconciliation of the extent to which the financial statements comply with another financial reporting framework, the auditor may consider this to be supplementary information that cannot be clearly differentiated from the financial statements. The auditor's opinion would also cover notes or supplementary schedules that are cross-referenced from the financial statements.
- When an additional profit and loss account that discloses specific items of expenditure is disclosed as a separate schedule included as an Appendix to the financial statements, the auditor may consider this to be supplementary information that can be clearly differentiated from the financial statements.

A72. Supplementary information that is covered by the auditor's opinion does not need to be specifically referred to in the auditor's report when the reference to the notes in the description of the statements that comprise the financial statements in the auditor's report is sufficient.

A73. Law or regulation may not require that the supplementary information be audited, and management may decide to ask the auditor not to include the supplementary information within the scope of the audit of the financial statements.

A74. The auditor's evaluation whether unaudited supplementary information is presented in a manner that could be construed as being covered by the auditor's opinion includes, for example, where that information is presented in relation to the financial statements and any audited supplementary information, and whether it is clearly labeled as "unaudited."

A75. Management could change the presentation of unaudited supplementary information that could be construed as being covered by the auditor's opinion, for example, by:

- Removing any cross-references from the financial statements to unaudited supplementary schedules or unaudited notes so that the demarcation between the audited and unaudited information is sufficiently clear.
- Placing the unaudited supplementary information outside of the financial statements or, if that is not possible in the circumstances, at a minimum placing the unaudited notes together at the end of the required notes to the financial statements and clearly labeling them as unaudited. Unaudited notes that are intermingled with the audited notes can be misinterpreted as being audited.

A76. The fact that supplementary information is unaudited does not relieve the auditor of the responsibilities described in Proposed SA 720 (Revised).³⁵

³⁵ Proposed SA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

Appendix
(Ref: Para. A14)**Illustrations of Independent Auditor's Reports on Financial Statements**

- Illustration 1: An auditor's report on financial statements of a listed entity prepared in accordance with a fair presentation framework
- Illustration 2: An auditor's report on consolidated financial statements of a listed company prepared in accordance with a fair presentation framework
- Illustration 3 – Auditor's Report on Financial Statements of an Unlisted Company Prepared in Accordance with a Fair Presentation Framework
- Illustration 4 – Auditor's Report on Financial Statements of a Non Corporate Entity Prepared in Accordance with a Fair Presentation Framework
- Illustration 5 – Auditor's Report on Financial Statements of Non Corporate Entity Prepared in Accordance with a General Purpose Compliance Framework

Illustration 1 – Auditor's Report on Financial Statements of a Listed Entity Prepared in Accordance with a Fair Presentation Framework

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 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 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 comprise the Code of Ethics issued by ICAI together with the other relevant ethical requirements relating to the audit and the auditor refers to both.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- 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 Statements¹

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*)² 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)]³.

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 generally accepted in India, of the state of affairs of the Company as at March 31, 20XX, and profit/loss, (*changes in equity*)⁴ 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.

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.

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

Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (*changes in equity*)⁵ and cash flows of the

¹ 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.

² Where applicable.

³ Where applicable.

⁴ Where applicable

⁵ Where applicable.

Company in accordance with⁶ the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate implementation and maintenance of accounting policies; making judgments and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those Board of Directors are also responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 40(b) of this SA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or applicable auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with SAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances. Under section 143(3)(i) of the Companies Act, 2013, we are also responsible for expressing our opinion on whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and,

⁶ Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ..."

based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Other Matter

We did not audit the financial statements/ information of (number) branches included in the stand alone financial statements of the Company whose financial statements/financial information reflect total assets of Rs. as at 31st March 20XX and the total revenue of Rs. for the year ended on that date, as considered in the standalone financial statements/information of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of branches, is based solely on the report of such branch auditors.

Our opinion is not modified in respect of these matters.

Report on Other Legal and Regulatory Requirements

As required by the Companies (Auditor's Report) Order, 2016 ("the Order"), issued by the Central Government of India in terms of sub-section (11) of section 143 of the Companies Act, 2013, we give in the Annexure a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.

As required by Section 143(3) of the Act, we report that:

- We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.
- In our opinion, proper books of account as required by law have been kept by the Company so far as it appears from our examination of those books *[and proper returns adequate for the purposes of our audit have been received from the branches not visited by us.]*⁷

⁷ Where applicable.

- (c) *[The reports on the accounts of the branch offices of the Company audited under Section 143(8) of the Act by branch auditors have been sent to us and have been properly dealt with by us in preparing this report⁸.]*
- (d) The Balance Sheet, the Statement of Profit and Loss, and the Cash Flow Statement dealt with by this Report are in agreement with the books of account *[and with the returns received from the branches not visited by us⁹].*
- (e) In our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014.
- (f) On the basis of the written representations received from the directors as on 31st March, 20XX taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164 (2) of the Act.
- (g) With respect to the adequacy of the internal financial controls over financial reporting of the Company and the operating effectiveness of such controls, refer to our separate Report in "Annexure A".
- (h) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:
- i. The Company has disclosed the impact of pending litigations on its financial position in its financial statements – Refer Note XX to the financial statements; *[or the Company does not have any pending litigations which would impact its financial position¹⁰]*
 - ii. The Company has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts – Refer Note XX to the financial statements; *[or the Company did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.¹¹]*
 - iii. There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company *{or, following are the instances of delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Company¹²}.*

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

⁸ Where applicable.

⁹ Where applicable.

¹⁰ As may be applicable.

¹¹ As may be applicable.

¹² As may be applicable.

Signature

(Name of the Member Signing the Audit Report)

(Designation¹³)(Membership No.
XXXXX)

Place of Signature:

Date:

Illustration 2 – Auditor's Report on Consolidated Financial Statements of a Listed Company (incorporated under the Companies Act, 2013) Prepared in Accordance with a Fair Presentation Framework

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

- Audit of a complete set of consolidated financial statements of a listed Company (incorporated under the Companies Act, 2013) using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., SA 600 applies).
- The consolidated financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in SA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The Code of Ethics issued by ICAI comprises all of the relevant ethical requirements that apply to the principal auditor in relation to this audit.
- Based on the audit evidence obtained, the principal auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated financial statements, the principal 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 Consolidated Financial Statements¹⁴**Opinion**

We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter

¹³ Partner or Proprietor, as the case may be

¹⁴ The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

referred to as the ‘Holding Company’) and its subsidiaries (Holding Company and its subsidiaries together referred to as “the Group”), its associates and jointly controlled entities, which comprise the consolidated Balance Sheet as at March 31, 20XX, and the consolidated statement of Profit and Loss, (*the consolidated statement of changes in equity*)¹⁵ and the consolidated cash flows Statement for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as “the consolidated financial statements”).

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid consolidated 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 their consolidated state of affairs of the Company as at March 31, 20XX, of consolidated profit/loss, (*consolidated changes in equity*)¹⁶ and its consolidated cash flows for the year then ended.

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 Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the *Code of Ethics issued by ICAI*, and we have fulfilled our other ethical responsibilities in accordance with the provisions of the Companies Act, 2013. 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 consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

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

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

The Holding Company’s Board of Directors is responsible for the preparation and presentation of these consolidated financial statements in term of the requirements of the Companies Act, 2013 that give a true and fair view of the consolidated financial position, consolidated financial performance and consolidated cash flows of the Group including its Associates and Jointly controlled entities in accordance with the accounting principles generally accepted in India, including the Accounting Standards specified under section 133 of the Act. The respective Board of Directors of the companies included in the Group and of its associates and jointly controlled entities are responsible for maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding the assets of the Group and for preventing and detecting frauds and other irregularities; the selection and application of appropriate accounting policies; making judgments and estimates that are reasonable and prudent; and the design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error, which have been used for the purpose of preparation of the consolidated financial statements by the Directors of the Holding Company, as aforesaid.

In preparing the consolidated financial statements, the respective Board of Directors of the companies included

¹⁵ Where applicable.

¹⁶ Where applicable.

in the Group and of its associates and jointly controlled entities are responsible for assessing the ability of the Group and of its associates and jointly controlled entities to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

The respective Board of Directors of the companies included in the Group and of its associates and jointly controlled entities are responsible for overseeing the financial reporting process of the Group and of its associates and jointly controlled entities.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

Paragraph 40(b) of this SA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or the applicable auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with SAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances. Under section 143(3)(i) of the Companies Act, 2013, we are also responsible for expressing our opinion on whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the ability of the Group and its associates and jointly controlled entities to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group and its associates and jointly controlled entities to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group and its associates and jointly controlled entities to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the audit of the financial statements of such entities included in the consolidated financial statements of which we are the independent auditors. For the other entities included in the consolidated financial statements, which have been audited by other auditors, such other auditors remain responsible for the direction, supervision and performance of the audits carried out by them. We remain solely responsible for our audit opinion.

We communicate with those charged with governance of the Holding Company and such other entities included in the consolidated financial statements of which we are the independent auditors regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Other Matters

- (a) We did not audit the financial statements / financial information of _____ subsidiaries, and _____ jointly controlled entities, whose financial statements / financial information reflect total assets of Rs. _____ as at 31st March, 20XX, total revenues of Rs. _____ and net cash flows amounting to Rs. _____ for the year ended on that date, as considered in the consolidated financial statements. The consolidated financial statements also include the Group's share of net profit/loss of Rs. _____ for the year ended 31st March, 20XX, as considered in the consolidated financial statements, in respect of _____ associates, whose financial statements / financial information have not been audited by us. These financial statements / financial information have been audited by other auditors whose reports have been furnished to us by the Management and our opinion on the consolidated financial statements, in so far as it relates to the amounts and disclosures included in respect of these subsidiaries, jointly controlled entities and associates, and our report in terms of sub-sections (3) and (11) of Section 143 of the Act, in so far as it relates to the aforesaid subsidiaries, jointly controlled entities and associates, is based solely on the reports of the other auditors.
- (b) We did not audit the financial statements / financial information of _____ subsidiaries and _____ jointly controlled entities, whose financial statements / financial information reflect total assets of Rs. _____ as at 31st March, 20XX, total revenues of Rs. _____ and net cash flows amounting to Rs. _____ for the year ended on that date, as considered in the consolidated financial statements. The consolidated financial statements also include the Group's share of net profit/loss of Rs. _____ for the year ended 31st March, 20XX, as considered in the consolidated financial statements, in respect of _____ associates, whose financial statements / financial information have not been audited by us. These financial statements /

financial information are unaudited and have been furnished to us by the Management and our opinion on the consolidated financial statements, in so far as it relates to the amounts and disclosures included in respect of these subsidiaries, jointly controlled entities and associates, and our report in terms of sub-sections (3) and (11) of Section 143 of the Act in so far as it relates to the aforesaid subsidiaries, jointly controlled entities and associates, is based solely on such unaudited financial statements / financial information. In our opinion and according to the information and explanations given to us by the Management, these financial statements / financial information are not material to the Group.

Our opinion on the consolidated financial statements, and our report on Other Legal and Regulatory Requirements below, is not modified in respect of the above matters with respect to our reliance on the work done and the reports of the other auditors and the financial statements / financial information certified by the Management.

Report on Other Legal and Regulatory Requirements

As required by Section 143(3) of the Act, we report, to the extent applicable, that:

- (a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit of the aforesaid consolidated financial statements.
- (b) In our opinion, proper books of account as required by law relating to preparation of the aforesaid consolidated financial statements have been kept so far as it appears from our examination of those books and the reports of the other auditors.
- (c) The Consolidated Balance Sheet, the Consolidated Statement of Profit and Loss, and the Consolidated Cash Flow Statement dealt with by this Report are in agreement with the relevant books of account maintained for the purpose of preparation of the consolidated financial statements.
- (d) In our opinion, the aforesaid consolidated financial statements comply with the Accounting Standards specified under Section 133 of the Act.
- (e) On the basis of the written representations received from the directors of the Holding Company as on 31st March, 20XX taken on record by the Board of Directors of the Holding Company and the reports of the statutory auditors of its subsidiary companies, associate companies and jointly controlled companies incorporated in India, none of the directors of the Group companies, its associate companies and jointly controlled companies incorporated in India is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164 (2) of the Act.
- (f) With respect to the adequacy of internal financial controls over financial reporting of the Group and the operating effectiveness of such controls, refer to our separate report in Annexure.
- (g) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditor's) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:
 - i. The consolidated financial statements disclose the impact of pending litigations on the consolidated financial position of the Group, its associates and jointly controlled entities– Refer Note XX to the consolidated financial statements.

Or

There were no pending litigations which would impact the consolidated financial position of the Group, its associates and jointly controlled entities.¹⁷

¹⁷ Where applicable.

- ii. Provision has been made in the consolidated financial statements, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts – Refer (a) Note XX to the consolidated financial statements in respect of such items as it relates to the Group, its associates and jointly controlled entities and (b) the Group's share of net profit/loss in respect of its associates.

Or

The Group, its associates and jointly controlled entities did not have any material foreseeable losses on long-term contracts including derivative contracts.¹⁸

- iii. There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Holding Company and its subsidiary companies, associate companies and jointly controlled companies incorporated in India.

Or

Following are the instances of delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Holding Company, and its subsidiary companies, associate companies and jointly controlled companies incorporated in India¹⁹.

Or

There were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Holding Company, and its subsidiary companies, associate companies and jointly controlled companies incorporated in India²⁰.

Place of Signature:

For XYZ & Co

Date:

Chartered Accountants
(Firm's Registration No.)

Signature

(Name of the Member Signing the Audit Report)

(Designation²¹)

(Membership No. XXXX)

Illustration 3 – Auditor's Report on Financial Statements of an Unlisted Company Prepared in Accordance with a Fair Presentation Framework

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

- Audit of a complete set of financial statements of an unlisted 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 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

¹⁸ Where applicable.

¹⁹ Where applicable.

²⁰ Where applicable.

²¹ Partner or Proprietor

statements in SA 210.

