INTERMEDIATE (IPC) COURSE
STUDY MATERIAL

PAPER : 6

AUDITING AND ASSURANCE

MODULE – 1

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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- The entire syllabus has been divided into nine chapters.
- In each chapter, learning objectives have been stated. The learning objectives would enable you to understand the sequence of various aspects dealt within the chapter before going into the details so that you know the direction of your studies.
- In each chapter, the topic has been covered in a step by step approach. The text has been explained, where appropriate, through illustrations and practical problems. You should go through the chapter carefully ensuring that you understand the topic and then can tackle the exercises.

Handbook on Auditing Pronouncements comprises of Standards on Auditing and Guidance Notes.

The Practice Manual aims to provide guidance as to the manner of writing an answer in the examination. Main features of Practice Manual are as under:

- Important Definitions have been given for quick recapitulation. Students are expected to attempt the questions and then compare it with the actual answers.
- Compilation of questions appearing during last twenty examinations.
- Exercises have been given at the end of each topic for independent practice.

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- Diagrammatic Presentation has been made in most of Chapters for quick revision of described concept.
- Feedback form is given at the end of this study material wherein students are encouraged to give their feedback/suggestions.

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3	Preparation for an Audit	3.1.1 Agreement on Audit Engagement Terms 3.3 Diagrammatic representation showing techniques commonly adopted by the Auditors 3.10.1 Diagrammatic representation showing types of Working Paper Files 3.10.3 Ownership and Custody of Working Papers 3.12.3 Diagrammatic representation showing Approaches to Sampling 3.12.4 Diagrammatic representation showing Sample Selection Methods 3.13.1 Concept of Audit Risk	3.3 3.6 3.21 3.24 3.34 3.36 3.40
4	Internal Control	4.2 Understanding the Entity and Its Environment, Including the Entity's Internal Control	4.4
5	Vouching	5.2.2 Transactions with Related Party 5.2.19 Retirement Gratuity to Employees	5.9 5.22
6	Verification of Assets and Liabilities	6.4.5 Fixed Assets and requirement of Companies (Auditor's Report) Order, 2015	6.22

STUDY PLAN – KEY TO EFFECTIVE LEARNING

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For the simplicity of the students it is suggested that the entire syllabus may be segregated into the following six parts which may be studied with the help of Chapters viz.

S. No.	Topics to be covered in each part	Reference of Chapters
Part 1	Auditing Concepts, Auditing engagement, Documentation, Audit evidence	Refer Chapter 1 & 2
Part 2	Standards on Auditing and Guidance Notes	Prescribed by ICAI in the form of list of publication Given in Handbook on Auditing Pronouncements
Part 3	Internal Control, Internal Control and Computerized Environment, Approaches to Auditing in Computerized Environment, Audit Sampling, Analytical review procedures.	Refer Chapter 3 & 4
Part 4	Audit of payments, Audit of receipts, Audit of Purchases, Audit of Sales, Audit of suppliers' ledger and the debtors' ledger, Audit of impersonal ledger, Audit of assets and liabilities.	Refer Chapter 5 & 6
Part 5	Company Audit, Audit Report	Refer Chapter 7 & 8
Part 6	Special points in audit of different types of undertakings, i.e., Educational institutions, Hotels, Clubs, Hospitals, Hire-purchase and leasing companies (excluding banks, electricity companies, cooperative societies, and insurance companies), Features and basic principles of government audit, Local bodies and not-for-profit organizations, Comptroller and Auditor General and its constitutional role.	Refer Chapter 9

For the better understanding of the Standards on Auditing (SAs) given in Part 2 it may be noted that they contain two distinct sections, one, the Requirements section and, two, the Application Guidance section.

The fundamental principles of the Standard are contained in the Requirements section and represented by use of "shall". 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. Further, the standard portion or principles enunciated in a Standard need not to be given in bold face.

For the remaining part of syllabus our study is divided in nine chapters viz. Nature of Auditing, Basic Concepts in Auditing, Preparation for an Audit, Internal Control, Vouching, Verification of Assets and Liabilities, The Company Audit – I, The Company Audit – II and Special Audits

Chapters from 1 to 4 are the backbone of the syllabus of Auditing and Assurance. These four chapters are basically based on Standards on Auditing. After preparing these chapters, students will be able to understand the other chapters like Vouching, Verification of Assets and Liabilities and Special Audit.

The Chapter 1 - Nature of Auditing deals with the Concept and objective of Auditing, aspects to be covered in Audit, Basic Principles Governing an Audit, Scope and Inherent Limitations of Audit, and Relationship of Auditing with other Disciplines. In this chapter, student will be able to understand the functional classification, qualities of an auditor, objectives of audit, basic principles of an audit, and different types of audit and relationship of auditing with other disciplines. The student should try to carefully understand the basic concepts and the structure of the auditing to gain the in depth knowledge of the subject. As already discussed these chapters are interlinked with Standards on Auditing. Therefore, to better understand the implication of this chapter, it is suggested to read it with SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing and SA 240, "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements". Instead of cramming the contents, the student should try to bring out the very idea of the chapter. This exercise will enable him to bridge the linkage for the further study.

After understanding the nature of auditing, student should try to link it with the basic concepts in auditing i.e. Chapter 2 which deals with Concept of Auditor's Independence, Audit Evidence, Concept of Materiality, Concept of True and Fair and Disclosure of Accounting Policies. Student should refer SA 500 on Audit Evidence, SA 320 on Materiality in Planning and Performing an Audit, SA 520 on Analytical Procedures and SA 505 on External Confirmations etc. alongwith this chapter. The fair understanding of the chapter has its roots in the above mentioned SAs. Hence, it is suggested that the students should understand the SAs comprehensively.

The Chapter 3 requires the students to identify the major areas for preparation for an audit for which they should refer SA 300 on Planning an Audit of Financial Statements, SA 220 on Quality Control for Audit of Financial Statements, SA 230 on Audit Documentation etc. After going through the text of these SAs the students can apprehend the chapter which deals with Auditor's Engagement, Audit Process, Techniques, Procedure, Planning, Programme, Risk, Continuous and Final Audit, Planning and Materiality, Audit Working Papers and Obtaining Certificate from Management.

Chapter 4 is on Internal Control which deals with Concept, Environment, Inherent limitations, Accounting and Financial Control, Internal Control - Management and the Auditor, Relationship between the Assessments of Inherent and Control Risks, Internal Control and the Computerized Information System (CIS) Environment, Internal Check, Internal Audit. To comprehend this chapter the students should try to establish linkage with the SA namely 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment, SA 330 on The Auditor's Responses to Assessed Risks, SA 610 Using the Work of Internal Auditors etc. While answering to the questions of this chapter, students should be analytical and objective, without losing focus on the statement.

Vouching and verification are very important chapters. While studying these chapters, students should have knowledge of basics of an audit. Students should not stuff the steps for vouching and verification. Instead they should apply their knowledge.

Vouching is discussed in Chapter 5 which deals with Audit of cash transactions, Audit of Trading Transactions, Audit of Ledgers, Balance Sheet Audit and Analytical Procedures. The general approach to study the chapter is to examine the existing internal control system in the organisation. The appropriate ledger accounts involved, if any should also be scrutinized. Further the vouching ends with the routine checking of the receipts and payments involved and preparation of bank reconciliation statement.

Similarly the Verification of Assets and Liabilities is discussed in the Chapter 6. The main aspects covered here include Capital and Revenue Expenditure, Depreciation, Reserves, Verification of assets, Current Assets, Book-debts, Bank Balances, Cash in hand, Miscellaneous Expenditure, Verification of Liabilities, Contingent Liabilities, Events occurring after the Balance Sheet Date, Prior Period and Extraordinary Items and Changes in Accounting Policies. The basic features to study involve existence, ownership, control, rights, valuation, disclosure and presentation of the items involved. Further, student may interlink this chapter with Guidance notes, Standards on Auditing and Accounting Standards.

The Chapter 7 - The Company Audit-I deals with Qualifications and Disqualifications, Appointment, Remuneration, Removal, Powers, Duties of auditor, Ceiling on number of audits, Audit Report, Audit of Branch Office Accounts, Joint Audit, Special Audit, Cost Audit and Statutory Report. . For gaining the in depth knowledge of the subject the student should focus on the various provisions of the Companies Act, 2013, and the reporting mechanism as suggested by SAs in 700 series, and Statement on Reporting Under Section 227 (1A) of The Companies Act, 1956.

The Chapter 8 - The Company Audit-II deals with General Considerations in a Company Audit, Specific Provisions as regards Accounts in the Companies Act, 2013, Special requirements of Company Audit, Audit of Share Capital, Option on Share Capital, Shares Transfer Audit, Verification of Issue of Bonus Shares, Audit of Debentures, Audit of Dividends and Presentation of Financial Statements. Again as contemplated by the chapter 7 the requirements for understanding this chapter is same. Since the chapter deals directly with the provisions of the Companies Act, 2013 the students should be very clear and concise in their applicational attribute. They should avoid going round and round by harping on one or two points repetitively in different ways. Instead they should reach the heart of the question and explain the major features or matters in a logical point-wise manner with sub-headings for each point and try to give a few examples in support of your reasoning.

The Chapter 9 Special Audits deals with Government Audit, Audit of Local Bodies, Audit of Non-Governmental Organizations (NGO's) and Miscellaneous Audits. Students are expected to study the procedure involved in various audits and try to establish the linkage with the knowledge gained from other disciplines like accounting for audit of partnership firms in learning the audit procedure. Further the students can relate their basic understanding while going through the other audits like audit of schools, hotels, cinemas etc. The important points in any audit include constitution, minute book, internal control, vouching of receipts and payments, verification of assets and liabilities etc. The students should try to encapsulate the procedures in various audits to command good holding of marks.

In general, students should in the first instance focus on studying Auditing concepts, procedures and techniques from the study material. The knowledge gained from meticulous study should be translated in the form of succinct notes. These notes may be accompanied by the relevant proforma and diagrams so that at the later stages of preparation, the conceptual knowledge underlying different topics may be gained within minimum time and minimum efforts without going through a number of books again.

Students should also take a keen interest in updating themselves on contemporary developments in the field of auditing by regularly referring to articles on Auditing in CA Journal, Students' monthly Journal and other relevant professional journals, publications and books.

Students may also scan through the Annual Financial Statements of Companies to analyse the notes and qualifications, if any, incorporated by the Auditors in their Audit Report.

Happy Reading and Best Wishes!

SYLLABUS

PAPER – 6: AUDITING AND ASSURANCE

(One Paper- Three hours -100 Marks)

Level of knowledge: Working Knowledge

Objective:

To understand objective and concept of auditing and gain working knowledge of generally accepted auditing procedures and of techniques and skills needed to apply them in audit and attestation engagements.

Contents:

1. **Auditing Concepts —** Nature and limitations of Auditing, Basic Principles governing an audit, Ethical principles and concept of Auditor's Independence, Relationship of auditing with other disciplines.

2. **Standards on Auditing and Guidance Notes —** Overview, Standard-setting process, Role of International Auditing and Assurance Standards Board, Standards on Auditing issued by the ICAI; Guidance Note(s) on — Audit of Fixed Assets, Audit of Inventories, Audit of Investments, Audit of Debtors, Loans and Advances, Audit of Cash and Bank Balances, Audit of Miscellaneous Expenditure, Audit of Liabilities, Audit of Revenue, Audit of Expenses and provision for proposed dividends.

3. **Auditing engagement —** Audit planning, Audit programme, Control of quality of audit work — Delegation and supervision of audit work.

4. **Documentation —** Audit working papers, Audit files: Permanent and current audit files, Ownership and custody of working papers.

5. **Audit evidence —** Audit procedures for obtaining evidence, Sources of evidence, Reliability of audit evidence, Methods of obtaining audit evidence — Physical verification, Documentation, Direct confirmation, Re-computation, Analytical review techniques, Representation by management, Obtaining certificate.

6. **Internal Control —** Elements of internal control, Review and documentation, Evaluation of internal control system, Internal control questionnaire, Internal control check list, Tests of control, Application of concept of materiality and audit risk, Concept of internal audit.

7. Internal Control and Computerized Environment, Approaches to Auditing in Computerised Environment.

8. **Auditing Sampling —** Types of sampling, Test checking, Techniques of test checks.

9. **Analytical review procedures**.

10. Audit of payments — General considerations, Wages, Capital expenditure, Other payments and expenses, Petty cash payments, Bank payments, Bank reconciliation.

11. Audit of receipts — General considerations, Cash sales, Receipts from debtors, Other Receipts.

12. Audit of Purchases — Vouching cash and credit purchases, Forward purchases, Purchase returns, Allowance received from suppliers.

13. Audit of Sales — Vouching of cash and credit sales, Goods on consignment, Sale on approval basis, Sale under hire-purchase agreement, Returnable containers, Various types of allowances given to customers, Sale returns.

14. Audit of suppliers' ledger and the debtors' ledger — Self-balancing and the sectional balancing system, Total or control accounts, Confirmatory statements from credit customers and suppliers, Provision for bad and doubtful debts, Writing off of bad debts.

15. Audit of impersonal ledger — Capital expenditure, deferred revenue expenditure and revenue expenditure, Outstanding expenses and income, Repairs and renewals, Distinction between reserves and provisions, Implications of change in the basis of accounting.

16. Audit of assets and liabilities.

17. Company Audit — Audit of Shares, 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, Other Important Provisions under the Companies Act, 2013 relating to Audit and Auditors and Rules made thereunder.

18. Audit Report — Qualifications, Disclaimers, Adverse opinion, Disclosures, Reports and certificates.

19. Special points in audit of different types of undertakings, i.e., Educational institutions, Hotels, Clubs, Hospitals, Hire-purchase and leasing companies (excluding banks, electricity companies, cooperative societies, and insurance companies).

20. Features and basic principles of government audit, Local bodies and not-for-profit organizations, Comptroller and Auditor General and its constitutional role.

Note:

(i) 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.

(ii) If new legislations 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.

CONTENTS

DETAIL CONTENTS : MODULES – 1

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All care has been taken to provide interpretations and discussions in a manner useful for the students. However, the study 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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The Chapter 7 - The Company Audit-I deals with Qualifications and Disqualifications, Appointment, Remuneration, Removal, Powers, Duties of auditor, Ceiling on number of audits, Audit Report, Audit of Branch Office Accounts, Joint Audit, Special Audit, Cost Audit and Statutory Report. . For gaining the in depth knowledge of the subject the student should focus on the various provisions of the Companies Act, 2013, and the reporting mechanism as suggested by SAs in 700 series, and Statement on Reporting Under Section 227 (1A) of The Companies Act, 1956.

The Chapter 8 - The Company Audit-II deals with General Considerations in a Company Audit, Specific Provisions as regards Accounts in the Companies Act, 2013, Special requirements of Company Audit, Audit of Share Capital, Option on Share Capital, Shares Transfer Audit, Verification of Issue of Bonus Shares, Audit of Debentures, Audit of Dividends and Presentation of Financial Statements. Again as contemplated by the chapter 7 the requirements for understanding this chapter is same. Since the chapter deals directly with the provisions of the Companies Act, 2013 the students should be very clear and concise in their applicational attribute. They should avoid going round and round by harping on one or two points repetitively in different ways. Instead they should reach the heart of the question and explain the major features or matters in a logical point-wise manner with sub-headings for each point and try to give a few examples in support of your reasoning.

The Chapter 9 Special Audits deals with Government Audit, Audit of Local Bodies, Audit of Non-Governmental Organizations (NGO's) and Miscellaneous Audits. Students are expected to study the procedure involved in various audits and try to establish the linkage with the knowledge gained from other disciplines like accounting for audit of partnership firms in learning the audit procedure. Further the students can relate their basic understanding while going through the other audits like audit of schools, hotels, cinemas etc. The important points in any audit include constitution, minute book, internal control, vouching of receipts and payments, verification of assets and liabilities etc. The students should try to encapsulate the procedures in various audits to command good holding of marks.

In general, students should in the first instance focus on studying Auditing concepts, procedures and techniques from the study material. The knowledge gained from meticulous study should be translated in the form of succinct notes. These notes may be accompanied by the relevant proforma and diagrams so that at the later stages of preparation, the conceptual knowledge underlying different topics may be gained within minimum time and minimum efforts without going through a number of books again.

Students should also take a keen interest in updating themselves on contemporary developments in the field of auditing by regularly referring to articles on Auditing in CA Journal, Students' monthly Journal and other relevant professional journals, publications and books.

Students may also scan through the Annual Financial Statements of Companies to analyse the notes and qualifications, if any, incorporated by the Auditors in their Audit Report.

Happy Reading and Best Wishes!

SYLLABUS

PAPER – 6: AUDITING AND ASSURANCE

(One Paper- Three hours -100 Marks)

Level of knowledge: Working Knowledge

Objective:

To understand objective and concept of auditing and gain working knowledge of generally accepted auditing procedures and of techniques and skills needed to apply them in audit and attestation engagements.

Contents:

1. **Auditing Concepts —** Nature and limitations of Auditing, Basic Principles governing an audit, Ethical principles and concept of Auditor's Independence, Relationship of auditing with other disciplines.

2. **Standards on Auditing and Guidance Notes —** Overview, Standard-setting process, Role of International Auditing and Assurance Standards Board, Standards on Auditing issued by the ICAI; Guidance Note(s) on — Audit of Fixed Assets, Audit of Inventories, Audit of Investments, Audit of Debtors, Loans and Advances, Audit of Cash and Bank Balances, Audit of Miscellaneous Expenditure, Audit of Liabilities, Audit of Revenue, Audit of Expenses and provision for proposed dividends.

3. **Auditing engagement —** Audit planning, Audit programme, Control of quality of audit work — Delegation and supervision of audit work.

4. **Documentation —** Audit working papers, Audit files: Permanent and current audit files, Ownership and custody of working papers.

5. **Audit evidence —** Audit procedures for obtaining evidence, Sources of evidence, Reliability of audit evidence, Methods of obtaining audit evidence — Physical verification, Documentation, Direct confirmation, Re-computation, Analytical review techniques, Representation by management, Obtaining certificate.

6. **Internal Control —** Elements of internal control, Review and documentation, Evaluation of internal control system, Internal control questionnaire, Internal control check list, Tests of control, Application of concept of materiality and audit risk, Concept of internal audit.

7. Internal Control and Computerized Environment, Approaches to Auditing in Computerised Environment.

8. **Auditing Sampling —** Types of sampling, Test checking, Techniques of test checks.

9. **Analytical review procedures**.

10. Audit of payments — General considerations, Wages, Capital expenditure, Other payments and expenses, Petty cash payments, Bank payments, Bank reconciliation.

11. Audit of receipts — General considerations, Cash sales, Receipts from debtors, Other Receipts.

12. Audit of Purchases — Vouching cash and credit purchases, Forward purchases, Purchase returns, Allowance received from suppliers.

13. Audit of Sales — Vouching of cash and credit sales, Goods on consignment, Sale on approval basis, Sale under hire-purchase agreement, Returnable containers, Various types of allowances given to customers, Sale returns.