- 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 comprise the Code of Ethics issued by ICAI together with the other relevant ethical requirements relating to the audit and the auditor refers to both.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with SA 570 (Revised).
- 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 the Companies Act, 2013.

INDEPENDENT AUDITOR’S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements²²

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*)²³ 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)]²⁴.

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 generally accepted in India, of the state of affairs of the Company as at March 31, 20XX, and profit/loss, (*changes in equity*)²⁵ 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

²² 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.

²³ Where applicable.

²⁴ Where applicable.

²⁵ Where applicable

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.

Responsibility of Management for Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (changes in equity)²⁶ and cash flows of the Company in accordance with the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate implementation and maintenance of accounting policies; making judgments and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those Board of Directors are also responsible for overseeing the company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 40(b) of this SA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or the applicable auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with SAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances. Under section 143(3)(i) of the Companies Act, 2013, we are also

²⁶ Where applicable.

responsible for expressing our opinion on whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

Other Matter

We did not audit the financial statements/ information of (number) branches included in the standalone financial statements of the company whose financial statements/financial information reflect total assets of Rs. as at 31st March 20XX and the total revenue of Rs. for the year ended on that date, as considered in the standalone financial statements/information of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of branches, is based solely on the report of such branch auditors.

Our opinion is not modified in respect of these matters.

Report on Other Legal and Regulatory Requirements

As required by the Companies (Auditor's Report) Order, 2016 ("the Order"), issued by the Central Government of India in terms of sub-section (11) of section 143 of the Companies Act, 2013, we give in the Annexure a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.

As required by Section 143(3) of the Act, we report that:

We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.

- (a) In our opinion, proper books of account as required by law have been kept by the Company so far as it appears from our examination of those books *[and proper returns adequate for the purposes of our audit have been received from the branches not visited by us.²⁷]*

²⁷ Where applicable.

- (b) *[The reports on the accounts of the branch offices of the Company audited under Section 143(8) of the Act by branch auditors have been sent to us and have been properly dealt with by us in preparing this report²⁸.]*
- (c) The Balance Sheet, the Statement of Profit and Loss, and the Cash Flow Statement dealt with by this Report are in agreement with the books of account *[and with the returns received from the branches not visited by us²⁹]*.
- (d) In our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014.
- (e) On the basis of the written representations received from the directors as on 31st March, 20XX taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164 (2) of the Act.
- (f) With respect to the adequacy of the internal financial controls over financial reporting of the Company and the operating effectiveness of such controls, refer to our separate Report in “Annexure A”.
- (g) With respect to the other matters to be included in the Auditor’s Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:
- i. The Company has disclosed the impact of pending litigations on its financial position in its financial statements – Refer Note XX to the financial statements; *[or the Company does not have any pending litigations which would impact its financial position³⁰]*
 - ii. The Company has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts – Refer Note XX to the financial statements; *[or the Company did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.³¹]*
 - iii. There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company {or, following are the instances of delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Company³²}.}

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

Signature
(Name of the Member Signing the Audit Report)

²⁸ Where applicable.

²⁹ Where applicable.

³⁰ As may be applicable.

³¹ As may be applicable.

³² As may be applicable.

(Designation³³)
(Membership No. XXXXX)

Place of Signature:

Date:

Illustration 4 – Auditor's Report on Financial Statements of a Non Corporate Entity Prepared in Accordance with a Fair Presentation Framework

For purposes of this 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 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 the Code of Ethics issued by ICAI³⁴.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- 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.
- The auditor has no other reporting responsibilities required under local law.
- The auditor elects to refer to the description of the auditor's responsibility included on a website of an appropriate authority.

INDEPENDENT AUDITOR'S REPORT

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

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)*³⁵ for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements give a true and fair view of the financial position of the

³³ Partner or Proprietor, as the case may be

³⁴ Specify any applicable ethical requirements under the relevant laws or regulations applicable to the entity.

³⁵ Where applicable.

entity as at March 31, 20XX, and of its financial performance (*and its cash flows*)³⁶ for the year then ended in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI).

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 Statements³⁷

Management is responsible for the preparation and fair presentation of the financial statements in accordance with the aforesaid Accounting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the entity's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and 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.

Those charged with governance are responsible for overseeing the entity's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of the auditor's responsibilities for the audit of the financial statements is located at [Organization's] website at: [website link]. This description forms part of our auditor's report.

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

Signature
(Name of the Member Signing the Audit Report)

³⁶ Where applicable

³⁷ Or other terms that are appropriate in the context of the legal framework of the particular entity.

(Designation³⁸)
(Membership No. XXXXX)

Place of Signature:

Date:

Illustration 5 – Auditor’s Report on Financial Statements of Non Corporate Entity Prepared in Accordance with a General Purpose Compliance Framework

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

- Audit of a complete set of financial statements of an entity, other than a listed company under the Companies Act 2013, required by law or regulation. 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 Financial Reporting Framework (XYZ Laws) of Jurisdiction X (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in SA 210.
- 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 does not exist related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern in accordance with SA 570 (Revised).
- 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.
- The auditor has no other reporting responsibilities required under local law.

INDEPENDENT AUDITOR’S REPORT

[Appropriate Addressee]

Opinion

We have audited the financial statements of ABC & Associates (the entity), which comprise the balance sheet as at March 31, 20X1, and the Profit and Loss Account (*and the cash flow statement*)³⁹ for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements of the entity are prepared, in all material respects, in accordance with XYZ Laws.

Basis for Opinion

³⁸ Partner or Proprietor, as the case may be

³⁹ Where applicable.

We conducted our audit in accordance with Standards on Auditing (SAs). 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, and we have fulfilled our other 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 Statements⁴⁰

Management is responsible for the preparation of the financial statements in accordance with XYZ Law and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the entity's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and 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.

Those charged with governance are responsible for overseeing the entity's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 40(b) of this SA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with SAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.⁴¹

Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

⁴⁰ Or other terms that are appropriate in the context of the legal framework of the particular entity.

⁴¹ This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and, 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. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the entity to cease to continue as a going concern.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

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

Signature
(Name of the Member Signing the Audit Report)
(Designation⁴²)
(Membership No. XXXXX)

Place of Signature:

Date:

⁴² Partner or Proprietor, as the case may be

SA 701

Communicating Key Audit Matters in the Independent Auditor's Report

(Effective for all audits relating to accounting periods beginning on or after April 1, 2017)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate key audit matters in the auditor's report. It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication.
2. The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements ("intended users") to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements. (Ref: Para. A1–A4)
3. The communication of key audit matters in the auditor's report may also provide intended users a basis to further engage with management and those charged with governance about certain matters relating to the entity, the audited financial statements, or the audit that was performed.
4. Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:
 - (a) A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
 - (b) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);¹
 - (c) A substitute for reporting in accordance with SA 570 (Revised)² when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
 - (d) A separate opinion on individual matters. (Ref: Para. A5–A8)
5. This SA applies to audits of complete sets of general purpose financial statements of listed entities and circumstances when the auditor otherwise decides to communicate key audit matters in the auditor's report. This SA also applies when the auditor is required by law or regulation to communicate key audit matters in the auditor's report.³ However, SA 705 (Revised) prohibits the auditor from communicating key audit matters when

¹ SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*.

² SA 570 (Revised), *Going Concern*, paragraphs 22–23.

³ SA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraphs 30–31.

the auditor disclaims an opinion on the financial statements, unless such reporting is required by law or regulation.⁴

Effective Date

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

Objectives

7. The objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.

Definition

8. For purposes of the SAs, the following term has the meaning attributed below:

Key audit matters— Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

Requirements

Determining Key Audit Matters

9. The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following: (Ref: Para. A9–A18)

- (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.⁵ (Ref: Para. A19–A22)
- (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty. (Ref: Para. A23–A24)
- (c) The effect on the audit of significant events or transactions that occurred during the period. (Ref: Para. A25–A26)

10. The auditor shall determine which of the matters determined in accordance with paragraph 9 were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters. (Ref: Para. A9–A11, A27–A30)

Communicating Key Audit Matters

11. The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters," unless the circumstances in paragraphs 14 or 15 apply. The introductory language in this section of the auditor's report shall state that:

- (a) Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements [of the current period]; and
- (b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters. (Ref: Para. A31–A33)

Key Audit Matters Not a Substitute for Expressing a Modified Opinion

⁴ SA 705 (Revised), paragraph 29.

⁵ SA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.

12. The auditor shall not communicate a matter in the Key Audit Matters section of the auditor's report when the auditor would be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter. (Ref: Para. A5)

Descriptions of Individual Key Audit Matters

13. The description of each key audit matter in the Key Audit Matters section of the auditor's report shall include a reference to the related disclosure(s), if any, in the financial statements and shall address: (Ref: Para. A34–A41)

- (a) Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter; and (Ref: Para. A42–A45)
- (b) How the matter was addressed in the audit. (Ref: Para. A46–A51)

Circumstances in Which a Matter Determined to Be a Key Audit Matter Is Not Communicated in the Auditor's Report

14. The auditor shall describe each key audit matter in the auditor's report unless: (Ref: Para. A53– A56)

- (a) Law or regulation precludes public disclosure about the matter; or (Ref: Para. A52)
- (b) In extremely rare circumstances, the auditor determines that the matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication. This shall not apply if the entity has publicly disclosed information about the matter.

Interaction between Descriptions of Key Audit Matters and Other Elements Required to Be Included in the Auditor's Report

15. A matter giving rise to a modified opinion in accordance with SA 705 (Revised), or a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised), are by their nature key audit matters. However, in such circumstances, these matters shall not be described in the Key Audit Matters section of the auditor's report and the requirements in paragraphs 13–14 do not apply. Rather, the auditor shall:

- (a) Report on these matter(s) in accordance with the applicable SA(s); and
- (b) Include a reference to the Basis for Qualified (Adverse) Opinion or the Material Uncertainty Related to Going Concern section(s) in the Key Audit Matters section. (Ref: Para. A6–A7)

Form and Content of the Key Audit Matters Section in Other Circumstances

16. If the auditor determines, depending on the facts and circumstances of the entity and the audit, that there are no key audit matters to communicate or that the only key audit matters communicated are those matters addressed by paragraph 15, the auditor shall include a statement to this effect in a separate section of the auditor's report under the heading "Key Audit Matters." (Ref: Para. A57– A59)

Communication with Those Charged with Governance

17. The auditor shall communicate with those charged with governance:

- (a) Those matters the auditor has determined to be the key audit matters; or
- (b) If applicable, depending on the facts and circumstances of the entity and the audit, the auditor's determination that there are no key audit matters to communicate in the auditor's report. (Ref: Para. A60–A63)

Documentation

18. The auditor shall include in the audit documentation:⁶ (Ref: Para. A64)
- (a) The matters that required significant auditor attention as determined in accordance with paragraph 9, and the rationale for the auditor's determination as to whether or not each of these matters is a key audit matter in accordance with paragraph 10;
 - (b) Where applicable, the rationale for the auditor's determination that there are no key audit matters to communicate in the auditor's report or that the only key audit matters to communicate are those matters addressed by paragraph 15; and
 - (c) Where applicable, the rationale for the auditor's determination not to communicate in the auditor's report a matter determined to be a key audit matter.

Application and Other Explanatory Material

Scope of this SA (Ref: Para. 2)

A1. Significance can be described as the relative importance of a matter, taken in context. The significance of a matter is judged by the auditor in the context in which it is being considered. Significance can be considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and effect on the subject matter and the expressed interests of intended users or recipients. This involves an objective analysis of the facts and circumstances, including the nature and extent of communication with those charged with governance.

A2. Users of financial statements have expressed an interest in those matters about which the auditor had the most robust dialogue with those charged with governance as part of the two-way communication required by SA 260 (Revised)⁷ and have called for additional transparency about those communications. For example, users have expressed particular interest in understanding significant judgments made by the auditor in forming the opinion on the financial statements as a whole, because they are often related to the areas of significant management judgment in preparing the financial statements.

A3. Requiring auditors to communicate key audit matters in the auditor's report may also enhance communications between the auditor and those charged with governance about those matters, and may increase attention by management and those charged with governance to the disclosures in the financial statements to which reference is made in the auditor's report.

A4. SA 320⁸ explains that it is reasonable for the auditor to assume that users of the financial statements:

- (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 the 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.

Because the auditor's report accompanies the audited financial statements, the users of the auditor's report are considered to be the same as the intended users of the financial statements.

Relationship between Key Audit Matters, the Auditor's Opinion and Other Elements of the Auditor's Report (Ref: Para. 4, 12, 15)

⁶ SA 230, *Audit Documentation*, paragraphs 8–11 and A6.

⁷ SA 260 (Revised), *Communication with Those Charged with Governance*.

⁸ SA 320, *Materiality in Planning and Performing the Audit*, paragraph 4.

A5. SA 700 (Revised) establishes requirements and provides guidance on forming an opinion on the financial statements.⁹ Communicating key audit matters is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation. SA 705 (Revised) addresses circumstances in which the auditor concludes that there is a material misstatement relating to the appropriateness or adequacy of disclosures in the financial statements.¹⁰

A6. When the auditor expresses a qualified or adverse opinion in accordance with SA 705 (Revised), presenting the description of a matter giving rise to a modified opinion in the Basis for Qualified (Adverse) Opinion section helps to promote intended users' understanding and to identify such circumstances when they occur. Separating the communication of this matter from other key audit matters described in the Key Audit Matters section, therefore, gives it the appropriate prominence in the auditor's report (see paragraph 15). The Appendix in SA 705 (Revised) includes illustrative examples of how the introductory language in the Key Audit Matters section is affected when the auditor expresses a qualified or adverse opinion and other key audit matters are communicated in the auditor's report. Paragraph A58 of this SA illustrates how the Key Audit Matters section is presented when the auditor has determined that there are no other key audit matters to be communicated in the auditor's report beyond matters addressed in the Basis for Qualified (Adverse) Opinion section or Material Uncertainty Related to Going Concern section of the auditor's report.