14. Audit of suppliers' ledger and the debtors' ledger — Self-balancing and the sectional balancing system, Total or control accounts, Confirmatory statements from credit customers and suppliers, Provision for bad and doubtful debts, Writing off of bad debts.

15. Audit of impersonal ledger — Capital expenditure, deferred revenue expenditure and revenue expenditure, Outstanding expenses and income, Repairs and renewals, Distinction between reserves and provisions, Implications of change in the basis of accounting.

16. Audit of assets and liabilities.

17. Company Audit — Audit of Shares, 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, Other Important Provisions under the Companies Act, 2013 relating to Audit and Auditors and Rules made thereunder.

18. Audit Report — Qualifications, Disclaimers, Adverse opinion, Disclosures, Reports and certificates.

19. Special points in audit of different types of undertakings, i.e., Educational institutions, Hotels, Clubs, Hospitals, Hire-purchase and leasing companies (excluding banks, electricity companies, cooperative societies, and insurance companies).

20. Features and basic principles of government audit, Local bodies and not-for-profit organizations, Comptroller and Auditor General and its constitutional role.

Note:

(i) 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.

(ii) If new legislations 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.

CONTENTS

DETAIL CONTENTS : MODULES – 1

1

Nature of Auditing

Learning Objective

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, basic principles covering audit etc
- Distinguish between auditing and investigation
- Understand different types of audit and relationship of auditing with other disciplines.

1.1 Introduction

Historically, the word '**auditing**' has been derived from Latin word "**audire**" which means "**to hear**". In fact, such an expression conveyed the manner in which the auditing was conducted during ancient time. However, over a period of time, the manner of conducting audit has undergone revolutionary change.

According to **Dicksee**, traditionally auditing can be understood as an examination of accounting records undertaken with a view to establishing whether they completely reflect the transactions correctly for the related purpose. But this is not the end of matter. In addition the auditor also expresses his opinion on the character of the statements of accounts prepared from the accounting records so examined as to whether they portray a true and fair picture.

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 points 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 or failure of the activities in achieving the objective of the organisation. 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 organisation 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 payables, and other participants in economic exchange.

To correctly understand the role of auditing, you must understand the nature and purpose of the financial statements. 'Financial statements' is a set of documents which show the result of business operation during a period - how the result was achieved and the position of assets and liabilities on the given date. Progress made or success achieved during a certain period can also be readily ascertained from such a set of documents. It also makes an implied representation that it has been properly prepared, shows correct figures and the figures are set against correct description and context.

Regardless of the type of entity - whether in the public or private sector or whether for profit or not - all entities use economic resources to pursue their goals. Financial statements enable an entity's management to provide useful information about its financial position at a particular point of time and the results of its operations and its changes in financial position for a particular period of time. External financial reporting for these entities is directed toward the common interest of various users.

However, you must be clear on one point. The statements of account are viewed by different interests from different angles; consequently a statement prepared primarily for the use of the owners may not be wholly useful to interest of other users. For example, management may need more detailed information on matters considered critical by it, the investors and financial analysts are keen to see the projected image of the present state of affairs. Government would look for inadmissible items under the taxation laws, etc. Separate statements of accounting highlighting the information needed by the interested parties, other than the owners cannot be expected to be prepared in the ordinary course unless the same is specially called for. This makes the preparation of the financial statements more onerous because other users of the statement would use the information subject to such modifications and enquiry as would be considered necessary to meet their respective objective. But they must have an honest assurance that the statements have been properly compiled, prepared and presented to adhere to the requirements of owners. The auditor can accomplish this by a process of examination and appraisal.

Further, it may be noted that the management is responsible for establishing an accounting system to identify, measure, record and adequately disclose an entity's transactions and other events that affect its financial position and results of operations. Management is responsible for selecting accounting principles that appropriately reflect events that occur and for making other accounting estimates and judgments. This responsibility is not lessened by an independent audit.

1.2 Definition of Auditing

According to General Guidelines on Internal Auditing issued by the ICAI, "Auditing is defined as a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognises the propositions before him for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report."

The nature of the propositions which an auditor is called upon to review varies. Thus an auditor may review the financial statements of an enterprise to ascertain whether they reflect a true and fair view of its state of affairs and of its working results. In another situation, he may analyse the operations of an enterprise to appraise their cost-effectiveness and in still another, he may seek evidence to review the managerial performances in an enterprise. In yet another type of audit, the auditor may examine whether the transactions of an enterprise have been executed within the framework of certain standards of financial propriety. However, the variations in the propositions do not change the basic philosophy of auditing, though the process of collection and evaluation of evidence and that of formulating a judgment thereon may have to be suitably modified.

"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 process should perform his work with knowledge of the use of the accounting statements discussed above and should take particular care to ensure that nothing contained in the statements will ordinarily 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 underlying papers and documents and by other 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 taken as an integrated whole, present a true and fair picture of the operational results and of the assets and liabilities.

The financial statements shall give a true and fair view of the state of affairs of the company or companies as at the end of the financial year [Section 129(1) of Companies Act, 2013].

The auditor's report shall state that—

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 the profit or loss and cash flow for the year and such other matters as may be prescribed [Section 143(2) of the Companies Act, 2013].

The aforesaid definition is very authoritative. It makes 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. The definition given above is restrictive since it covers financial information aspect only. However, the scope of auditing is not restricted to financial information only, but, today it extends to variety of non-financial areas as well. That is how various expressions like marketing audit, personnel audit, efficiency audit, production audit, etc. came into existence. Students may note that study material deals with various aspects of financial audit only unless otherwise specified.

1.3 Standards on Auditing

1.3.1 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.

The IAASB's Pronouncements: The IAASB's pronouncements govern audit, review, other assurance and related services engagements that are conducted in accordance with International Standards. They do not override the local laws or regulations that govern the audit of historical financial statements or assurance engagements on other information in a particular country required to be followed in accordance with that country's national standards. In the event that local laws or regulations differ from, or conflict with, the IAASB's Standards on a particular subject, an engagement conducted in accordance with local laws or regulations will not automatically comply with the IAASB's Standards. A professional accountant should not represent compliance with the IAASB's Standards unless the professional accountant has complied fully with all of those relevant to the engagement.

1.3.2 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

The Auditing and Assurance Standards Board, in 2007, adopted the *Revised Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Services.* 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	• applies in the audit of historical financial information.
SREs	• applies in the review of historical financial information
SAEs	• applies in assurance engagements, dealing with subject matters other than historical financial information
SRSs	• applies to engagements to apply agreed upon procedures to information and other related services engagements such as compilation engagements

Further, there is also a mother standard on quality control. In addition, each of the above group of Standards has been allotted a numerical series as follows and the Standards pertaining to a particular group is allotted a number from that numerical series:

Type of Standard	**Numerical Series**
Standards on Quality Control (SQCs)	01-99
Standards on Auditing (SAs)	100-999
Standards on Review Engagements (SREs)	2000-2699
Standards on Assurance Engagements (SAEs)	3000-3699
Standards on Related Services (SRSs)	4000-4699

The Standards on Auditing have also been further divided into seven categories

Based on the aspect of audit engagement addressed by them and each of these categories has a unique numerical series allotted. Therefore, a standard pertaining to a particular aspect of audit would be allotted a number from that relevant numerical series. These categories and series are as follows:

Aspect of Auditing Covered	Numerical Series
Introductory Matters	100 - 199
General Principles and Responsibilities	200 – 299
Risk Assessment and Response to Assessed Risk	300 - 499
Audit Evidence	500 – 599
Using Work of Others	600 - 699
Audit Conclusions and Reporting	700 - 799
Specialised Areas	800 - 899

The Council of the ICAI has issued following **Quality Control and Engagement Standards**

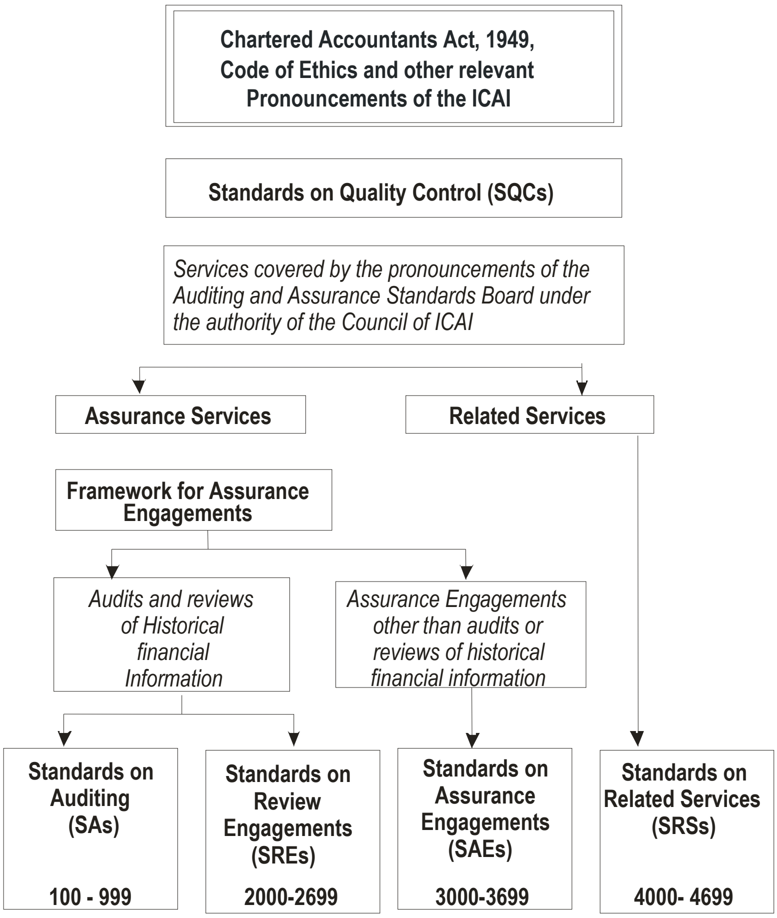
S.No	No. of Standard	Title of the Standard	Effective Date
1	SQC 1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements	April 1, 2009
2	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	April 1, 2010
3	SA 210	Agreeing the Terms of Audit Engagements	April 1, 2010
4	SA 220	Quality Control for an Audit of Financial Statements	April 1, 2010
5	SA 230	Audit Documentation	April 1, 2009
6	SA 240	The Auditor’s responsibilities Relating to Fraud in an Audit of Financial Statements	April 1, 2009
7	SA 250	Consideration of Laws and Regulations in an Audit of Financial Statements	April 1, 2009
8	SA 260	Communication with Those Charged with Governance	April 1, 2009
9	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	April 1, 2010
10	SA 299	Responsibility of Joint Auditors	April 1, 1996
11	SA 300	Planning an Audit of Financial Statements	April 1, 2008
12	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment	April 1, 2008
13	SA 320	Materiality in Planning and Performing an Audit	April 1, 2010
14	SA 330	The Auditor’s Responses to Assessed Risks	April 1, 2008
15	SA 402	Audit Considerations Relating to an Entity Using a Service Organization	April 1, 2010
16	SA 450	Evaluation of Misstatements Identified During the Audits	April 1, 2010
17	SA 500	Audit Evidence	April 1, 2009
18	SA 501	Audit Evidence - Specific Considerations for Selected Items	April 1, 2010
19	SA 505	External Confirmations	April 1, 2010
20	SA 510	Initial Audit Engagements-Opening Balances	April 1, 2010
21	SA 520	Analytical Procedures	April 1, 2010

22	SA 530	Audit Sampling	April 1, 2009
23	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	April 1, 2009
24	SA 550	Related Parties	April 1, 2010
25	SA 560	Subsequent Events	April 1, 2009
26	SA 570	Going Concern	April 1, 2009
27	SA 580	Written Representations	April 1, 2009
28	SA 600	Using the Work of Another Auditor	April 1, 2002
29	SA 610	Using the Work of Internal Auditors	April 1, 2010
30	SA 620	Using the Work of an Auditor's Expert	April1, 2010
31	SA 700	Forming an Opinion and Reporting on Financial Statements	April 1, 2012
32	SA 705	Modifications to the Opinion in the Independent Auditor's Report	April 1, 2012
33	SA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	April 1, 2012
34	SA 710	Comparative Information – Corresponding Figures and Comparative Financial Statements	April 1, 2011
35	SA 720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements	April 1, 2010
36	SA 800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks	April 1, 2011
37	SA 805	Special Considerations-Audits of Single Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement	April 1, 2011
38	SA 810	Engagements to Report on Summary Financial Statements	April 1, 2011
39	SRE 2400	Engagements to Review Financial Statements	April 1, 2010
40	SRE 2410	Review of Interim Financial Information Performed by the Independent Auditor of the Entity	April 1, 2010
41	SAE 3400	The Examination of Prospective Financial Information	April 1, 2007
42	SAE 3402	Assurance Reports on Controls At a Service Organisation	April 1, 2011

43	SRS 4400	Engagements to Perform Agreed Upon Procedures Regarding Financial Information	April 1, 2004
44	SRS 4410	Engagements to Compile Financial Information	April 1, 2004

A diagrammatic representation of the structure of Standards under the new Preface is given below:

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.

Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services: The 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).

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 reproduced in the **Handbook on Auditing Pronouncements.**

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.

1.4 The Auditor

The person conducting audit is known as the auditor; he makes a report to the person appointing him after due examination of the accounting records and the accounting statement in the form of an opinion on the financial statements. The opinion that he is called upon to express is whether the financial statement reflect a true and fair view. Auditing, especially of companies and for public purposes has become the preserve of persons having recognised professional training and qualification. In India, under the authority of the Companies Act, 2013, Chartered Accountants are professionally qualified for the audit of the accounts of companies.

1.4.1 Functional Classification of Auditors: Internal Auditor vs. External Auditor:

On the basis of functional division, auditors can be classified in two broad categories, namely, external auditors and internal auditors. External auditors are the persons who practise the profession of accountancy having qualified in the professional examination and are external *vis-a-vis* the organisation of which they audit the accounts. The internal auditors, on the other hand, may be professionally qualified or not and are internal *vis-a-vis* the organisation in which they are appointed to perform specific work. **It is statutory requirement too as per section 138 of the Companies Act, 2013 where the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.** The external auditors, on the other hand, are appointed by the owners of the organisation, say, shareholders of the company and thus they are treated external to the organisation in which they have been appointed. When an external auditor is appointed under a particular statute, such auditor may be known as the statutory auditor. Their scope of work is determined by the statute under which they have been appointed. Another significant distinction between the internal and external auditor is that the former is not considered independent *vis-a-vis* the management of the organisation while the latter is independent of the management of the organisation which is responsible for the preparation of the books of account. Finally the scope of work of an internal auditor may extend even beyond the financial accounting and may include cost investigation, inquiries relating to losses and wastages, production audit, performance audit, etc. It must be remembered that the basic foundation of any type of auditing, whether internal or external, envisages that the auditor must be independent of the activity for which he is going to conduct an audit. Even though the internal auditor is an employee yet he must be independent to the extent practicable.

1.4.2 Qualities of an Auditor: So far we have discussed the question of formal qualifications of an auditor. But 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, 2013*** and the Partnership Act, 1932 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".

1.5 Objectives of Audit

1.5.1 Expression of opinion: *If there remains a deep laid fraud in the accounts, which in the normal course of examination of accounts may not come to light, it will not be construed as failure of audit, provided the auditor was not negligent in the carrying out his normal work. This principle was established as early as in 1896 in the leading case in Re-Kingston Cotton Mills Co.*

The nature of audit objectives was also highlighted in the leading case Re The London and General Bank Ltd. [1895]. It was held that an auditor must ascertain that the books of account show the true financial position of the company. For the first time, the duties of the company auditor were spelled out in specific terms. Lord Justice Lindley observed, "It is no part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans without security. It is nothing to him whether the business of company is being conducted prudently or imprudently, profitably or unprofitably; it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit and his duty is confined to that."

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, 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 auditor's findings.

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.

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.

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 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.

So it follows from above that it is no part of the auditor's duty to probe into the propriety of business conduct. This contention has been held perfectly valid as it has been asserted that the conventional financial audit is concerned with examination of the transactions to ascertain the true and fair nature of the financial statements. The auditor is merely concerned with evaluating the evidence in support of transactions but need not examine the regularity and prudence of various decisions taken by the management.

However, of late, this has undergone a change as some of the requirements of law introduced in the past require the company auditor to go beyond the functions of reporting and express an opinion about the propriety or prudence of certain transactions in certain specific areas. Section 143 of the Companies Act, 2013 contain various such matters. It may also be clarified that the usage of words "true and fair" is restricted to certain countries such as U.K. while in other countries like United States the expression "full and fair" is prevalent. However both expressions aim to convey same meaning.

On a consideration of what has been discussed, it may be summed up that auditing has the principal objective of seeing whether or not the financial statements portray a true and fair state of affair and of reporting accordingly. An incidental and secondary, but by no means an insignificant audit objective, flowing from the former, is detection of errors and frauds and making recommendations to prevent their occurrence.

The term "Applicable financial reporting framework" is being explained here to have better understanding of this topic.

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 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.

1.5.2 Errors and Frauds: Accounting is a device for collecting and presenting useful information in financial terms about a business enterprise. It should as well be recognised that accounting data may contain errors for a variety of reasons, and those who rely on accounting data frequently have no way of determining for themselves the reliability of data presented. Even today the human element is the most significant element for recording and processing the accounting data. Human beings as they are always open to personal failures and allurement. The audit objective, in the past was, primarily concerned with the detection of errors and frauds and now, though the general audit engagement do not specifically require their detection, they do not rule them out and in fact stipulate their detection on the premise that no statements of account can be considered true and fair if substantial errors and frauds remain to distort the picture. Another presumption about errors and frauds which has wide recognition, is that the audit techniques and processes, if carried on conscientiously would bring to light errors and frauds even though the examination was not specifically directed to reveal them.

In the context of auditor's role in detection of frauds, a significant development in the sphere of management is the installation of control devices by the management to ensure compilation of reliable statements of account. These are designed to plug the possibilities of errors and frauds as they provide means for their early detection. It is true that management is responsible for prevention of errors and frauds. It can be argued that the auditor's role in their detection is very much conditioned by these developments. The auditor can achieve a lot by a purposeful review of those control systems and their operation. While conducting audit, the auditor may come to know the area where control is not foolproof or where control measures have not been properly operated with a view to ensuring better control over errors and frauds. In such instances, the auditor may provide the management with practicable suggestions for alteration or modification of the controls and checks. This is a safety for the future. It is a matter of safety for the business because by acting on the expert suggestions, a better assurance for obtaining reliable accounts is there. It is a safety for the auditor, if in future he is hauled up before the Court to defend a charge of negligence for non-detection of errors and frauds; it would be to his defense that he had already made the management aware of the weaknesses in the book-keeping system and procedures and the management had failed to act on his suggestions [*Re S. P. Catterson & Sons Ltd.]*.