A7. When the auditor expresses a qualified or adverse opinion, communicating other key audit matters would still be relevant to enhancing intended users' understanding of the audit, and therefore the requirements to determine key audit matters apply. However, as an adverse opinion is expressed in circumstances when the auditor has concluded that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements:¹¹

- Depending on the significance of the matter(s) giving rise to an adverse opinion, the auditor may determine that no other matters are key audit matters. In such circumstances, the requirement in paragraph 15 applies (see paragraph A58).
- If one or more matters other than the matter(s) giving rise to an adverse opinion are determined to be key audit matters, it is particularly important that the descriptions of such other key audit matters do not imply that the financial statements as a whole are more credible in relation to those matters than would be appropriate in the circumstances, in view of the adverse opinion (see paragraph A47).

A8. SA 706 (Revised)¹² establishes mechanisms for auditors of financial statements of all entities to include additional communication in the auditor's report through the use of Emphasis of Matter paragraphs and Other Matter paragraphs when the auditor considers it necessary to do so. In such cases, these paragraphs are presented separately from the Key Audit Matters section in the auditor's report. When a matter has been determined to be a key audit matter, the use of such paragraphs is not a substitute for the description of the individual key audit matter in accordance with paragraph 13¹³. SA 706 (Revised) provides further guidance on the relationship between key audit matters and Emphasis of Matter paragraphs in accordance with that SA.¹⁴

Determining Key Audit Matters (Ref: Para. 9–10)

A9. The auditor's decision-making process in determining key audit matters is designed to select a smaller

⁹ SA 700(Revised), paragraphs 10–15 and A1–A10.

¹⁰ See paragraph A7 of SA 705 (Revised).

¹¹ SA 705(Revised), paragraph 8.

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

¹³ See paragraphs 8(b) and 10(b) of SA 706 (Revised).

¹⁴ SA 706 (Revised), paragraphs A1–A3.

number of matters from the matters communicated with those charged with governance, based on the auditor's judgment about which matters were of most significance in the audit of the financial statements of the current period.

A10. The auditor's determination of key audit matters is limited to those matters of most significance in the audit of the financial statements of the current period, even when comparative financial statements are presented (i.e., even when the auditor's opinion refers to each period for which financial statements are presented).¹⁵

A11. Notwithstanding that the auditor's determination of key audit matters is for the audit of the financial statements of the current period and this SA does not require the auditor to update key audit matters included in the prior period's auditor's report, it may nevertheless be useful for the auditor to consider whether a matter that was a key audit matter in the audit of the financial statements of the prior period continues to be a key audit matter in the audit of the financial statements of the current period.

Matters that Required Significant Auditor Attention (Ref: Para. 9)

A12. The concept of significant auditor attention recognizes that an audit is risk-based and focuses on identifying and assessing the risks of material misstatement of the financial statements, designing and performing audit procedures responsive to those risks, and obtaining audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. For a particular account balance, class of transactions 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 designing further audit procedures, the auditor is required to obtain more persuasive audit evidence the higher the auditor's assessment of risk.¹⁶ When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, for example, by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.¹⁷

A13. Accordingly, matters that pose challenges to the auditor in obtaining sufficient appropriate audit evidence or pose challenges to the auditor in forming an opinion on the financial statements may be particularly relevant in the auditor's determination of key audit matters.

A14. Areas of significant auditor attention often relate to areas of complexity and significant management judgment in the financial statements, and therefore often involve difficult or complex auditor judgments. In turn, this often affects the auditor's overall audit strategy, the allocation of resources and extent of audit effort in relation to such matters. These effects may include, for example, the extent of involvement of senior personnel on the audit engagement or the involvement of an auditor's expert or individuals with expertise in a specialized area of accounting or auditing, whether engaged or employed by the firm to address these areas.

A15. Various SAs require specific communications with those charged with governance and others that may relate to areas of significant auditor attention. For example:

- SA 260 (Revised) requires the auditor to communicate significant difficulties, if any, encountered during the audit with those charged with governance.¹⁸ The SAs acknowledge potential difficulties in relation to, for example:

¹⁵ See SA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements*.

¹⁶ SA 330, *The Auditor's Responses to Assessed Risks*, paragraph 7(b).

¹⁷ SA 330, paragraph A19.

¹⁸ SA 260 (Revised), paragraphs 16(b) and A21.

- Related party transactions¹⁹, in particular limitations on the auditor's ability to obtain audit evidence that all other aspects of a related party transaction (other than price) are equivalent to those of a similar arm's length transaction.
- Limitations on the group audit, for example, where the group engagement team's access to information may have been restricted.²⁰
- SA 220 establishes requirements for the engagement partner in relation to undertaking appropriate consultation on difficult or contentious matters.²¹ For example, the auditor may have consulted with others within the firm or outside the firm on a significant technical matter, which may be an indicator that it is a key audit matter. The engagement partner is also required to discuss, among other things, significant matters arising during the audit engagement with the engagement quality control reviewer.²²

Considerations in Determining Those Matters that Required Significant Auditor Attention (Ref: Para. 9)

A16. The auditor may develop a preliminary view at the planning stage about matters that are likely to be areas of significant auditor attention in the audit and therefore may be key audit matters. The auditor may communicate this with those charged with governance when discussing the planned scope and timing of the audit in accordance with SA 260 (Revised). However, the auditor's determination of key audit matters is based on the results of the audit or evidence obtained throughout the audit.

A17. Paragraph 9 includes specific required considerations in the auditor's determination of those matters that required significant auditor attention. These considerations focus on the nature of matters communicated with those charged with governance that are often linked to matters disclosed in the financial statements, and are intended to reflect areas of the audit of the financial statements that may be of particular interest to intended users. The fact that these considerations are required is not intended to imply that matters related to them are always key audit matters; rather, matters related to such specific considerations are key audit matters only if they are determined to be of most significance in the audit in accordance with paragraph 10. As the considerations may be interrelated (e.g., matters relating to the circumstances described in paragraphs 9(b)-(c) may also be identified as significant risks), the applicability of more than one of the considerations to a particular matter communicated with those charged with governance may increase the likelihood of the auditor identifying that matter as a key audit matter.

A18. In addition to matters that relate to the specific required considerations in paragraph 9, there may be other matters communicated with those charged with governance that required significant auditor attention and that therefore may be determined to be key audit matters in accordance with paragraph 10. Such matters may include, for example, matters relevant to the audit that was performed that may not be required to be disclosed in the financial statements. For example, the implementation of a new IT system (or significant changes to an existing IT system) during the period may be an area of significant auditor attention, in particular if such a change had a significant effect on the auditor's overall audit strategy or related to a significant risk (e.g., changes to a system affecting revenue recognition).

Areas of Higher Assessed Risk of Material Misstatement, or Significant Risks Identified in Accordance with SA 315 (Ref: Para. 9(a))

A19. SA 260 (Revised) requires the auditor to communicate with those charged with governance about the significant risks identified by the auditor.²³ Paragraph A13 of SA 260 (Revised) explains that the auditor may

¹⁹ SA 550, *Related Parties*, paragraph A42.

²⁰ SA 600, *Using the work of Another Auditor*.

²¹ SA 220, *Quality Control for an Audit of Financial Statements*, paragraph 18.

²² SA 220, paragraph 19.

²³ SA 260 (Revised), paragraph 15.

also communicate with those charged with governance about how the auditor plans to address areas of higher assessed risks of material misstatement.

A20. SA 315 defines a significant risk as an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration. Areas of significant management judgment and significant unusual transactions may often be identified as significant risks. Significant risks are therefore often areas that require significant auditor attention.

A21. However, this may not be the case for all significant risks. For example, SA 240 presumes that there are risks of fraud in revenue recognition and requires the auditor to treat those assessed risks of material misstatement due to fraud as significant risks.²⁴ In addition, SA 240 indicates that, due to the unpredictable way in which management override of controls could occur, it is a risk of material misstatement due to fraud and thus a significant risk.²⁵ Depending on their nature, these risks may not require significant auditor attention, and therefore would not be considered in the auditor's determination of key audit matters in accordance with paragraph 10.

A22. SA 315 explains that the auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained.²⁶ Revision to the auditor's risk assessment and reevaluation of the planned audit procedures with respect to a particular area of the financial statements (i.e., a significant change in the audit approach, for example, if the auditor's risk assessment was based on an expectation that certain controls were operating effectively and the auditor has obtained audit evidence that they were not operating effectively throughout the audit period, particularly in an area with higher assessed risk of material misstatement) may result in an area being determined as one requiring significant auditor attention.

Significant Auditor Judgments Relating to Areas in the Financial Statements that Involved Significant Management Judgment, Including Accounting Estimates that Have Been Identified as Having High Estimation Uncertainty (Ref: Para. 9(b))

A23. SA 260 (Revised) requires the auditor to communicate with those charged with governance the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.²⁷ In many cases, this relates to critical accounting estimates and related disclosures, which are likely to be areas of significant auditor attention, and also may be identified as significant risks.

A24. However, users of the financial statements have highlighted their interest in accounting estimates that have been identified as having high estimation uncertainty in accordance with SA 540²⁸ that may have not been determined to be significant risks. Among other things, such estimates are highly dependent on management judgment and are often the most complex areas of the financial statements, and may require the involvement of both a management's expert and an auditor's expert. Users have also highlighted that accounting policies that have a significant effect on the financial statements (and significant changes to those policies) are relevant to their understanding of the financial statements, especially in circumstances where an entity's practices are not consistent with others in its industry.

The Effect on the Audit of Significant Events or Transactions that Occurred during the Period (Ref: Para. 9(c))

²⁴ SA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs 26–27.

²⁵ SA 240, paragraph 31.

²⁶ SA 315, *Identifying and Assessing the Risks of Material Misstatement through understanding the Entity and its environment*, paragraph 31.

²⁷ SA 260 (Revised), paragraph 16(a).

²⁸ See paragraphs 10–11 of SA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

A25. Events or transactions that had a significant effect on the financial statements or the audit may be areas of significant auditor attention and may be identified as significant risks. For example, the auditor may have had extensive discussions with management and those charged with governance at various stages throughout the audit about the effect on the financial statements of significant transactions with related parties or significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.²⁹ Management may have made difficult or complex judgments in relation to recognition, measurement, presentation or disclosure of such transactions, which may have had a significant effect on the auditor's overall strategy.

A26. Significant economic, accounting, regulatory, industry, or other developments that affected management's assumptions or judgments may also affect the auditor's overall approach to the audit and result in a matter requiring significant auditor attention.

Matters of Most Significance (Ref: Para. 10)

A27. Matters that required significant auditor attention also may have resulted in significant interaction with those charged with governance. The nature and extent of communication about such matters with those charged with governance often provides an indication of which matters are of most significance in the audit. For example, the auditor may have had more in-depth, frequent or robust interactions with those charged with governance on more difficult and complex matters, such as the application of significant accounting policies that were the subject of significant auditor or management judgment.

A28. The concept of matters of most significance is applicable in the context of the entity and the audit that was performed. As such, the auditor's determination and communication of key audit matters is intended to identify matters specific to the audit and to involve making a judgment about their importance relative to other matters in the audit.

A29. Other considerations that may be relevant to determining the relative significance of a matter communicated with those charged with governance and whether such a matter is a key audit matter include:

- The importance of the matter to intended users' understanding of the financial statements as a whole, in particular, its materiality to the financial statements.
- The nature of the underlying accounting policy relating to the matter or the complexity or subjectivity involved in management's selection of an appropriate policy compared to other entities within its industry.
- The nature and materiality, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements due to fraud or error related to the matter, if any.
- The nature and extent of audit effort needed to address the matter, including:
 - The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any.
 - The nature of consultations outside the engagement team regarding the matter.
- The nature and severity of difficulties in applying audit procedures, evaluating the results of those procedures, and obtaining relevant and reliable evidence on which to base the auditor's opinion, in particular as the auditor's judgments become more subjective.
- The severity of any control deficiencies identified relevant to the matter.
- Whether the matter involved a number of separate, but related, auditing considerations. For example, long-term contracts may involve significant auditor attention with respect to revenue recognition, litigation

²⁹ See paragraphs 16(a), 16(c) and A22, and Appendix 2 of SA 260 (Revised).

or other contingencies, and may have an effect on other accounting estimates.

A30. Determining which, and how many, of those matters that required significant auditor attention were of most significance in the audit of the financial statements of the current period is a matter of professional judgment. The number of key audit matters to be included in the auditor's report may be affected by the size and complexity of the entity, the nature of its business and environment, and the facts and circumstances of the audit engagement. In general, the greater the number of matters initially determined to be key audit matters, the more the auditor may need to reconsider whether each of these matters meets the definition of a key audit matter. Lengthy lists of key audit matters may be contrary to the notion of such matters being those of most significance in the audit.

Communicating Key Audit Matters

Separate Key Audit Matters Section in the Auditor's Report (Ref: Para. 11)

A31. Placing the separate Key Audit Matters section in close proximity to the auditor's opinion may give prominence to such information and acknowledge the perceived value of engagement-specific information to intended users.

A32. The order of presentation of individual matters within the Key Audit Matters section is a matter of professional judgment. For example, such information may be organized in order of relative importance, based on the auditor's judgment, or may correspond to the manner in which matters are disclosed in the financial statements. The requirement in paragraph 11 to include subheadings is intended to further differentiate the matters.

A33. When comparative financial information is presented, the introductory language of the Key Audit Matters section is tailored to draw attention to the fact that the key audit matters described relate to only the audit of the financial statements of the current period, and may include reference to the specific period covered by those financial statements (e.g., "for the year ended March 31, 20X1").

Descriptions of Individual Key Audit Matters (Ref: Para. 13)

A34. The adequacy of the description of a key audit matter is a matter of professional judgment. The description of a key audit matter is intended to provide a succinct and balanced explanation to enable intended users to understand why the matter was one of most significance in the audit and how the matter was addressed in the audit. Limiting the use of highly technical auditing terms also helps to enable intended users who do not have a reasonable knowledge of auditing to understand the basis for the auditor's focus on particular matters during the audit. The nature and extent of information provided by the auditor is intended to be balanced in the context of the responsibilities of the respective parties (i.e., for the auditor to provide useful information in a concise and understandable form, while not inappropriately being the provider of original information about the entity).