If the books of account are not properly maintained and if the control system is weak, the possibility of frauds and errors are enormous and the auditor, even with the best of his efforts, may not be able to detect all of them. The fact is recognised by the Courts as is obvious from a study of the various judgments. The auditor's performance is judicially viewed by applying the following tests:

(a) whether the auditor has exercised reasonable care and skill in carrying out his work;

(b) whether the errors and frauds were such as could have been detected in the ordinary course of checking without the aid of any special efforts;

(c) whether the auditor had any reason to suspect the existence of the errors and frauds; and

(d) whether the error or fraud was so deep laid that the same might not have been detected by the application of normal audit procedures.

We have so far discussed the general background and the position of the auditors as regards errors and frauds and we know that the auditor has a certain amount of responsibility for their detection.

We shall now analyse the causes and nature of errors and frauds. If an auditor is aware of these, detection becomes easier in the sense that he can direct his enquiry more objectively and plan his work having regard to general possibility of errors and frauds.

R.K. Mautz, in his book on "Fundamentals of Auditing" has classified the reasons and circumstances of errors and he has included fraud in the broad category of errors. The classifications are the following:

1. Ignorance on the part of employees of accounting developments, generally accepted accounting principles, appropriate account classification of the necessary reconciling subsidiary ledgers with controlling accounts and of good accounting practices in general.
2. Carelessness on the part of those doing the accounting work.
3. A desire to conceal the effect of defalcations of shortages of one kind or another.
4. A tendency of the management to permit prejudice or bias to influence the interpretation of transactions or events or their presentation in the financial statements.
5. An ever present desire to hold taxes on income to minimum.

A sixth cause may be added to those Mr. Mautz has listed and that is more serious in nature. It is the intentional effort committed by persons in position of authority to:

(i) show up the picture depicted by the statements;

(ii) depress the picture depicted by the statements; and

(iii) convert the error to a personal benefit.

Errors and frauds both distort the true picture either by omission or by commission but the distinction between the two lies in intent. Error is an involuntary act whereas fraud is a deliberate act. Mautz also has classified the types of errors. These are:

1. Self-revealing and not self-revealing
2. Unintentional and intentional
3. Unconcealed and concealed
4. Affecting general ledger balances and not affecting general ledger balances.

Self-revealing errors: These are such errors the existence of which becomes apparent in the process of compilation of accounts. 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 balances 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.

Many other errors, however, are not revealed by either of these possibilities. If an item of expense which should have been charged to repairs account has been charged by mistake to the building account or if the amount of depreciation is calculated incorrectly, there is nothing in the book-keeping system which will bring the error to notice. Such errors are non self-revealing errors.

Suppose a debit entry is omitted to be posted in the ledger and there are one or more of such omissions of credit entries which exactly compensate the effect of the former omission, then another self-revealing error turns to be not so. Such mistakes may remain undetected indefinitely unless measures aimed at discovering such errors are applied.

Intentional Errors or Frauds: 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.

As per SA-240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

Although fraud is a broad legal concept, 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.

1. 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 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.

2. 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.*

3. 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.

4. 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.

5. 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.

6. 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, Section143(12) the Companies Act, 2013 requires that, 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 within such time and in such manner prescribed in rule 13.

Also, Clause (xii) of Paragraph 3 of the Companies (Auditor's Report) Order, 2015 requires the auditor to specifically report "whether any fraud on or by the company 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.

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. The auditors have also learnt by experience that although most people are honest under different circumstances but they may be unable to resist temptations. When circumstances are such that the possibility of being caught is rather remote, most people are likely to respond to temptation. This is a well known aspect of human behaviour. Auditors while studying the possibility and nature of fraud, must keep this always in mind and should not make any exception for those who held high offices. Factors, like job satisfaction in terms of responsibility, trust and reward, personal habits, temporary requirements etc., have great bearing on the matter of commission of fraud. These things generally start in a non-consequential way-often a subordinate staff member first borrows small amounts from the cash box to meet his temporary difficulty and then gradually it becomes his habit to borrow in such manner whenever he is in difficulty; when he finds that nobody has even an inkling of the matter, he ventures with far larger amounts which on many occasions, he finds himself unable to replace. Fraud also takes place in forms other than cash defalcation, discussed above. It may be misappropriation of goods or manipulation of accounts with a view to presenting a false state of affairs.

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.

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 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. For example, the gross profit ratio adjusted for any recorded change during the year, reveals whether the value of inventory is reasonable with reference to the amount of the sale. Similarly, the input-output ratio of production in terms of physical quantity may reveal whether output is normal with reference to the quantity consumed for production.

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:

(a) to avoid incidence of income-tax or other taxes;

(b) for declaring a dividend when there are insufficient profits;

(c) 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

(d) 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:

(i) 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.

Concealed and Unconcealed Errors: As a general rule, mistakes are unconcealed but frauds are deliberately concealed. This proposition does not need any elaboration; but exceptions are in both cases. Mistakes become concealed if compensated by another or more mistakes in the opposite direction; or it may even be greatly minimised by that chance happening. For example, by mistake one or more accounts were short debited by an aggregate figure of ₹ 30,000 and this short debit is compensated by chance error or say short casting or one or more credit accounts to the tune of say ₹ 30,200 the dimension of the error would apparently be ₹ 200 by which the trial balance would be thrown out of agreement and there may be a temptation to think, "the error is small, let us ignore it". This attitude towards apparently small errors is dangerous because its true dimensions remain concealed and that may render the statements of account totally unacceptable. Mistakes may as well be concealed for wrong arithmetical calculations or for a faulty process of verification. Depreciation and inventories are examples which immediately come to one's mind. Wrong calculation of depreciation or omission to include certain inventories in the inventory or wrong valuation of inventories is not apparent. Petty cash defalcation is often unconcealed because petty cash is an item which on many occasions is left out of checking.

Procedural Errors: Sometimes we become so obsessed with the general ledger and its supporting records that we neglect other important features of the accounting system. An accounting system includes both records and procedure. Errors can appear in either or both. Whatever errors occur in the implementation of the procedures may be termed as procedural errors (which include frauds also). For example, the sales procedure of a company may include the following steps:

(a) Receipt of an order through salesman.

(b) Review of order by the credit department to determine whether the customer should be given credit as requested.

(c) Clearance with inventory department to be sure that the order can be executed.

(d) Preparation of forwarding note with copies to obtain the customer's acknowledgement of the receipt of goods.

(e) Preparation of invoice and despatch of the same to the customer.

If the procedure requires that these steps should be taken in the order indicated and if, for any reason, the second step is omitted, or is not completed before subsequent steps have been taken an error in procedure has been made and this may lead the company into financial loss caused by non-recovery of the money. Procedures are established to maintain control over resources and over transactions; any failure to follow the established procedures lessens the control and may permit errors which do affect ledger accounts. Any breakdown in established procedures thus suggests not only the presence of a procedure type error but also of other consequences.

Other errors of this type include the approving of transactions of documents by someone other than the person authorised to do so, failure to ensure that all preceding steps have been taken before approving a document and substitution of one person by another in a procedural function without proper authority. It is the normal procedure that goods, when received should be inspected for quality by the inspection department staff. If the store-keeper carried out this function it is indeed risky. Similarly, if the procedure requires that the timber godown should have been given periodical insecticide treatment and management has ignored that, a great loss may be caused to the timber by white ants. What is needed to be emphasised here is this that a procedural error, which is neither a defalcation nor misappropriation, may involve the company in a sizeable loss. This type of error or fraud cannot be located by any rigorous examination of the books of account.

All these errors discussed above may be grouped in the following categories in terms of their accounting incidence:

(i) Errors of omission - where a transaction has been omitted either wholly or partially.

(ii) Errors of commission - where a transaction has been mis-recorded either wholly or partially.

(iii) Compensating errors - where there are two or more errors which exactly counter balance each other, so that the trial balance agrees in spite of them.

(iv) Errors of principle - these are errors arising as a result of transactions having been recorded in a fundamentally incorrect manner; for example, a distinction not being made between capital and revenue income or expenditure.

(v) Procedural errors.

1.5.3 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", states that 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. *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.

SA-240, further explains by way of example lists certain risk factors and circumstances relating to possibility of fraud which may be considered by the auditor are dealt in the following paragraphs. *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.

I 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., 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 trade payables, 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, inventory options, and earn-out arrangements) being contingent upon achieving aggressive targets for inventory price, operating results, financial position, or cash flow.
- Personal guarantees of debts of the entity.
- There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

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

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

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 inventory price or earnings trend.
- The practice by management of committing to analysts, trade payables, 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.

II. 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 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.
- 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.

1.6 Basic Principles Governing an Audit

Presently there is no specific standard namely basic principles governing an audit. But there are certain basic principle which governs the auditor's professional responsibilities and should be complied with whenever an audit is carried out. Compliance with the basic principles requires the application of auditing procedures and reporting practices appropriate to the particular circumstances. The basic principles as stated in this guideline are:

1. ***Integrity, objectivity and independence*****:** 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, whatever its actual effect, as being incompatible with integrity and objectivity.
2. ***Confidentiality***: 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.
3. ***Skills and competence*****:** The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing. The auditor requires specialised skills and competence which are acquired through a combination of general education, knowledge obtained through study and formal courses concluded by qualifying examination recognised for this purpose and practical experience under proper supervision. In addition, the auditor requires a continuing awareness of developments including pronouncements of the ICAI on accounting and auditing matters, and relevant regulations and statutory requirements.
4. ***Work performed by others*****:** When the auditor delegates work to assistants or uses work performed by other auditors and experts he continues 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. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, as in the case of the work of branch auditors appointed under the Companies Act, 2013 the auditor's report should expressly state the fact of such reliance. The auditor should carefully direct, supervise and review work delegated to assistants.

The auditor should obtain reasonable assurance that work performed by other auditor or experts is adequate for his purpose.

5. ***Documentation*:** The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

6. ***Planning*:** 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 system, 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.

7. ***Audit Evidence*:** The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions there from on which to base his opinion on the financial information. *Compliance procedures* are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. *Substantive procedures* are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.

   They are of two types:

   (i) test of details of transactions and balances; and

   (ii) analysis of significant ratios and trends including the resulting enquiry of unusual fluctuations and items.

8. ***Accounting System and Internal Control*:** 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. The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal controls normally contribute to such assurance.

   The auditor should gain an understanding of the accounting system and related controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures. Where the auditor concludes that he can rely on certain internal controls, his substantive procedures would normally be less extensive than would otherwise be required and may also differ as to their nature and timing.

9. ***Audit conclusions and reporting*: The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information. This review and assessment involves forming an overall conclusion as to whether :
   (a) the financial information has been prepared using acceptable accounting policies, which have been consistently applied;
   (b) the financial information complies with relevant regulations and statutory requirements;
   (c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

The audit report should contain a clear written opinion on the financial information and if the form or content of the report is laid down in or prescribed under any agreement or statute or regulation, the audit report should comply with such requirements. An unqualified opinion indicates the auditor's satisfaction in all material respects with the matters stated above or as may be laid down or prescribed under the agreement or statute or regulation as the case may be.

When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons therefore.

Note: Student may note that at present, there is no specific standard namely basic principles governing an audit. However, there are certain fundamental principles which are ethically required as per Code of Ethics read with SA 200 (Revised) and SA 220. But in general above mentioned principles are basic principles only.

1.7 Scope of Audit

The scope of an audit of financial statements will be determined by the auditor for having regard to the terms of the engagement, the requirement of relevant legislation and the pronouncements of the Institute. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute.

The audit should be organized to cover adequately all aspects of the enterprise as far as they are relevant to the financial statements being audited. 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. 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. 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 on which he wishes to rely and testing those internal controls to determine the nature, extent and timing of other auditing procedures; 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.

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.

In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operation results of the enterprise. The auditor recognizes that because of the test nature and other inherent limitations of an audit together with inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatements may remain undiscovered. While in many situations the discovery of material misstatement by management may often arise during the conduct of the audit, such discovery is not the main objective of audit nor is the auditor's programme of work specifically designed for such discovery. The audit cannot, therefore, be relied upon to ensure the discovery of all frauds or errors but where the auditor has any indication that some fraud or error may have occurred which could result in material misstatement, the auditor should extend his procedures to confirm or dispel his suspicions.

The auditor is primarily concerned with items which either individually or as a group are material in relation to the affairs of an enterprise. However, it is difficult to lay down any definite standard by which materiality can be judged. Material items are those which might influence the decisions of the user of the financial statements. It is a matter in which a decision is arrived at on the basis of the auditor's professional experience and judgment.

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.

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.

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. 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.

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.

Aspects to Be Covered In Audit: The principal aspect 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. This is followed by such tests and enquiries as are considered necessary to ascertain whether the system is in actual operation. These steps are necessary to form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account.

(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.

(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.

It will thus be realised that the duties are not limited to the verification of the arithmetical accuracy of the books of account kept by his client; he must also satisfy himself that entries in the books are true and contain a complete record of all the transactions of the business and these are recorded in such a manner that their real nature is revealed. On that account, he must examine all vouchers, invoices, minutes of directors or partners correspondence and other documentary evidence that is available to establish the nature and authenticity of the transactions. Besides, he must verify that there exists a proper authority in respect of each transaction; that each transaction is correctly recorded, etc. Finally, he must verify that the form in which the final accounts are drawn up is the one prescribed by law or is the one that ordinarily would present a true and fair picture of state of affairs of the business.

1.8 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, 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:

(i) **The Nature of Financial Reporting**: The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures. ***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 judgments.***

(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. ***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.***

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 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.*** There is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

(iv) **Other Matters that Affect the Limitations of an Audit:** In the case of certain assertions or subject matters, the potential effects of the limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

Because of the limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs. ***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.***

1.9 Auditing And Investigation

To understand auditing in its correct perspective, one should know how auditing is distinct from investigation.

Auditing is different from investigation which is another significant service, a professional accountant renders. Investigation is a critical examination of the accounts with a special purpose. For example if fraud is suspected and an accountant is called upon to check the accounts to whether fraud really exists and if so, the amount involved, the character of the enquiry changes into investigation. Investigation may be undertaken in numerous areas of accounts, *e.g.*, the extent of waste and loss, profitability, cost of production, etc. It normally concerns only specified areas, but at times, it may involve the whole field of accounting. Its essence lies in going into the matter with some pre-conceived notion suited to the objective. The techniques fit the circumstances of the case. For auditing on the other hand, the general objective is to find out whether the accounts show a true and fair view.

Audit never undertakes discovery of specific happenings and is never started with a pre-conceived notion about the state of affairs. The auditor seeks to report what he finds in the normal course of examination of the accounts adopting generally followed techniques unless circumstances call for a special probe: fraud, error, irregularity, whatever comes to the auditor's notice in the usual course of checking, are all looked into in depth and sometimes investigation results from the *prima facie* findings of the auditor. However, 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 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 within such time and in such manner prescribed in rule 13.

Rules 13 of the Companies (Audit and Auditors) Rules, 2014, prescribes that in case the auditor has sufficient 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 report the matter to the Central Government immediately but not later than sixty days of his knowledge and after following the procedure indicated herein below:

(i) auditor shall forward his report to the Board or the Audit Committee, as the case may be, immediately after he comes to knowledge of the fraud, seeking their reply or observations within forty-five days;

(ii) 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 alongwith his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within fifteen days of receipt of such reply or observations;

(iii) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of forty-five days, he shall forward his report to the Central Government alongwith a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he failed to receive any reply or observations within the stipulated time.

Further, 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. This report shall be on the letter-head of the auditor containing postal address, e-mail address and contact number and be signed by the auditor with his seal and shall indicate his Membership Number. The report shall be in the form of a statement as specified in Form ADT-4.

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 provision of this rule 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.

1.10 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:

  (a) companies governed by the Companies Act, 2013;

  (b) banking companies governed by the Banking Regulation Act, 1949;

  (c) electricity supply companies governed by the Electricity Supply Act, 1948;

  (d) co-operative societies registered under the Co-operative Societies Act, 1912;

  (e) public and charitable trusts registered under various Religious and Endowment Acts;

  (g) corporations set up under an Act of Parliament or State Legislature such as the Life Insurance Corporation of India.

  (h) Specified entities under various sections of the Income-tax Act, 1961.

(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.

1.11 Advantages of an Independent Audit

The fact that audit is compulsory by law, in certain cases by itself should show that there must be some positive utility in it. 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.

(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.

(g) 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.

(h) As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies, etc., in them.

(i) Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.

(j) Government may require audited and certified statement before it gives assistance or issues a license for a particular trade.

1.12 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.

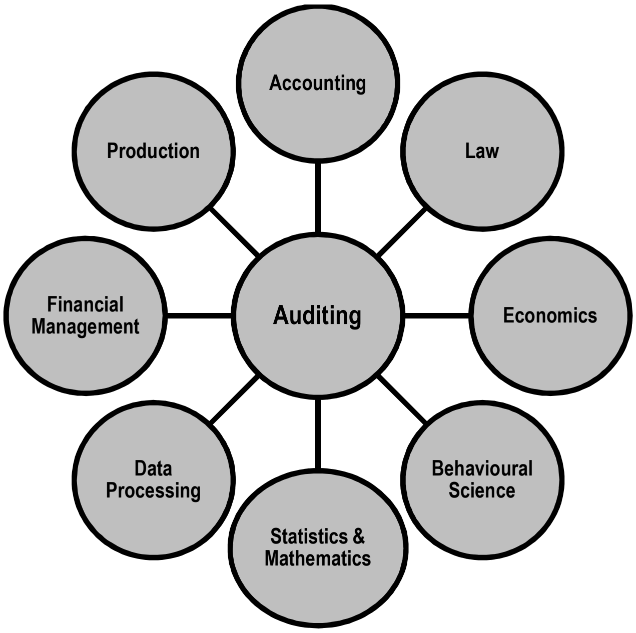


Diagram showing the relationship of Auditing with other Disciplines

1.12.1 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.

1.12.2 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.

1.12.3 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.

1.12.4 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. Howsoever, 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.

1.12.5 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.

1.12.6 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, EDP auditing in itself is developing as a discipline in itself.

1.12.7 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.

1.12.8 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.

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.

2

Basic Concepts in Auditing

Learning Objectives

After reading this chapter, student should be able to -

- Understand the concepts of auditor's independence, its importance under the Companies Act and Chartered Accountants Act.
- 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 as per AS 1 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.

2.1 Concept of Auditor's Independence

Professional accountants have an important role in society. Investors, trade payable, employers and other sectors of the business community, as well as the government and the public at large rely on professional accountants for sound financial accounting and reporting, effective financial management and competent advice on a variety of business and taxation matters. The attitude and behaviour of professional accountants in providing such services have an impact on the economic well-being of their community and country. Professional accountants can remain in this advantageous position only by continuing to provide the public with these unique services at a level which demonstrates that the public confidence is firmly founded. It is in the best interest of the worldwide accountancy profession to make known to users of the services provided by professional accountants that they are executed at the highest level of performance and in accordance with ethical requirements that strive to ensure such performance.

In order to achieve the objectives of the accountancy profession, professional accountants have to observe a number of prerequisites or fundamental principles as under:

Integrity: A professional accountant should be straightforward and honest in performing professional services.

Objectivity: A professional accountant should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.

Professional Competence and Due Care: A professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques.

Confidentiality: A professional accountant should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose.

Professional Behaviour: A professional accountant should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession.