A35. Original information is any information about the entity that has not otherwise been made publicly available by the entity (e.g., has not been included in the financial statements or other information available at the date of the auditor's report, or addressed in other oral or written communications by management or those charged with governance, such as a preliminary announcement of financial information or investor briefings). Such information is the responsibility of the entity's management and those charged with governance.

A36. It is appropriate for the auditor to seek to avoid the description of a key audit matter inappropriately providing original information about the entity. The description of a key audit matter is not usually of itself original information about the entity, as it describes the matter in the context of the audit. However, the auditor may consider it necessary to include additional information to explain why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter, and how the matter was addressed in the audit, provided that disclosure of such information is not precluded by law or regulation.

When such information is determined to be necessary by the auditor, the auditor may encourage management or those charged with governance to disclose additional information, rather than the auditor providing original information in the auditor's report.

A37. Management or those charged with governance may decide to include new or enhanced disclosures in the financial statements or elsewhere in the annual report relating to a key audit matter in light of the fact that the matter will be communicated in the auditor's report. Such new or enhanced disclosures, for example, may be included to provide more robust information about the sensitivity of key assumptions used in accounting estimates or the entity's rationale for a particular accounting practice or policy when acceptable alternatives exist under the applicable financial reporting framework.

A38. Although the auditor's opinion on the financial statements does not extend to the other information addressed by SA 720³⁰ the auditor may consider this information, as well as other publicly available communications by the entity or other credible sources, in formulating the description of a key audit matter.

A39. Audit documentation prepared during the audit can also be useful to the auditor in formulating the description of a key audit matter. For example, written communications, or the auditor's documentation of oral communications, with those charged with governance and other audit documentation provides a useful basis for the auditor's communication in the auditor's report. This is because audit documentation in accordance with SA 230 is intended to address the significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions, and serves as a record of the nature, timing and extent of the audit procedures performed, the results of those procedures, and the audit evidence obtained. Such documentation may assist the auditor in developing a description of key audit matters that explains the significance of the matter and also in applying the requirement in paragraph 18.

Reference to Where the Matter Is Disclosed in the Financial Statements (Ref: Para. 13)

A40. Paragraphs 13(a)-(b) requires the description of each key audit matter to address why the auditor considered the matter to be one of most significance in the audit and how the matter was addressed in the audit. Accordingly, the description of key audit matters is not a mere reiteration of what is disclosed in the financial statements. However, a reference to any related disclosures enables intended users to further understand how management has addressed the matter in preparing the financial statements.

A41. In addition to referring to related disclosure(s), the auditor may draw attention to key aspects of them. The extent of disclosure by management about specific aspects or factors in relation to how a particular matter is affecting the financial statements of the current period may help the auditor in pinpointing particular aspects of how the matter was addressed in the audit such that intended users can understand why the matter is a key audit matter. For example:

- When an entity includes robust disclosure about accounting estimates, the auditor may draw attention to the disclosure of key assumptions, the disclosure of the range of possible outcomes, and other qualitative and quantitative disclosures relating to key sources of estimation uncertainty or critical accounting estimates, as part of addressing why the matter was one of most significance in the audit and how the matter was addressed in the audit.
- When the auditor concludes in accordance with SA 570 (Revised) that no material uncertainty exists relating to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, the auditor may nevertheless determine that one or more matters relating to this conclusion arising from the auditor's work effort under SA 570 (Revised) are key audit matters. In such circumstances, the auditor's description of such key audit matters in the auditor's report could include

³⁰ SA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*.

aspects of the identified events or conditions disclosed in the financial statements, such as substantial operating losses, available borrowing facilities and possible debt refinancing, or non-compliance with loan agreements, and related mitigating factors.³¹

Why the Auditor Considered the Matter to Be One of Most Significance in the Audit (Ref: Para. 13(a))

A42. The description of a key audit matter in the auditor's report is intended to provide insight as to why the matter was determined to be a key audit matter. Accordingly, the requirements in paragraphs 9–10 and the application material in paragraphs A12–A29 related to determining key audit matters may also be helpful for the auditor in considering how such matters are to be communicated in the auditor's report. For example, explaining the factors that led the auditor to conclude that a particular matter required significant auditor attention and was of most significance in the audit is likely to be of interest to intended users.

A43. The relevance of the information for intended users is a consideration for the auditor in determining what to include in the description of a key audit matter. This may include whether the description would enable a better understanding of the audit and the auditor's judgments.

A44. Relating a matter directly to the specific circumstances of the entity may also help to minimize the potential that such descriptions become overly standardized and less useful over time. For example, certain matters may be determined as key audit matters in a particular industry across a number of entities due to the circumstances of the industry or the underlying complexity in financial reporting. In describing why the auditor considered the matter to be one of most significance, it may be useful for the auditor to highlight aspects specific to the entity (e.g., circumstances that affected the underlying judgments made in the financial statements of the current period) in order to make the description more relevant for intended users. This also may be important in describing a key audit matter that recurs over periods.

A45. The description may also make reference to the principal considerations that led the auditor, in the circumstances of the audit, to determine the matter to be one of most significance, for example:

- Economic conditions that affected the auditor's ability to obtain audit evidence, for example illiquid markets for certain financial instruments.
- New or emerging accounting policies, for example entity-specific or industry-specific matters on which the engagement team consulted within the firm.
- Changes in the entity's strategy or business model that had a material effect on the financial statements.

How the Matter Was Addressed in the Audit (Ref: Para. 13(b))

A46. The amount of detail to be provided in the auditor's report to describe how a key audit matter was addressed in the audit is a matter of professional judgment. In accordance with paragraph 13(b), the auditor may describe:

- Aspects of the auditor's response or approach that were most relevant to the matter or specific to the assessed risk of material misstatement;
- A brief overview of procedures performed;
- An indication of the outcome of the auditor's procedures; or
- Key observations with respect to the matter,

or some combination of these elements.

Law or regulation or national auditing standards may prescribe a specific form or content for the description of a key audit matter, or may specify the inclusion of one or more of these elements.

³¹ See paragraph A3 of SA 570(Revised), Going Concern.

A47. In order for intended users to understand the significance of a key audit matter in the context of the audit of the financial statements as a whole, as well as the relationship between key audit matters and other elements of the auditor's report, including the auditor's opinion, care may be necessary so that language used in the description of a key audit matter:

- Does not imply that the matter has not been appropriately resolved by the auditor in forming the opinion on the financial statements.
- Relates the matter directly to the specific circumstances of the entity, while avoiding generic or standardized language.
- Takes into account how the matter is addressed in the related disclosure(s) in the financial statements, if any.
- Does not contain or imply discrete opinions on separate elements of the financial statements.

A48. Describing aspects of the auditor's response or approach to a matter, in particular when the audit approach required significant tailoring to the facts and circumstances of the entity, may assist intended users in understanding unusual circumstances and significant auditor judgment required to address the risk of material misstatement. In addition, the audit approach in a particular period may have been influenced by entity-specific circumstances, economic conditions, or industry developments. It may also be useful for the auditor to make reference to the nature and extent of communications with those charged with governance about the matter.

A49. For example, in describing the auditor's approach to an accounting estimate that has been identified as having high estimation uncertainty, such as the valuation of complex financial instruments, the auditor may wish to highlight that the auditor employed or engaged an auditor's expert. Such a reference to the use of an auditor's expert does not reduce the auditor's responsibility for the opinion on the financial statements and is therefore not inconsistent with paragraphs 14–15 of SA 620.³²

A50. There may be challenges in describing the auditor's procedures, particularly in complex, judgmental areas of the audit. In particular, it may be difficult to summarize the procedures performed in a succinct way that adequately communicates the nature and extent of the auditor's response to the assessed risk of material misstatement, and the significant auditor judgments involved. Nonetheless, the auditor may consider it necessary to describe certain procedures performed to communicate how the matter was addressed in the audit. Such description may typically be at a high level, rather than include a detailed description of procedures.

A51. As noted in paragraph A46, the auditor may also provide an indication of the outcome of the auditor's response in the description of the key audit matter in the auditor's report. However, if this is done, care is needed to avoid the auditor giving the impression that the description is conveying a separate opinion on an individual key audit matter or that in any way may call into question the auditor's opinion on the financial statements as a whole.

Circumstances in Which a Matter Determined to Be a Key Audit Matter is Not Communicated in the Auditor's Report (Ref: Para. 14)

A52. Law or regulation may preclude public disclosure by either management or the auditor about a specific matter determined to be a key audit matter. For example, law or regulation may specifically prohibit any public communication that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act (e.g., matters that are or appear to be related to money laundering).

A53. As indicated by paragraph 14(b), it will be extremely rare for a matter determined to be a key audit matter not to be communicated in the auditor's report. This is because there is presumed to be a public interest

³² SA 620, *Using the Work of an Auditor's Expert*.

benefit in providing greater transparency about the audit for intended users. Accordingly, the judgment not to communicate a key audit matter is appropriate only in cases when the adverse consequences to the entity or the public as a result of such communication are viewed as so significant that they would reasonably be expected to outweigh the public interest benefits of communicating about the matter.

A54. The determination not to communicate a key audit matter takes into account the facts and circumstances related to the matter. Communication with management and those charged with governance helps the auditor understand management's views about the significance of the adverse consequences that may arise as a result of communicating about a matter. In particular, communication with management and those charged with governance helps to inform the auditor's judgment in determining whether to communicate the matter by:

- Assisting the auditor in understanding why the matter has not been publicly disclosed by the entity (e.g., if law, regulation or certain financial reporting frameworks permit delayed disclosure or non-disclosure of the matter) and management's views as to the adverse consequences, if any, of disclosure. Management may draw attention to certain aspects in law or regulation or other authoritative sources that may be relevant to the consideration of adverse consequences (e.g., such aspects may include harm to the entity's commercial negotiations or competitive position). However, management's views about the adverse consequences alone do not alleviate the need for the auditor to determine whether the adverse consequences would reasonably be expected to outweigh the public interest benefits of communication in accordance with paragraph 14(b).
- Highlighting whether there have been any communications with applicable regulatory, enforcement or supervisory authorities in relation to the matter, in particular whether such discussions would appear to support management's assertion as to why public disclosure about the matter is not appropriate.
- Enabling the auditor, where appropriate, to encourage management and those charged with governance to make public disclosure of relevant information about the matter. In particular, this may be possible if the concerns of management and those charged with governance about communicating are limited to specific aspects relating to the matter, such that certain information about the matter may be less sensitive and could be communicated.

The auditor also may consider it necessary to obtain a written representation from management as to why public disclosure about the matter is not appropriate, including management's view about the significance of the adverse consequences that may arise as a result of such communication.

A55. It may also be necessary for the auditor to consider the implications of communicating about a matter determined to be a key audit matter in light of relevant ethical requirements. In addition, the auditor may be required by law or regulation to communicate with applicable regulatory, enforcement or supervisory authorities in relation to the matter, regardless of whether the matter is communicated in the auditor's report. Such communication may also be useful to inform the auditor's consideration of the adverse consequences that may arise from communicating about the matter.

A56. The issues considered by the auditor regarding a decision to not communicate a matter are complex and involve significant auditor judgment. Accordingly, the auditor may consider it appropriate to obtain legal advice.

Form and Content of the Key Audit Matters Section in Other Circumstances (Ref: Para. 16)

A57. The requirement in paragraph 16 applies in three circumstances:

- (i) The auditor determines in accordance with paragraph 10 that there are no key audit matters (see paragraph A59).
- (ii) The auditor determines in accordance with paragraph 14 that a key audit matter will not be communicated in the auditor's report and no other matters have been determined to be key audit matters.

- (iii) The only matters determined to be key audit matters are those communicated in accordance with paragraph 15.

A58. The following illustrates the presentation in the auditor's report if the auditor has determined there are no key audit matters to communicate:

Key Audit Matters

[Except for the matter described in the *Basis for Qualified (Adverse) Opinion* section or *Material Uncertainty Related to Going Concern* section,] We have determined that there are no [other] key audit matters to communicate in our report.

A59. The determination of key audit matters involves making a judgment about the relative importance of matters that required significant auditor attention. Therefore, it may be rare that the auditor of a complete set of general purpose financial statements of a listed entity would not determine at least one key audit matter from the matters communicated with those charged with governance to be communicated in the auditor's report. However, in certain limited circumstances (e.g., for a listed entity that has very limited operations), the auditor may determine that there are no key audit matters in accordance with paragraph 10 because there are no matters that required significant auditor attention.

Communication with Those Charged with Governance (Ref: Para. 17)

A60. SA 260 (Revised) requires the auditor to communicate with those charged with governance on a timely basis.³³ The appropriate timing for communications about key audit matters will vary with the circumstances of the engagement. However, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit, and may further discuss such matters when communicating about audit findings. Doing so may help to alleviate the practical challenges of attempting to have a robust two-way dialogue about key audit matters at the time the financial statements are being finalized for issuance.

A61. Communication with those charged with governance enables them to be made aware of the key audit matters that the auditor intends to communicate in the auditor's report, and provides them with an opportunity to obtain further clarification where necessary. The auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate this discussion. Communication with those charged with governance recognizes their important role in overseeing the financial reporting process, and provides the opportunity for those charged with governance to understand the basis for the auditor's decisions in relation to key audit matters and how these matters will be described in the auditor's report. It also enables those charged with governance to consider whether new or enhanced disclosures may be useful in light of the fact that these matters will be communicated in the auditor's report.

A62. The communication with those charged with governance required by paragraph 17(a) also addresses the extremely rare circumstances in which a matter determined to be a key audit matter is not communicated in the auditor's report (see paragraphs 14 and A54).

A63. The requirement in paragraph 17(b) to communicate with those charged with governance when the auditor has determined there are no key audit matters to communicate in the auditor's report may provide an opportunity for the auditor to have further discussion with others who are familiar with the audit and the significant matters that may have arisen (including the engagement quality control reviewer, where one has been appointed). These discussions may cause the auditor to re-evaluate the auditor's determination that there are no key audit matters.