Technical Standards: A professional accountant should carry out professional services in accordance with the relevant technical and professional standards. Professional accountants have a duty to carry out with care and skill, the instructions of the client or employer insofar as they are compatible with the requirements of integrity, objectivity and, in the case of professional accountants in public practice, independence.

Independence is the keystone upon which the respect and dignity of a profession is based. Independence stands for the strength of individuals to adopt an unbiased view on the matters undaunted by any favour or frown. In all matters relating to the assignment, independence in mental attitude is to be maintained. Only so long as the auditor maintains a high standard of independence and impartiality, the audit reports will continue to be accepted and respected by business, financial institutions, Government and investors. Professional integrity and independence are essential characteristics of all the learned professions but are more so in the case of accounting profession.

Independence is a state of mind and personal character and an enlightened view of the professional duties involved. Independence is much affected by the state of the profession, i.e., the ability and willingness to enforce a proper code of ethics as well as its ability to withstand pressures. The more the esteem for the profession in the public eyes because of the standards of independence prescribed by it for its members, greater the reliance there would be on the reports and opinions given by the members of the profession. Independence, as has been stated earlier, is a qualitative condition but rules are often framed by professional bodies to help and guide members in preserving independence in variety of complex circumstances.

Independence of auditor must not only exist in fact, but should also appear to exist to all reasonable persons. This is very important because very often the relationships are misunderstood. It is, therefore, necessary that relationship maintained by the auditor shall be such that no reasonable man can doubt his objectivity and integrity.

The Guidance Note issued by the ICAI on “Independence of Auditors” contemplates that it is not possible to define “Independence” precisely. According to it, “independence implies that the judgment of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his own self-interest. It stipulates that the independence is a condition of mind and personal character and should not be confused with the superficial and visible standards of independence which are sometimes imposed by law. These legal standards may be relaxed or strengthened but the quality of independence remains unaltered. Independence of the auditor has not only to exist in fact, but should also appear to so exist to all reasonable persons. The relationship between the auditor and his client should be such that firstly he himself is satisfied about his client and secondly, no unbiased person would be forced to the conclusion that on an objective assessment of the circumstances, there is likely to be an abridgment of the auditors’ independence. There is also a collective aspect of independence that is important to the accounting profession as a whole.

The chartered accountant is not personally known to the third parties who rely on professional opinion and accept his opinion principally on a larger faith on the entire accounting profession.

The Companies Act has enacted specific provisions to give concrete shape to this vital concept. The provisions disqualifying certain types of persons from undertaking audit of limited companies, provisions relating to ceiling on the number of audits that can be undertaken by chartered accountant, provisions requiring special resolution for appointing auditors in certain cases and other provisions on appointment, reappointment and removal of auditors are designed to invest this institution of audit with sufficient independence to carry out the audit in the larger interest of shareholders and other users. The vast powers of access given to the auditor to the books of account and other documents of the company are specifically designed to give independence to the auditors. The power to qualify his report is yet another weapon in the armoury of the auditor to protect his independence. The enactment of specific instances of misconduct in the Schedules to the Chartered Accountants Act, 1949 is yet another attempt to keep the independence and professional competence of the accounting profession.

In order to ensure independence, the law has also made certain provisions which put either prohibitions or regulations in the matter of appointment of auditors -

Accordingly a person is disqualified to act as an auditor from being appointed as such if he is :

(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 rupees one lakh;

It may also be noted that the condition of rupees one lakh shall, wherever relevant, be also applicable in the case of a company not having share capital or other securities:

It may further be noted 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 sixty days of such acquisition or interest.

(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 rupees five lakh; 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 one lakh rupees;

(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;

Student 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;

(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) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

The following are some specific instances where the question of independence vis a vis indebtedness has been considered:

1. The Research Committee of the ICAI has expressed the opinion that where in accordance with the terms of his engagement by a client the auditor recovers his fees on a progressive basis as and when a part of the work is done without waiting for the completion of the whole job, he cannot be said to be indebted to the company at any stage.
2. 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 and has to vacate his office. It will not make any difference if the company allows him the period of credit as it allows to other customers in the normal business. He, in fact, in such a case also has become indebted to the company and consequently has to vacate his office.
3. A partner is disqualified when a firm in which he is a partner is indebted to the company for a sum exceeding rupees five lakh. Similarly, a firm is disqualified if a partner of that firm is so indebted.

2.2 Audit Evidence

2.2.1 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.

2.2.2 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.

(i) 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.

(ii) 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.

(iii) 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.

2.2.3 Sources of Audit Evidence

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.

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.

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.

2.2.4 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) 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.

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, tests 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

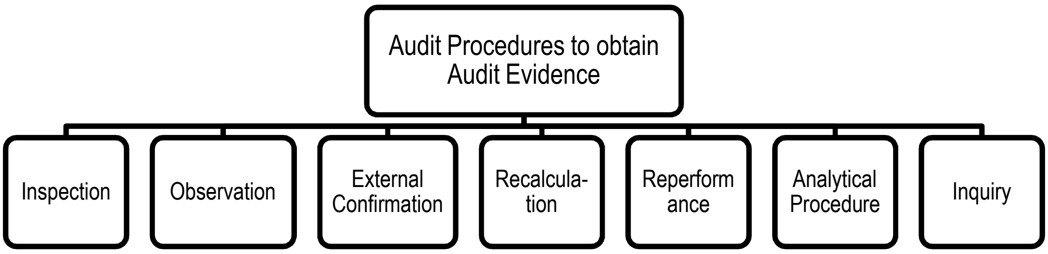
(iii) External Confirmation

(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. An 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, 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.

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. 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.

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.

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.

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.

Tests 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 Tests of Controls

In designing and performing tests 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 tests 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 Tests 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 tests of controls that have been performed provide an appropriate basis for reliance on the controls;

(b) Additional tests of controls are necessary; or

(c) The potential risks of misstatement need to be addressed using substantive procedures.

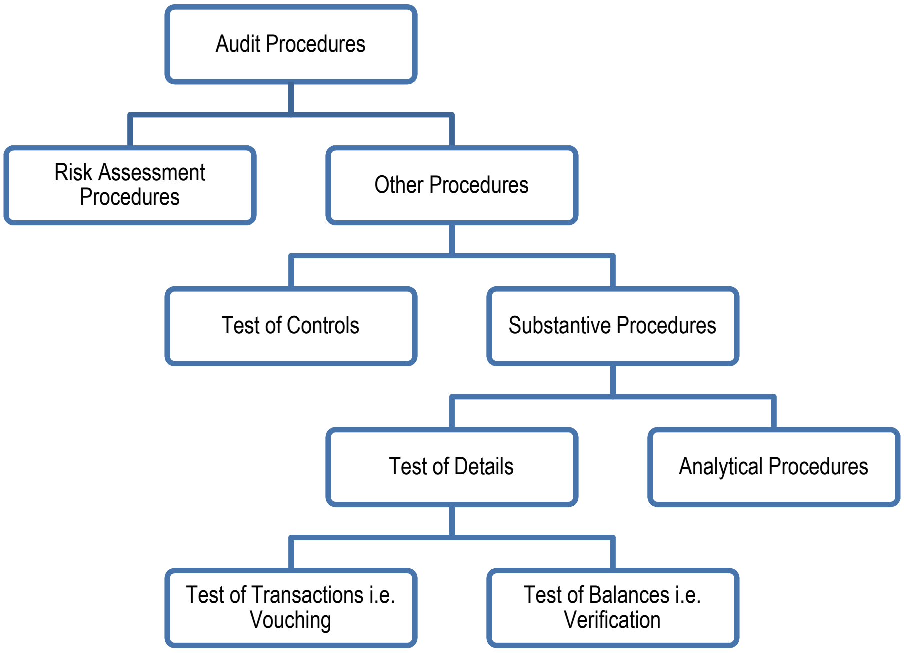
Substantive Procedures

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:*
   - *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 tests of controls.*
   - *Only tests of details are appropriate.*
   - *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 tests 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:*

   - *Bank balances and other information relevant to banking relationships.*
   - *Accounts receivable balances and terms.*
   - *Inventories held by third parties at bonded warehouses for processing or on consignment.*
   - *Property title deeds held by lawyers or financiers for safe custody or as security.*
   - *Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.*

- *Amounts due to lenders, including relevant terms of repayment and restrictive covenants.*
- *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. For 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. 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:*

   - *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.*
   - *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.

   - *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. For 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. For example, 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.

Take another example:

		₹
Plant and Machinery (at cost)		2,00,000
Less: Depreciation till the end of previous year	70,000	
Depreciation for the year	13,000	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 in payable.

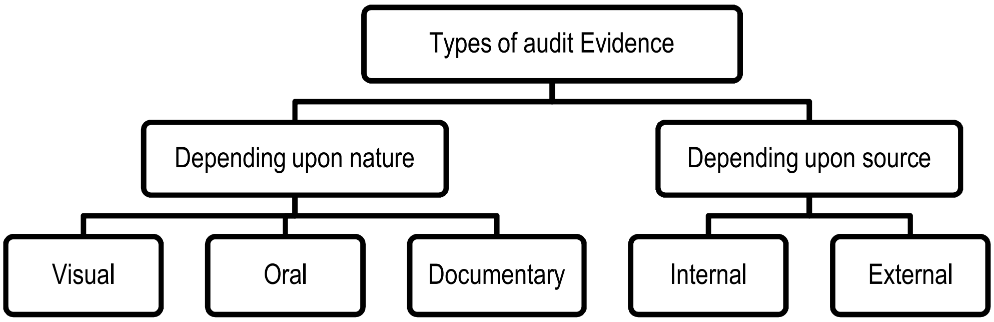
A specific mention is required about these things for a proper appreciation of the item and the financial position. Negative assertions are also encountered in the financial statements and the same may be expressed or implied. For example, if it is stated that there is no contingent liability it would 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.