Documentation (Ref: Para. 18)

³³ SA 260 (Revised), paragraph 21.

A64. Paragraph 8 of SA 230 requires the auditor to prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand, among other things, significant professional judgments. In the context of key audit matters, these professional judgments include the determination, from the matters communicated with those charged with governance, of the matters that required significant auditor attention, as well as whether or not each of those matters is a key audit matter. The auditor's judgments in this regard are likely to be supported by the documentation of the auditor's communications with those charged with governance and the audit documentation relating to each individual matter (see paragraph A39), as well as certain other audit documentation of the significant matters arising during the audit (e.g., a completion memorandum). However, this SA does not require the auditor to document why other matters communicated with those charged with governance were not matters that required significant auditor attention.

SA 705

Modifications to the Opinion in the Independent Auditor's Report

(Effective for all audits relating to accounting periods beginning on or after April 1, 2017)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised),¹ the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. This SA also deals with how the form and content of the auditor's report is affected when the auditor expresses a modified opinion. In all cases, the reporting requirements in SA 700 (Revised) apply, and are not repeated in this SA unless they are explicitly addressed or amended by the requirements of this SA.

Types of Modified Opinions

2. This SA establishes three types of modified opinions, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion. The decision regarding which type of modified opinion is appropriate depends upon:

- (a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
- (b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements. (Ref: Para. A1)

Effective Date

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

Objective

4. The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:

- (a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Definitions

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

- (a) Pervasive – A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any,

¹ SA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

- (i) Are not confined to specific elements, accounts or items of the financial statements;
 - (ii) If so confined, represent or could represent a substantial proportion of the financial statements; or
 - (iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.
- (b) Modified opinion – A qualified opinion, an adverse opinion or a disclaimer of opinion on the financial statements.

Requirements

Circumstances When a Modification to the Auditor's Opinion is Required

6. The auditor shall modify the opinion in the auditor's report when:
- (a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or (Ref: Para. A2–A7)
 - (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement. (Ref: Para. A8–A12)

Determining the Type of Modification to the Auditor's Opinion

Qualified Opinion

7. The auditor shall express a qualified opinion when:
- (a) 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
 - (b) 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.

Adverse Opinion

8. 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.

Disclaimer of Opinion

9. 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.

10. 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.

Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management-Imposed Limitation after the Auditor Has Accepted the Engagement

11. If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

12. If management refuses to remove the limitation referred to in paragraph 11 of this SA, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity,² and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

13. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:

- (a) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or
- (b) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
 - (i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or (Ref: Para. A13)
 - (ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements. (Ref. Para. A14)

14. If the auditor withdraws as contemplated by paragraph 13(b)(i), before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion. (Ref: Para. A15)

Other Considerations Relating to an Adverse Opinion or Disclaimer of Opinion

15. When the auditor considers it necessary to express an adverse opinion or disclaim an opinion on the financial statements as a whole, the auditor's report shall not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts or items of a financial statement. To include such an unmodified opinion in the same report³ in these circumstances would contradict the auditor's adverse opinion or disclaimer of opinion on the financial statements as a whole. (Ref: Para. A16)

Form and Content of the Auditor's Report When the Opinion is Modified

Auditor's Opinion

16. When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section. (Ref: Para. A17–A19)

Qualified Opinion

17. When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion section:

- (a) When reporting in accordance with a fair presentation framework, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or
- (b) When reporting in accordance with a compliance framework, the accompanying financial statements

² SA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

³ SA 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*, deals with circumstances where the auditor is engaged to express a separate opinion on one or more specific elements, accounts or items of a financial statement.

have been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase “except for the possible effects of the matter(s) ...” for the modified opinion. (Ref: Para. A20)

Adverse Opinion

18. When the auditor expresses an adverse opinion, the auditor shall state that, in the auditor’s opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion section:

- (a) When reporting in accordance with a fair presentation framework, the accompanying financial statements do not present fairly (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or
- (b) When reporting in accordance with a compliance framework, the accompanying financial statements have not been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

Disclaimer of Opinion

19. When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall:

- (a) State that the auditor does not express an opinion on the accompanying financial statements;
- (b) State that, because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
- (c) Amend the statement required by paragraph 24(b) of SA 700 (Revised), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.

Basis for Opinion

20. When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised): (Ref: Para. A21)

- (a) Amend the heading “Basis for Opinion” required by paragraph 28 of SA 700 (Revised) to “Basis for Qualified Opinion,” “Basis for Adverse Opinion,” or “Basis for Disclaimer of Opinion,” as appropriate; and
- (b) Within this section, include a description of the matter giving rise to the modification.

21. If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures in the notes to the financial statements), the auditor shall include in the Basis for Opinion section a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor shall so state in this section. (Ref: Para. A22)

22. If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the Basis for Opinion section an explanation of how the disclosures are misstated.

23. If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:

- (a) Discuss the non-disclosure with those charged with governance;
- (b) Describe in the Basis for Opinion section the nature of the omitted information; and
- (c) Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so

and the auditor has obtained sufficient appropriate audit evidence about the omitted information. (Ref: Para. A23)

24. If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.

25. When the auditor expresses a qualified or adverse opinion, the auditor shall amend the statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion required by paragraph 28(d) of SA 700 (Revised) to include the word "qualified" or "adverse", as appropriate.

26. When the auditor disclaims an opinion on the financial statements, the auditor's report shall not include the elements required by paragraphs 28(b) and 28(d) of SA 700 (Revised). Those elements are:

- (a) A reference to the section of the auditor's report where the auditor's responsibilities are described; and
- (b) A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

27. Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the Basis for Opinion section the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof. (Ref: Para. A24)

Description of Auditor's Responsibilities for the Audit of the Financial Statements When the Auditor Disclaims an Opinion on the Financial Statements

28. When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by paragraphs 38–40 of SA 700 (Revised) to include only the following: (Ref: Para. A25)

- (a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;
- (b) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
- (c) The statement about auditor independence and other ethical responsibilities required by paragraph 28(c) of SA 700 (Revised).

Considerations When the Auditor Disclaims an Opinion on the Financial Statements

- Unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with SA 701.⁴ (Ref: Para. A26)

Communication with Those Charged with Governance

- When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification. (Ref: Para. A27)

Application and Other Explanatory Material

Types of Modified Opinions (Ref: Para. 2)

⁴ SA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, paragraphs 11–13

A1. The table below illustrates how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but Not Pervasive	Material and Pervasive
Financial statements Are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Circumstances When a Modification to the Auditor's Opinion is Required

Nature of Material Misstatements (Ref: Para. 6(a))

A2. SA 700 (Revised) requires the auditor, in order to form an opinion on the financial statements, to conclude as to whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement.⁵ This conclusion takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements in accordance with SA 450.⁶

A3. SA 450 defines a misstatement as a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Accordingly, a material misstatement of the financial statements may arise in relation to:

- (a) The appropriateness of the selected accounting policies;
- (b) The application of the selected accounting policies; or
- (c) The appropriateness or adequacy of disclosures in the financial statements.

Appropriateness of the Selected Accounting Policies

A4. In relation to the appropriateness of the accounting policies management has selected, material misstatements of the financial statements may arise when:

- (a) The selected accounting policies are not consistent with the applicable financial reporting framework; or
- (b) The financial statements, including the related notes, do not represent the underlying transactions and events in a manner that achieves fair presentation.

A5. Financial reporting frameworks often contain requirements for the accounting for, and disclosure of, changes in accounting policies. Where the entity has changed its selection of significant accounting policies, a material misstatement of the financial statements may arise when the entity has not complied with these

⁵ SA 700 (Revised), paragraph 11

⁶ SA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 11

requirements.

Application of the Selected Accounting Policies

A6. In relation to the application of the selected accounting policies, material misstatements of the financial statements may arise:

- (a) When management has not applied the selected accounting policies consistently with the financial reporting framework, including when management has not applied the selected accounting policies consistently between periods or to similar transactions and events (consistency in application); or
- (b) Due to the method of application of the selected accounting policies (such as an unintentional error in application).

Appropriateness or Adequacy of Disclosures in the Financial Statements

A7. In relation to the appropriateness or adequacy of disclosures in the financial statements, material misstatements of the financial statements may arise when:

- (a) The financial statements do not include all of the disclosures required by the applicable financial reporting framework;
- (b) The disclosures in the financial statements are not presented in accordance with the applicable financial reporting framework; or
- (c) The financial statements do not provide the disclosures necessary to achieve fair presentation.

Nature of an Inability to Obtain Sufficient Appropriate Audit Evidence (Ref: Para. 6(b))

A8. The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

- (a) Circumstances beyond the control of the entity;
- (b) Circumstances relating to the nature or timing of the auditor's work; or
- (c) Limitations imposed by management.

A9. An inability to perform a specific procedure does not constitute a limitation on the scope of the audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures. If this is not possible, the requirements of paragraphs 7(b) and 9–10 apply as appropriate. Limitations imposed by management may have other implications for the audit, such as for the auditor's assessment of fraud risks and consideration of engagement continuance.

A10. Examples of circumstances beyond the control of the entity include when:

- The entity's accounting records have been destroyed.
- The accounting records of a significant component have been seized indefinitely by governmental authorities.

A11. Examples of circumstances relating to the nature or timing of the auditor's work include when:

- The entity is required to use the equity method of accounting for an associated entity, and the auditor is unable to obtain sufficient appropriate audit evidence about the latter's financial information to evaluate whether the equity method has been appropriately applied.
- The timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories.
- The auditor determines that performing substantive procedures alone is not sufficient, but the entity's controls are not effective.

A12. Examples of an inability to obtain sufficient appropriate audit evidence arising from a limitation on the scope of the audit imposed by management include when:

- Management prevents the auditor from observing the counting of the physical inventory.
- Management prevents the auditor from requesting external confirmation of specific account balances.

Determining the Type of Modification to the Auditor's Opinion

Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management-Imposed Limitation after the Auditor Has Accepted the Engagement (Ref: Para. 13(b)(i)–14)

A13. The practicality of withdrawing from the audit may depend on the stage of completion of the engagement at the time that management imposes the scope limitation. If the auditor has substantially completed the audit, the auditor may decide to complete the audit to the extent possible, disclaim an opinion and explain the scope limitation within the Basis for Disclaimer of Opinion section prior to withdrawing.

A14. In certain circumstances, withdrawal from the audit may not be possible if the auditor is required by law or regulation to continue the audit engagement. This may be the case for an auditor that is appointed to audit the financial statements of public sector entities. It may also be the case in entities where the auditor is appointed to audit the financial statements covering a specific period, or appointed for a specific period and is prohibited from withdrawing before the completion of the audit of those financial statements or before the end of that period, respectively. The auditor may also consider it necessary to include an Other Matter paragraph in the auditor's report.⁷

A15. When the auditor concludes that withdrawal from the audit is necessary because of a scope limitation, there may be a professional, legal or regulatory requirement for the auditor to communicate matters relating to the withdrawal from the engagement to regulators or the entity's owners.

Other Considerations Relating to an Adverse Opinion or Disclaimer of Opinion (Ref: Para. 15)

A16. The following are examples of reporting circumstances that would not contradict the auditor's adverse opinion or disclaimer of opinion:

- The expression of an unmodified opinion on financial statements prepared under a given financial reporting framework and, within the same report, the expression of an adverse opinion on the same financial statements under a different financial reporting framework.⁸
- The expression of a disclaimer of opinion regarding the results of operations, and cash flows, where relevant, and an unmodified opinion regarding the financial position (see SA 510⁹). In this case, the auditor has not expressed a disclaimer of opinion on the financial statements as a whole.

Form and Content of the Auditor's Report When the Opinion Is Modified

Illustrative Auditor's Reports (Ref: Para. 16)

A17. Illustrations 1 and 2 in the Appendix contain auditor's reports with qualified and adverse opinions, respectively, as the financial statements are materially misstated.

A18. Illustration 3 in the Appendix contains an auditor's report with a qualified opinion as the auditor is unable to obtain sufficient appropriate audit evidence. Illustration 4 contains a disclaimer of opinion due to an inability to obtain sufficient appropriate audit evidence about a single element of the financial statements. Illustration 5 contains a disclaimer of opinion due to an inability to obtain sufficient appropriate audit evidence about multiple

⁷ SA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, paragraph A10

⁸ See paragraph A25 of SA 700 (Revised) for a description of this circumstance.

⁹ SA 510, *Initial Audit Engagements — Opening Balances*, paragraph 10 and A5

elements of the financial statements. In each of the latter two cases, the possible effects on the financial statements of the inability are both material and pervasive. The Appendices to other SAs that include reporting requirements, including SA 570 (Revised),¹⁰ also include illustrations of auditor's reports with modified opinions.

Auditor's Opinion (Ref: Para. 16)

A19. Amending this heading makes it clear to the user that the auditor's opinion is modified and indicates the type of modification.

Qualified Opinion (Ref: Para. 17)

A20. When the auditor expresses a qualified opinion, it would not be appropriate to use phrases such as "with the foregoing explanation" or "subject to" in the Opinion section as these are not sufficiently clear or forceful.

Basis for Opinion (Ref: Para. 20, 21, 23, 27)

A21. Consistency in the auditor's report helps to promote users' understanding and to identify unusual circumstances when they occur. Accordingly, although uniformity in the wording of a modified opinion and in the description of the reasons for the modification may not be possible, consistency in both the form and content of the auditor's report is desirable.

A22. An example of the financial effects of material misstatements that the auditor may describe within the Basis for Opinion section in the auditor's report is the quantification of the effects on income tax, income before taxes, net income and equity if inventory is overstated.

A23. Disclosing the omitted information within the Basis for Opinion section would not be practicable if:

- (a) The disclosures have not been prepared by management or the disclosures are otherwise not readily available to the auditor; or
- (b) In the auditor's judgment, the disclosures would be unduly voluminous in relation to the auditor's report.

A24. An adverse opinion or a disclaimer of opinion relating to a specific matter described within the Basis for Opinion section does not justify the omission of a description of other identified matters that would have otherwise required a modification of the auditor's opinion. In such cases, the disclosure of such other matters of which the auditor is aware may be relevant to users of the financial statements.

Description of Auditor's Responsibilities for the Audit of the Financial Statements When the Auditor Disclaims an Opinion on the Financial Statements (Ref: Para. 28)

A25. When the auditor disclaims an opinion on the financial statements, the following statements are better positioned within the Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report, as illustrated in Illustrations 4–5 of the Appendix to this SA:

- The statement required by paragraph 28(a) of SA 700 (Revised), amended to state that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with SAs; and
- The statement required by paragraph 28(c) of SA 700 (Revised) about independence and other ethical responsibilities.

Considerations When the Auditor Disclaims an Opinion on the Financial Statements (Ref: Para. 29)

A26. Providing the reasons for the auditor's inability to obtain sufficient appropriate audit evidence within the Basis for Disclaimer of Opinion section of the auditor's report provides useful information to users in understanding why the auditor has disclaimed an opinion on the financial statements and may further guard

¹⁰ SA 570 (Revised), *Going Concern*

against inappropriate reliance on them. However, communication of any key audit matters other than the matter(s) giving rise to the disclaimer of opinion may suggest that the financial statements as a whole are more credible in relation to those matters than would be appropriate in the circumstances, and would be inconsistent with the disclaimer of opinion on the financial statements as a whole. Accordingly, paragraph 29 of this SA prohibits a Key Audit Matters section from being included in the auditor's report when the auditor disclaims an opinion on the financial statements, unless the auditor is otherwise required by law or regulation to communicate key audit matters.

Communication with Those Charged with Governance (Ref: Para. 30)

A27. Communicating with those charged with governance the circumstances that lead to an expected modification to the auditor's opinion and the wording of the modification enables:

- The auditor to give notice to those charged with governance of the intended modification(s) and the reasons (or circumstances) for the modification(s);
- The auditor to seek the concurrence of those charged with governance regarding the facts of the matter(s) giving rise to the expected modification(s), or to confirm matters of disagreement with management as such; and
- Those charged with governance to have an opportunity, where appropriate, to provide the auditor with further information and explanations in respect of the matter(s) giving rise to the expected modification(s).

Appendix

(Ref: Para. A17–A18, A25)

Illustrations of Auditor's Reports with Modifications to the Opinion

- Illustration 1: An auditor's report containing a qualified opinion due to a material misstatement of the financial statements.
- Illustration 2: An auditor's report containing an adverse opinion due to a material misstatement of the consolidated financial statements.
- Illustration 3: An auditor's report containing a qualified opinion due to the auditor's inability to obtain sufficient appropriate audit evidence regarding a foreign associate.
- Illustration 4: An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements.
- Illustration 5: An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements.

Illustration 1 – Qualified Opinion due to a Material Misstatement of the Financial Statements

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 financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.¹¹*
- *Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial*

¹¹ SA 210, *Agreeing the Terms of Audit Engagements*

statements (i.e., a qualified opinion is appropriate).

- *The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.*
- *Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).*
- *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 Statements¹²

Qualified Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20XX, and the statement of Profit and Loss, (*statement of changes in equity*)¹³ and the 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*))¹⁴.

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the aforesaid financial statements 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 31st, 2XXX and profit/loss, (*changes in equity*) and its cash flows for the year ended on that date.

Basis for Qualified Opinion

The Company's inventories are carried in the Balance Sheet at Rs. XXX. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from the Accounting Standards prescribed under section 133 of the Companies Act, 2013. The Company's records indicate that, had management stated the inventories at the lower of cost and net realizable value, an amount of Rs. xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by Rs. xxx, and income tax, net income and shareholders' funds would have been reduced by Rs. xxx, Rs. xxx and Rs. xxx, respectively.

We conducted our audit in accordance with 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

¹² 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.

¹³ As may be applicable.

¹⁴ As may be applicable.

provisions of the Companies Act, 2013 and we have fulfilled our other ethical responsibilities in accordance with these requirements and the ICAI's Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified 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.

[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).]

Auditor's Responsibilities for the Audit of the Financial Statements

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

Other Matter¹⁵

We did not audit the financial statements/information of _____(number) branches included in the standalone financial statements of the Company whose financial statements / financial information reflect total assets of Rs. _____ as at 31st March, 20XX and total revenues of Rs. _____ for the year ended on that date, as considered in the standalone financial statements. The financial statements/information of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of these branches, is based solely on the report of such branch auditors.

Our opinion is not modified in respect of this matter.

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)
(Designation¹⁶)
(Membership No. XXXXX)

Place of Signature:

Date:

¹⁵ Where applicable.

¹⁶ Partner or Proprietor, as the case may be

Illustration 2 – Adverse Opinion due to a Material Misstatement of the Consolidated Financial Statements

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

- *Audit of a complete set of consolidated financial statements of a listed company (incorporated under the Companies Act, 2013) using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., SA 600 applies).*
- *The consolidated financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in SA 210.*
- *The consolidated financial statements are materially misstated due to the non-consolidation of a subsidiary. The material misstatement is deemed to be pervasive to the consolidated financial statements. The effects of the misstatement on the consolidated financial statements have not been determined because it was not practicable to do so (i.e., an adverse opinion is appropriate).*
- *The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.*
- *Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).*
- *SA 701 applies; however, the auditor has determined that there are no key audit matters other than the matter described in the Basis for Adverse Opinion section.*
- *Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.*
- *In addition to the audit of the consolidated 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 Consolidated Financial Statements¹⁷**Adverse Opinion**

We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), its associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 2XXX, the consolidated statement of profit and Loss, (consolidated statement of changes in equity)¹⁸ and the consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "consolidated financial statements").

In our opinion and to the best of our information and according to the explanations given to us, because of

¹⁷ The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

¹⁸ Where applicable.

the significance of the matter discussed in the *Basis for Adverse Opinion* section of our report, the accompanying consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India, of their consolidated state of affairs of the Group, its associates and jointly controlled entities, as at March 31, 20XX, of its consolidated profit/loss, (*consolidated position of changes in equity*)¹⁹ and the consolidated cash flows for the year then ended.

Basis for Adverse Opinion

As explained in Note X, the Group has not consolidated subsidiary XYZ Company that the Group acquired during 20XX because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under the accounting principles generally accepted in India, the Group should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

We conducted our audit in accordance with 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 Consolidated Financial Statements* section of our report. We are independent of the Group, its associates and jointly controlled entities, in accordance with the Code of Ethics and provisions of the Companies Act, 2013 that are relevant to our audit of the consolidated financial statements in India under the Companies Act, 2013, and we have fulfilled our other ethical responsibilities in accordance with the Code of Ethics and the requirements under the Companies act, 2013. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

Key Audit Matters

Except for the matter described in the *Basis for Adverse Opinion* section, we have determined that there are no other key audit matters to communicate in our report.

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements²⁰

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

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

Signature
(Name of the Member Signing the Audit Report)
(Designation²¹)
(Membership No. XXXXX)

Place of Signature:

Date:

¹⁹ Where applicable.

²⁰ Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction.

²¹ Partner or Proprietor, as the case may be

Illustration 3 – Qualified Opinion due to the Auditor's Inability to Obtain Sufficient Audit Evidence Regarding a Foreign Associate

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

- Audit of a complete set of consolidated financial statements of a listed Company (incorporated under the Companies Act, 2013) using a fair presentation framework. The audit is a group audit of an entity with subsidiaries, associates and jointly controlled entities (i.e., SA 600 applies).
- The consolidated 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 consolidated financial statements in SA 210.
- The auditor was unable to obtain sufficient appropriate audit evidence regarding an investment in a foreign associate. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be material but not pervasive to the consolidated financial statements (i.e., a qualified opinion is appropriate).
- The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and the relevant provisions of the Companies Act, 2013.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated 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 Consolidated Financial Statements²²**Qualified Opinion**

We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), its associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 20XX, and the consolidated statement of Profit and Loss, (*consolidated statement of changes in equity*)²³ and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as "the consolidated financial statements").

In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects of the matter described in the *Basis for Qualified Opinion* section of our report, the aforesaid consolidated financial statements give a true and fair view in conformity with the accounting

²² The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

²³ Where applicable.

principles generally accepted in India, of their consolidated state of affairs as at March 31, 2XXX, consolidated profit/loss, (*consolidated changes in equity*)²⁴, consolidated cash flows for the year then ended.

Basis for Qualified Opinion

The Group's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at Rs. xxx on the consolidated balance sheet as at March 31, 20XX, and ABC's share of XYZ's net income of xxx is included in ABC's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ as at March 31, 2XXX and ABC's share of XYZ's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

We conducted our audit in accordance with Standards on Auditing (SAs) prescribed 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 Consolidated Financial Statements* section of our report. We are independent of the Group and its associates and joint ventures in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in India in terms of the Code of Ethics issued by the Institute of Chartered Accountants of India and the relevant provisions of the Companies Act, 2013, 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 qualified opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated 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.

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

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements²⁵

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

²⁴ Where applicable.

²⁵ Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

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

Signature
(Name of the Member signing the Audit Report)
(Designation²⁶)
(Membership No. XXXXX)

Place of Signature:

Date:

Illustration 4 – Disclaimer of Opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence about a Single Element of the Consolidated Financial Statements

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

- *Audit of a complete set of consolidated financial statements of an unlisted Company incorporated under the Companies Act, 2013 using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., SA 600 applies).*
- *The consolidated financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013(a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in SA 210.*
- *The auditor was unable to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements. That is, the auditor was also unable to obtain audit evidence about the financial information of a joint venture investment that represents over 90% of the entity's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the consolidated financial statements (i.e., a disclaimer of opinion is appropriate).*
- *The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and provisions of the Companies Act, 2013.*
- *Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.*
- *A more limited description of the auditor's responsibilities section is required.*
- *In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013*

²⁶ Partner or Proprietor, as the case may be

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Consolidated Financial Statements²⁷**Disclaimer of Opinion**

We were engaged to audit the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), which comprise the consolidated balance sheet as at March 31, 20XX, the consolidated statement of Profit and Loss, (*consolidated statement of changes in equity*)²⁸ and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "Consolidated Financial Statements").

We do not express an opinion on the accompanying consolidated financial statements of the Group. Because of the significance of the matter described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

Basis for Disclaimer of Opinion

The Group's investment in its joint venture XYZ Company is carried at Rs. xxx on the Group's consolidated balance sheet, which represents over 90% of the Group's net assets as at March 31, 20XX. We were not allowed access to the management and the auditors of XYZ Company, including XYZ Company's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of XYZ Company's assets that it controls jointly, its proportional share of XYZ Company's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, (*and the elements making up the consolidated statement of changes in equity*)²⁹ and the consolidated cash flow statement.

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements³⁰

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our responsibility is to conduct an audit of the Group's consolidated financial statements in accordance with Standards on Auditing and to issue an auditor's report. However, because of the matter described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements and we have fulfilled our other ethical responsibilities in accordance with these requirements.

²⁷ The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

²⁸ Where applicable.

²⁹ Where applicable.

³⁰ Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 2 in SA 700 (Revised).]

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

Signature
(Name of the Member signing the Audit Report)
(Designation³¹)
(Membership No. XXXXX)

Place of Signature:

Date:

Illustration 5 – Disclaimer of Opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence about Multiple Elements of the Financial Statements

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

- *Audit of a complete set of financial statements of an entity other than a company incorporated 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 Accounting Standards issued by the Institute of Chartered Accountants of India (a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.*
- *The auditor was unable to obtain sufficient appropriate audit evidence about multiple elements of the financial statements, that is, the auditor was also unable to obtain audit evidence about the entity's inventories and accounts receivable. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements.*
- *The relevant ethical requirements that apply to the audit are ICAI's Code of Ethics and applicable law/regulation*
- *Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.*
- *A more limited description of the auditor's responsibilities section is required.*
- *In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under relevant law/ regulation.*

³¹ Partner or Proprietor, as the case may be

INDEPENDENT AUDITOR'S REPORT

To the Partners of ABC & Associates

Report on the Audit of the Financial Statements³²**Disclaimer of Opinion**

We were engaged to audit the financial statements of ABC & Associates ("the entity"), which comprise the balance sheet as at March 31, 20XX, the statement of Profit and Loss, *(the statement of changes in equity)*³³ and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of the entity. Because of the significance of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

We were not appointed as auditors of the Company until after March 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at March 31, 20X0 and 20X1, which are stated in the Balance Sheets at Rs xxx and Rs xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the Balance Sheet at a total amount of Rs xxx as at March 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of Profit and Loss *(and statement of cash flows)*³⁴.

Responsibilities of Management and Those Charged with Governance for the Financial Statements³⁵

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

Auditor's Responsibilities for the Audit of the Financial Statements

Our responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report. However, because of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

We are independent of the entity in accordance with the ethical requirements in accordance with the requirements of the Code of Ethics issued by ICAI and the ethical requirements as prescribed under the laws and regulations applicable to the entity.

³² 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.

³³ Where applicable.

³⁴ Where applicable.

³⁵ Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

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)
(Designation³⁶)
(Membership No. XXXXX)

Place of Signature:

Date:

³⁶ Partner or Proprietor, as the case may be

SA 706

Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

(Effective for all audits relating to accounting periods beginning on or after April 1, 2017)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with additional communication in the auditor's report when the auditor considers it necessary to:
 - (a) Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or
 - (b) Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.
2. SA 701¹ establishes requirements and provides guidance when the auditor determines key audit matters and communicates them in the auditor's report. When the auditor includes a Key Audit Matters section in the auditor's report, this SA addresses the relationship between key audit matters and any additional communication in the auditor's report in accordance with this SA. (Ref: Para. A1–A3)
3. SA 570 (Revised)² establishes requirements and provides guidance about communication in the auditor's report relating to going concern.
4. Appendices 1 and 2 identify SAs that contain specific requirements for the auditor to include Emphasis of Matter paragraphs or Other Matter paragraphs in the auditor's report. In those circumstances, the requirements in this SA regarding the form of such paragraphs apply. (Ref: Para. A4)

Effective Date

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

Objective

7. The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:
 - (a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or
 - (b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

¹ SA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

² SA 570 (Revised), *Going Concern*

Definitions

7. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) **Emphasis of Matter paragraph** – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.
 - (b) **Other Matter paragraph** – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Requirements**Emphasis of Matter Paragraphs in the Auditor's Report**

8. If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided: (Ref: Para. A5–A6)
- (a) The auditor would not be required to modify the opinion in accordance with SA 705 (Revised)³ as a result of the matter; and
 - (b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report. (Ref: Para. A1–A3)
9. When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:
- (a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
 - (b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
 - (c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized. (Ref: Para. A7–A8, A16–A17)

Other Matter Paragraphs in the Auditor's Report

10. If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the auditor shall include an Other Matter paragraph in the auditor's report, provided:
- (a) This is not prohibited by law or regulation; and
 - (b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report. (Ref: Para. A9–A14)
11. When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading. (Ref: Para. A15–A17)

Communication with Those Charged with Governance

³ SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

12. If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph. (Ref: Para. A18)

Application and Other Explanatory Material

The Relationship between Emphasis of Matter Paragraphs and Key Audit Matters in the Auditor's Report (Ref: Para. 2, 8(b))

A1. Key audit matters are defined in SA 701 as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance, which include significant findings from the audit of the financial statements of the current period.⁴ Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit and may also assist them in understanding the entity and areas of significant management judgment in the audited financial statements. When SA 701 applies, the use of Emphasis of Matter paragraphs is not a substitute for a description of individual key audit matters.

A2. Matters that are determined to be key audit matters in accordance with SA 701 may also be, in the auditor's judgment, fundamental to users' understanding of the financial statements. In such cases, in communicating the matter as a key audit matter in accordance with SA 701, the auditor may wish to highlight or draw further attention to its relative importance. The auditor may do so by presenting the matter more prominently than other matters in the Key Audit Matters section (e.g., as the first matter) or by including additional information in the description of the key audit matter to indicate the importance of the matter to users' understanding of the financial statements.

A3. There may be a matter that is not determined to be a key audit matter in accordance with SA 701 (i.e., because it did not require significant auditor attention), but which, in the auditor's judgment, is fundamental to users' understanding of the financial statements (e.g., a subsequent event). If the auditor considers it necessary to draw users' attention to such a matter, the matter is included in an Emphasis of Matter paragraph in the auditor's report in accordance with this SA.

Circumstances in Which an Emphasis of Matter Paragraph May Be Necessary (Ref: Para. 4, 8)

A4. Appendix 1 identifies SAs that contain specific requirements for the auditor to include Emphasis of Matter paragraphs in the auditor's report in certain circumstances. These circumstances include:

- When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.
- To alert users that the financial statements are prepared in accordance with a special purpose framework.
- When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).⁵

A5. Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

⁴ SA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 16.

⁵ SA 560, *Subsequent Events*, paragraphs 12(b) and 16

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.⁶
- Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

A6. However, a widespread use of Emphasis of Matter paragraphs may diminish the effectiveness of the auditor's communication about such matters.

Including an Emphasis of Matter Paragraph in the Auditor's Report (Ref: Para. 9)

A7. The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion. An Emphasis of Matter paragraph is not a substitute for:

- (a) A modified opinion in accordance with SA 705 (Revised) when required by the circumstances of a specific audit engagement;
- (b) Disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation; or
- (c) Reporting in accordance with SA 570 (Revised)⁷ when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

A8. Paragraphs A16–A17 provide further guidance on the placement of Emphasis of Matter paragraphs in particular circumstances.

Other Matter Paragraphs in the Auditor's Report (Ref: Para. 10–11)

Circumstances in Which an Other Matter Paragraph May Be Necessary

Relevant to Users' Understanding of the Audit

A9. SA 260 (Revised) requires the auditor to communicate with those charged with governance about the planned scope and timing of the audit, which includes communication about the significant risks identified by the auditor.⁸ Although matters relating to significant risks may be determined to be key audit matters, other planning and scoping matters (e.g., the planned scope of the audit, or the application of materiality in the context of the audit) are unlikely to be key audit matters because of how key audit matters are defined in SA 701. However, law or regulation may require the auditor to communicate about planning and scoping matters in the auditor's report, or the auditor may consider it necessary to communicate about such matters in an Other Matter paragraph.

A10. In the rare circumstance where the auditor is unable to withdraw from an engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a limitation on the scope of the audit imposed by management is pervasive,⁹ the auditor may consider it necessary to include an Other Matter paragraph in the auditor's report to explain why it is not possible for the auditor to withdraw from the engagement.

⁶ SA 560, paragraph 6

⁷ SA 570 (Revised), paragraphs 22–23

⁸ SA 260 (Revised), paragraph 15

⁹ See paragraph 13(b)(ii) of SA 705 (Revised) for a discussion of this circumstance.

Relevant to Users' Understanding of the Auditor's Responsibilities or the Auditor's Report

A11. Law, regulation or generally accepted practice may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon. When the Other Matter section includes more than one matter that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, it may be helpful to use different sub-headings for each matter.

A12. An Other Matter paragraph does not deal with circumstances where the auditor has other reporting responsibilities that are in addition to the auditor's responsibility under the SAs (see Other Reporting Responsibilities section in SA 700 (Revised)¹⁰), or where the auditor has been asked to perform and report on additional specified procedures, or to express an opinion on specific matters.

Reporting on more than one set of financial statements

A13. An entity may prepare one set of financial statements in accordance with a general purpose framework (e.g., the national framework) and another set of financial statements in accordance with another general purpose framework (e.g., International Financial Reporting Standards), and engage the auditor to report on both sets of financial statements. If the auditor has determined that the frameworks are acceptable in the respective circumstances, the auditor may include an Other Matter paragraph in the auditor's report, referring to the fact that another set of financial statements has been prepared by the same entity in accordance with another general purpose framework and that the auditor has issued a report on those financial statements.

Restriction on distribution or use of the auditor's report

A14. Financial statements prepared for a specific purpose may be prepared in accordance with a general purpose framework because the intended users have determined that such general purpose financial statements meet their financial information needs. Since the auditor's report is intended for specific users, the auditor may consider it necessary in the circumstances to include an Other Matter paragraph, stating that the auditor's report is intended solely for the intended users, and should not be distributed to or used by other parties.

Including an Other Matter Paragraph in the Auditor's Report

A15. The content of an Other Matter paragraph reflects clearly that such other matter is not required to be presented and disclosed in the financial statements. An Other Matter paragraph does not include information that the auditor is prohibited from providing by law, regulation or other professional standards, for example, ethical standards relating to confidentiality of information. An Other Matter paragraph also does not include information that is required to be provided by management.

Placement of Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Auditor's Report (Ref: Para. 9, 11)

A16. The placement of an Emphasis of Matter paragraph or Other Matter paragraph in the auditor's report depends on the nature of the information to be communicated, and the auditor's judgment as to the relative significance of such information to intended users compared to other elements required to be reported in accordance with SA 700 (Revised). For example:

Emphasis of Matter Paragraphs

- When the Emphasis of Matter paragraph relates to the applicable financial reporting framework, including circumstances where the auditor determines that the financial reporting framework prescribed by law or

¹⁰ SA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraphs 42–44.

regulation would otherwise be unacceptable,¹¹ the auditor may consider it necessary to place the paragraph immediately following the Basis of Opinion section to provide appropriate context to the auditor's opinion.

- When a Key Audit Matters section is presented in the auditor's report, an Emphasis of Matter paragraph may be presented either directly before or after the Key Audit Matters section, based on the auditor's judgment as to the relative significance of the information included in the Emphasis of Matter paragraph. The auditor may also add further context to the heading "Emphasis of Matter", such as "Emphasis of Matter – Subsequent Event", to differentiate the Emphasis of Matter paragraph from the individual matters described in the Key Audit Matters section.

Other Matter Paragraphs

- When a Key Audit Matters section is presented in the auditor's report and an Other Matter paragraph is also considered necessary, the auditor may add further context to the heading "Other Matter", such as "Other Matter – Scope of the Audit", to differentiate the Other Matter paragraph from the individual matters described in the Key Audit Matters section.
- When an Other Matter paragraph is included to draw users' attention to a matter relating to Other Reporting Responsibilities addressed in the auditor's report, the paragraph may be included in the Report on Other Legal and Regulatory Requirements section.
- When relevant to all the auditor's responsibilities or users' understanding of the auditor's report, the Other Matter paragraph may be included as a separate section following the Report on the Audit of the Financial Statements and the Report on Other Legal and Regulatory Requirements.

A17. Appendix 3 is an illustration of the interaction between the Key Audit Matters section, an Emphasis of Matter paragraph and an Other Matter paragraph when all are presented in the auditor's report. The illustrative report in Appendix 4 includes an Emphasis of Matter paragraph in an auditor's report for an entity other than a listed entity that contains a qualified opinion and for which key audit matters have not been communicated.

Communication with Those Charged with Governance (Ref. Para. 12)

A18. The communication required by paragraph 12 enables those charged with governance to be made aware of the nature of any specific matters that the auditor intends to highlight in the auditor's report, and provides them with an opportunity to obtain further clarification from the auditor where necessary. Where the inclusion of an Other Matter paragraph on a particular matter in the auditor's report recurs on each successive engagement, the auditor may determine that it is unnecessary to repeat the communication on each engagement, unless otherwise required to do so by law or regulation.

Appendix 1

(Ref: Para. 4, A4)

List of SAs Containing Requirements for Emphasis of Matter Paragraphs

This appendix identifies paragraphs in other SAs that require the auditor to include an Emphasis of Matter paragraph in the auditor's report in certain circumstances. The list is not a substitute for considering the requirements and related application and other explanatory material in SAs.

- SA 210, *Agreeing the Terms of Audit Engagements* – paragraph 19(b)
- SA 560, *Subsequent Events* – paragraphs 12(b) and 16

¹¹ For example, as required by SA 210, *Agreeing the Terms of Audit Engagements*, paragraph 19 and SA 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, paragraph 14

- SA 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks* – paragraph 14

Appendix 2

(Ref: Para. 4)

List of SAs Containing Requirements for Other Matter Paragraphs

This appendix identifies paragraphs in other SAs that require the auditor to include an Other Matter paragraph in the auditor's report in certain circumstances. The list is not a substitute for considering the requirements and related application and other explanatory material in SAs.

- SA 560, *Subsequent Events* – paragraphs 12(b) and 16
- SA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements* – paragraphs 13–14, 16–17 and 19
- SA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements* – paragraph 10(a)

Appendix 3

(Ref: Para. A17)

Illustration of an Auditor's Report that Includes a Key Audit Matters Section, an Emphasis of Matter Paragraph, and an Other Matter Paragraph

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 financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.
- 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 ICAI's Code of Ethics and the provisions of the Companies Act, 2013.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.
- Key audit matters have been communicated in accordance with SA 701.
- Corresponding figures are presented, and the prior period's financial statements were audited by a predecessor auditor. The auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and has decided to do so.

- *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 Statements¹²**Opinion**

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit & Loss, (statement of changes in equity) and the 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))¹³.

In our opinion, and to the best of our information and according to the explanations given to us the aforesaid financial statements, *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 31st, 2XXX and profit/loss, (*changes in equity*) and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with Standards on Auditing (SAs). 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 ethical requirements that are relevant to our audit of the financial statements as per the ICAI's *Code of Ethics and the provisions of the Companies Act, 2013*, 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.

Emphasis of Matter¹⁴

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. 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.

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

Other Matter

¹² ¹ 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.

¹³ As may be applicable

¹⁴ As noted in paragraph A16, an Emphasis of Matter paragraph may be presented either directly before or after the Key Audit Matters section based on the auditor's judgment as to the relative significance of the information included in the Emphasis of Matter paragraph.

The financial statements of ABC Company for the year ended March 31, 20X0, were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X1.

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).]

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)
(Designation¹⁵)
(Membership No. XXXXX)

Place of Signature:

Date:

Appendix 4
(Ref: Para. A8)

Illustration of an Auditor's Report Containing a Qualified Opinion Due to a Departure from the Applicable Financial Reporting Framework and that Includes an Emphasis of Matter Paragraph

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

- *Audit of a complete set of financial statements of an company other than a listed company (registered under the Companies Act, 2013) using a fair presentation framework..*
- *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 (a general purpose framework).*
- *The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.*
- *A departure from the applicable financial reporting framework resulted in a qualified opinion.*
- *The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.*
- *Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).*
- *Between the date of the financial statements and the date of the auditor's report, there was a fire in the*

¹⁵ Partner or Proprietor, as the case may be

entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.

- *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 the Companies Act, 2013.*

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements¹⁶

Qualified Opinion

We have audited the standalone financial statements of ABC Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit and Loss, (statement of changes in equity) and the 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)*)².

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the aforesaid financial statements present fairly, in all material respects, or *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 31st, 2XXX and profit/loss, *(changes in equity)* and its cash flows for the year ended on that date.

Basis for Qualified Opinion

The Company's short-term marketable securities are carried in the statement of financial position at xxx. Management has not marked these securities to market but has instead stated them at cost, which constitutes a departure from the Accounting Standards prescribed in section 133 of the Companies Act, 2013. The Company's records indicate that had management marked the marketable securities to market, the Company would have recognized an unrealized loss of Rs.xxx in the statement of comprehensive income for the year. The carrying amount of the securities in the statement of financial position would have been reduced by the same amount at March 31, 20X1, and income tax, net income and shareholders' equity would have been reduced by Rs.xxx, Rs.xxx and Rs.xxx, respectively.

We conducted our audit in accordance with Standards on Auditing (SAs). 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 ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the ICAI's Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for

¹⁶ 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.

our qualified opinion.

Emphasis of Matter – Effects of a Fire

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

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).]

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 ¹⁷)
(Membership No. XXXXX)

Place of Signature:

Date:

¹⁷ Partner or Proprietor, as the case may be

SA 710*

**Comparative Information—Corresponding Figures
and Comparative Financial Statements**
*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2011)*

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding comparative information in an audit of financial statements. When the financial statements of the prior period have been audited by a predecessor auditor or were not audited, the requirements and guidance in SA 510¹ regarding opening balances also apply.

The Nature of Comparative Information

2. The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures² and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.

3. The essential audit reporting differences between the approaches are:

- (a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas
- (b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

This SA addresses separately the auditor's reporting requirements for each approach.

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

Objectives

5. The objectives of the auditor are:

- (a) To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and
- (b) To report in accordance with the auditor's reporting responsibilities.

* Published in the April, 2010 issue of the Journal.

¹ SA 510, "Initial Audit Engagements—Opening Balances".

² Typically, financial reporting frameworks in India use the corresponding figures approach for general purpose financial statements.

Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:
- (a) Comparative information – The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.
 - (b) Corresponding figures – Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures”). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.
 - (c) Comparative financial statements – Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor’s opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

For purposes of this SA, references to “prior period” should be read as “prior periods” when the comparative information includes amounts and disclosures for more than one period.

Requirements

Audit Procedures

7. The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:
- (a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and
 - (b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.
8. If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period’s financial statements, the auditor shall also follow the relevant requirements of SA 560³.
9. As required by SA 580⁴, the auditor shall request written representations for all periods referred to in the auditor’s opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year’s statement of profit and loss. (Ref: Para. A1)

Audit Reporting

Corresponding Figures

10. When corresponding figures are presented, the auditor’s opinion shall not refer to the corresponding figures except in the circumstances described in paragraphs 11, 12, and 14. (Ref: Para. A2)
11. If the auditor’s report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor

³ SA 560, “Subsequent Events”, paragraphs 14-17.

⁴ SA 580, “Written Representations”, paragraph 14.

shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

- (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
- (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures. (Ref: Para. A3-A5)

12. If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein. (Ref: Para. A6)

Prior Period Financial Statements Audited by a Predecessor Auditor

13. If the financial statements of the prior period were audited by a predecessor auditor and the auditor is permitted by law or regulation to refer to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor shall state in an Other Matter paragraph in the auditor's report:

- (a) That the financial statements of the prior period were audited by the predecessor auditor;
- (b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
- (c) The date of that report. (Ref: Para. A7)

Prior Period Financial Statements Not Audited

14. If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements⁵. (Ref: Para. A7a)

Comparative Financial Statements

15. When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed. (Ref: Para. A8-A9)

16. When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with SA 706⁶. (Ref: Para. A10)

Prior Period Financial Statements Audited by a Predecessor Auditor

17. If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter

⁵ SA 510, paragraph 6.

⁶ SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", paragraph 8.

paragraph:

- (a) That the financial statements of the prior period were audited by a predecessor auditor;
- (b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefor; and
- (c) The date of that report,

unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.

18. If the auditor concludes that a material misstatement exists that affects the prior period financial statements on which the predecessor auditor had previously reported without modification, the auditor shall communicate the misstatement with the appropriate level of management and those charged with governance and request that the predecessor auditor be informed. If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period. (Ref: Para. A11)

Prior Period Financial Statements Not Audited

19. If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph that the comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements⁷.

Application and Other Explanatory Material

Audit Procedures

Written Representations (Ref: Para. 9)

A1. In the case of comparative financial statements, the written representations are requested for all periods referred to in the auditor's opinion because management needs to re-affirm that the written representations it previously made with respect to the prior period remain appropriate. In the case of corresponding figures, the written representations are requested for the financial statements of the current period only because the auditor's opinion is on those financial statements, which include the corresponding figures. However, the auditor requests a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

Audit Reporting

Corresponding Figures

No Reference in Auditor's Opinion (Ref: Para.10)

A2. The auditor's opinion does not refer to the corresponding figures because the auditor's opinion is on the current period financial statements as a whole, including the corresponding figures.

Modification in Auditor's Report on the Prior Period Unresolved (Ref: Para. 11)

A3. When the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

A4. When the auditor's opinion on the prior period, as previously expressed, was modified, the unresolved

⁷ SA 510, paragraph 6.

matter that gave rise to the modification may not be relevant to the current period figures. Nevertheless, a qualified opinion, a disclaimer of opinion, or an adverse opinion (as applicable) may be required on the current period's financial statements because of the effects or possible effects of the unresolved matter on the comparability of the current and corresponding figures.

A5. Illustrative examples of the auditor's report if the auditor's report on the prior period included a modified opinion and the matter giving rise to the modification is unresolved are contained in Examples A and B of the Appendix.

Misstatement in Prior Period Financial Statements (Ref: Para. 12)

A6. When the prior period financial statements that are misstated have not been amended and an auditor's report thereon has not been issued in accordance with the requirements of SA 560, "Subsequent Events", but the corresponding figures have been properly dealt with as required under the applicable financial reporting framework and the appropriate disclosures have been made in the current period financial statements, the auditor's report may include an Emphasis of Matter paragraph describing the circumstances and referring to, where relevant, disclosures that fully describe the matter that can be found in the financial statements (see SA 706).

Prior Period Financial Statements Audited by a Predecessor Auditor (Ref: Para. 13)

A7. An illustrative example of the auditor's report if the prior period financial statements were audited by a predecessor auditor and the auditor is permitted by law or regulation to refer to the predecessor auditor's report on the corresponding figures is contained in Example C of the Appendix.

Prior Period Financial Statements Not Audited (Ref: Para. 14)

A7a. Where prior period financial statements were not audited, the auditor should request the management to disclose this fact on the face of the current period financial statements with respect to the corresponding figures.

Comparative Financial Statements

Reference in Auditor's Opinion (Ref: Para. 15)

A8. Because the auditor's report on comparative financial statements applies to the financial statements for each of the periods presented, the auditor may express a qualified opinion or an adverse opinion, disclaim an opinion, or include an Emphasis of Matter paragraph with respect to one or more periods, while expressing a different auditor's opinion on the financial statements of the other period.

A9. An illustrative example of the auditor's report if the auditor is required to report on both the current and the prior period financial statements in connection with the current year's audit and the prior period included a modified opinion and the matter giving rise to the modification is unresolved, is contained in Example D of the Appendix.

Opinion on Prior Period Financial Statements Different from Previous Opinion (Ref: Para. 16)

A10. When reporting on the prior period financial statements in connection with the current period's audit, the opinion expressed on the prior period financial statements may be different from the opinion previously expressed if the auditor becomes aware of circumstances or events that materially affect the financial statements of a prior period during the course of the audit of the current period. In some circumstances, the auditor may have additional reporting responsibilities designed to prevent future reliance on the auditor's previously issued report on the prior period financial statements.

Prior Period Financial Statements Audited by a Predecessor Auditor (Ref: Para. 18)

A11. The predecessor auditor may be unable or unwilling to revise the auditor's report on the prior period financial statements. An Other Matter paragraph of the auditor's report may indicate that the predecessor

auditor reported on the financial statements of the prior period before amendment. In addition, if the auditor is engaged to audit and obtains sufficient appropriate audit evidence to be satisfied as to the appropriateness of the amendment, the auditor's report may also include the following paragraph:

As part of our audit of the 20X2 financial statements, we also audited the adjustments described in Note X that were applied to amend the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 20X1 financial statements of the company other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X1 financial statements taken as a whole.

Material Modifications vis-a-vis ISA 710, "Comparative Information—Corresponding Figures and Comparative Financial Statements"

Deletions

1. Paragraphs 9 and 12 of ISA 710 deal with the restatement of the prior period financial statements. Since in India, Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived, the restatement of the prior period financial statements does not exist in the Indian scenario. Hence, to align with the requirements of AS 5, the requirement of restatement of prior period items has been replaced with the requirement to disclose the prior period items in the current year's Statement of Profit & Loss. Corresponding changes have also been made at the relevant places of the Standard.

2. Paragraph 17 of ISA 710 deals with the situation wherein the predecessor auditor reissue his audit report. Since in India, the nomenclature, "Reissue" is not used for the re-issuance of the audit report by an auditor, the same has been replaced with the word, "Revised". Corresponding changes have also been made at the relevant places of the Standard.

Appendix

Example Auditors' Reports

Example A - Corresponding Figures (Ref: Para. A5)

Report illustrative of the circumstances described in paragraph 11(a), as follows:

- The auditor's report on the prior period, as previously issued, included a qualified opinion.
- The matter giving rise to the modification is unresolved.
- The effects or possible effects of the matter on the current period's figures are material and require a modification to the auditor's opinion regarding the current period figures.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements⁸

We have audited the accompanying financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of profit and loss, and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory

⁸ The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation of these financial statements that give a true and fair view of the state of affairs, results of operations and cash flows of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control⁹. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which constitutes a departure from the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This is the result of a decision taken by management at the start of the preceding financial year and caused us to qualify our audit opinion on the financial statements relating to that year. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by ₹ XXX in 20X1 and ₹ XXX in 20X0, property, plant and equipment should be reduced by accumulated depreciation of ₹ XXX in 20X1 and ₹ XXX in 20X0, and the accumulated loss should be increased by ₹ XXX in 20X1 and Rs.XXX in 20X0.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of affairs of the Company as of March 31, 20X1, and of its results of operations and its cash flows for the year then ended in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act").

⁹ The underlined text has been added pursuant to decision of Council of ICAI taken at its 329th adjourned meeting held in January 2014. The complete text of the Announcement in this regard has been published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation ¹⁰)
Membership Number

Place of Signature

Date

Example B - Corresponding Figures (Ref: Para. A5)

Report illustrative of the circumstances described in paragraph 11(b), as follows:

- The auditor's report on the prior period, as previously issued, included a qualified opinion.
- The matter giving rise to the modification is unresolved.
- The effects or possible effects of the matter on the current period's figures are immaterial but require a modification to the auditor's opinion because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements ¹¹

We have audited the accompanying financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of profit and loss, and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation of these financial statements that give a true and fair view of the state of affairs, results of operations and cash flows of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit

¹⁰ Partner or Proprietor, as the case may be.

¹¹ The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control¹². An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

Because we were appointed auditors of the Company during 20X0, we were not able to observe the counting of the physical inventories at the beginning of that period or satisfy ourselves concerning those inventory quantities by alternative means. Since opening inventories affect the determination of the results of operations, we were unable to determine whether adjustments to the results of operations and opening retained earnings might be necessary for 20X0. Our audit opinion on the financial statements for the year ended 31 March, 20X0 was modified accordingly. Our opinion on the current period's financial statements is also modified because of the possible effect of this matter on the comparability of the current period's figures and the corresponding figures.

Qualified Opinion

In our opinion, except for the possible effects on the corresponding figures of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of affairs of the Company as of March 31, 20X1, and of its results of operations and its cash flows for the year then ended in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act").

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹³)
Membership Number

Place of Signature

Date

¹² The underlined text has been added pursuant to decision of Council of ICAI taken at its 329th adjourned meeting held in January 2014. The complete text of the Announcement in this regard has been published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

¹³ Partner or Proprietor, as the case may be.

Example C - Corresponding Figures (Ref: Para. A7)**Report illustrative of the circumstances described in paragraph 13, as follows**

- The prior period's financial statements were audited by a predecessor auditor.
- The auditor is permitted by law or regulation to refer to the predecessor auditor's report on the corresponding figures and decides to do so.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements¹⁴

We have audited the accompanying financial statements of ABC Company Ltd. ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of profit and loss, and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation of these financial statements that give a true and fair view of the state of affairs, results of operations and cash flows of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control¹⁵. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

¹⁴ The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

¹⁵ The underlined text has been added pursuant to decision of Council of ICAI taken at its 329th adjourned meeting held in January 2014. The complete text of the Announcement in this regard has been published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

Opinion

In our opinion, the financial statements give a true and fair view of the state of affairs of the Company as of March 31, 20X1, and of its results of operations and its cash flows for the year then ended in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act").

Other Matters

The financial statements of the Company for the year ended March 31, 20X1, were audited by another auditor who expressed an unmodified opinion on those statements on June 30, 20X1.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁶)
Membership Number

Place of Signature

Date

Example D - Comparative Financial Statements (Ref: Para. A9)

Report illustrative of the circumstances described in paragraph 15, as follows:

- Auditor is required to report on both the current period financial statements and the prior period financial statements in connection with the current year's audit.
- The financial reporting framework used in preparing the financial statements is other than accounting principals generally accepted in India. However, the audit is performed in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India.
- The auditor's report on the prior period, as previously issued, included a qualified opinion.
- The matter giving rise to the modification is unresolved.
- The effects or possible effects of the matter on the current period's figures are material to both the current period financial statements and prior period financial statements and require a modification to the auditor's opinion.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements¹⁷

We have audited the accompanying financial statements of ABC Company Ltd. ("the Company"), which

¹⁶ Partner or Proprietor, as the case may be.

¹⁷ The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

comprise the balance sheets as at March 31, 20X1 and 20X0, and the statements of profit & loss, and cash flow statements for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation of these financial statements that give a true and fair view of the state of affairs, results of operations and cash flows of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control¹⁸. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which constitutes a departure from the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by Rs.XXX in 20X1 and Rs.XXX in 20X0, property, plant and equipment should be reduced by accumulated depreciation of Rs.XXX in 20X1 and Rs.XXX in 20X0, and the accumulated loss should be increased by Rs.XXX in 20X1 and Rs.XXX in 20X0.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of affairs of the Company as of March 31, 20X1 and 20X0 and of its results of operations and its cash flows for the years then ended in accordance

¹⁸ The underlined text has been added pursuant to decision of Council of ICAI taken at its 329th adjourned meeting held in January 2014. The complete text of the Announcement in this regard has been published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act").

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁹)
Membership Number

Place of Signature

Date

¹⁹ Partner or Proprietor, as the case may be.