2.2.4 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 organisation; for 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.

2.2.5 Relevance and Reliability: Since the 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: 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.

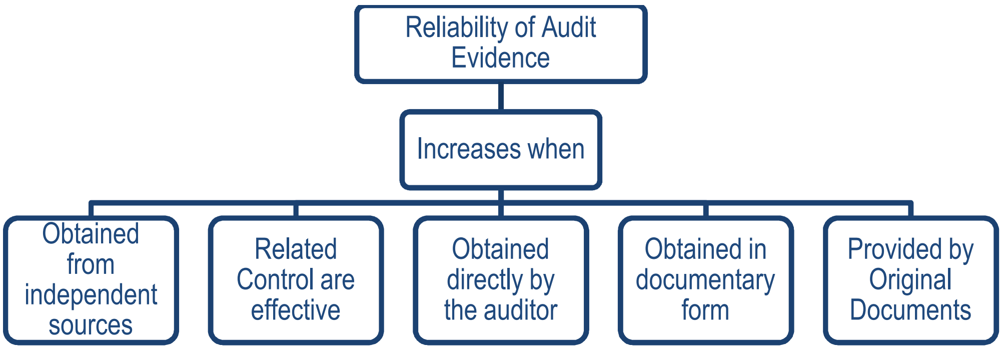
A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off. 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.

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 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.



2.3 Concept of Materiality

The concept of materiality is fundamental to the process of accounting. It covers all the stages from the recording to classification and presentation. It is, therefore, an important and relevant consideration for an auditor who has constantly to judge whether a particular item or transaction is material or not. SA-320 on Materiality in Planning and Performing an Audit lays down standard on the concept of materiality and its relationship with audit risk. It deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. SA 450, "Evaluation of Misstatements Identified during the Audit", 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. Obviously, an auditor requires more reliable evidence in support of material items. He also has to ensure that such items are properly and distinctly disclosed in the financial statements.

“Accounting Standard 1 defines material items as relatively important and relevant items, i.e. “items the knowledge of which would influence the decisions of the users of the financial statements”. Whether or not the knowledge of an item would influence the decisions of the users of the financial statements is dependent on the particular facts and circumstances of each case. It is not possible to lay down precisely either in terms of specific account or in terms of amounts the items which could be considered as material in all circumstances. Materiality is a relative term and what may be material in one circumstance may not be material in another. Therefore, the decision to judge the materiality of the item whether in the aggregation of items, presentation or classification of items shall depend upon the judgment of preparers of the account in the circumstances of the particular case. In many cases percentage comparison may be useful in indicating the materiality of an item. **As per SA 320, this percentage criteria for determining materiality levels is known as Benchmarking. For example, Part II of Schedule III to the Companies Act, 2013** requires that any expense exceeding one per cent of the total revenue of the company or ₹ 1,00,000 whichever is higher, shall be disclosed by way of notes as additional information and shall not be combined with any other item to be shown under miscellaneous expenses. Actually the detailed disclosure requirements of Schedule III to the Companies Act, 2013 seek to ensure that the financial statements disclose all material items so as to give a true and fair view of the state of affairs of the company. Apart from the percentage criterion, the relative significance of an item has to be viewed from many angles while judging its materiality. It is generally felt that in respect of items appearing in the profit and loss account and having an effect on the profit for the year, materiality should be judged in relation to the group to which the asset or the liability belongs, for example, for any item of current asset in relation to total current assets and any item of current liability in relation to total current liabilities. Another angle to judge the materiality of the item can be to compare it with the corresponding figure in the previous year. Suppose the item is of a low amount this year but it was of a much higher amount in the previous year then it becomes material when compared to the corresponding figure of the previous year. Thus, materiality of an item can be judged: (a) from the impact that the item has on the profit or loss or on the balance sheet, or on the total of the category of items to which it pertains, and (b) on its comparison with the corresponding figure of the previous year. In many circumstances even small amount may be considered material. Thus, if there is a statutory requirement of disclosure of amount paid as sitting fee to directors the amount so paid must be disclosed precisely and separately. Similarly, a payment of ₹100 to directors as remuneration in excess of statutory limits may be material. A small inaccuracy may be considered material if it further depresses or boosts a low profit or converts a small loss into a profit or vice versa. Similarly, if it creates or eliminates a margin of insolvency in the balance sheet, it will be a material item. Transaction of abnormal or non-recurring nature is also considered material even though the amount involved may not be significant. In off-setting and aggregating items, care must be taken to see that items which are independently material are not set-off against each other. For example, the surplus arising from a change in the basis of accounting may not be set-off against a non-recurring loss. Even as item with a nil or small balance may assume materiality in a situation where it was not expected to be nil or insignificant.

Thus, materiality is an important and relevant consideration for the auditor also because he has to evaluate whether an item is material in giving or distorting a true and fair view of financial statement. He also has to ensure that a material item is disclosed separately and distinctly or atleast clear information about the item is available in the accounting statements.

The relationship between audit materiality and risk is explained in Chapter 3.

2.4 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.

The importance of the concept of true and fair view can also be understood and appreciated from the fact that sections 128, 129 and 143 of the Companies Act, 2013 also discuss this concept in relation to account books, financial statements and reporting on financial statements respectively.

Section 128(1) of the Companies Act, 2013 provides that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any. The company shall be in a position to explain the transactions effected both at the registered office and its branches. Such books of Accounts shall be kept on accrual basis and according to the double entry system of accounting.

Section 129(1) of the Companies Act, 2013 provides that the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 of the Companies Act, 2013, (in which the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority) and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III to the said Act.

The term "financial statement" shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes under the said Act.

It may be noted that nothing contained in sub-section (1) of section 129 shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company.

However, the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose-

(a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;

(b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;

(c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;

(d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

It may be noted that where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

Further, according to section 143(2) of the said Act, the auditor is required to make a report to the members of the company indicating that, to the best of his information and knowledge, the financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

SA 700 "Forming an Opinion and Reporting on Financial Statements", requires the auditor to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and express clearly that opinion through a written report that also describes the basis for the opinion. The auditor is required to express his opinion on the financial statements that it gives a true and fair view in conformity with the accounting principles generally accepted in India (a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX; (b) in the case of the Statement of Profit and Loss, of the profit/ loss for the year ended on that date; and (c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

In the context of audit of a company, the accounts of a company shall be deemed as not disclosing a true and fair view, if they do not disclose any matters which are required to be disclosed by virtue of provisions of Schedule III to that Act, or by virtue of a notification or an order of the Central Government modifying the disclosure requirements. Therefore, the auditor will have to see that the accounts are drawn up in conformity with the provisions of Schedule

III of the Companies Act, 2013 and whether they contain all the matters required to be disclosed therein. In case of companies which are governed by special Acts, the auditor should see whether the disclosure requirements of the governing Act are complied with. It must be noted that the disclosure requirements laid down by the law are the minimum requirements. If certain information is vital for showing a true and fair view, the accounts should disclose it even though there may not be a specific legal provision to do so. Thus, 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 discloses all the matters required to be disclosed by Part II of Schedule III and the balance sheet has been prepared in accordance with Part I of Schedule III; (vii) accounting policies have been followed consistently; and (viii) all unusual, exceptional or non-recurring items have been disclosed separately.

In this context, it is noteworthy that the Council of the Institute while issuing a clarification regarding authority attached to documents issued by the Institute also observed that, "The Companies Act, as well as many other statutes require that the financial statements of an enterprise should give a true and fair view of its financial position and working results. This requirement is implicit even in the absence of a specific statutory provision to this effect. However, what constitutes 'true and fair' view has not been defined either in the Companies Act, 2013 or in any other statute. The pronouncements of the Institute seek to describe the accounting principles and the methods of applying these principles in the preparation and presentation of financial statements so that they give a true and fair view. The pronouncements issued by the Institute include various statements, standards and guidance notes.

2.5 Disclosure of Accounting Policies

2.5.1 Nature of Accounting Policies: Accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

There is no single list of accounting policies which are applicable to all circumstances. The different circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgment by the management of the enterprise.

The various statements of the Institute of chartered accountants of India combined with the efforts of government and other regulatory agencies and progressive managements have reduced in recent years the number of acceptable alternatives particularly in the case of a corporate enterprise. While continuing efforts in this regard in the future are likely to reduce the number still further the availability of alternative accounting principles and methods of applying those stances faced by the enterprises.

2.5.2 Areas in which Different Accounting Policies are encountered: The following are examples of the areas as given in AS 1, Disclosure of Accounting Policies in which different accounting policies may be adopted by different enterprises.

- Methods of depreciation, depletion and amortisation
- Valuation of inventories
- Treatment of goodwill
- Valuation of investments
- Treatment of retirement benefits
- Valuation of fixed assets

Note: (The above list is not exhaustive. There may be other examples as well.)

2.5.3 Disclosure of Accounting Policies: The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated.

The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by law in some cases.

The purpose of AS-1 is to promote better understanding of financial statements by establishing through an accounting standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. Such disclosure should form part of the financial statements.

It would be helpful to the reader of financial statements if they are all disclosed at one place instead of being scattered over several statements, schedules and notes and form part of financial statements.

Any change in an accounting policy which has a material effect should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

2.5.4 Fundamental Accounting Assumptions: Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

The following have been generally accepted as fundamental accounting assumption:

(a) Going Concern: The enterprise is normally viewed as a going concern, that is as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing.

(b) Consistency: It is assumed that accounting policies are consistent from one period to another.

(c) Accrual: Revenues and costs are accrued, that is recognised as they are earned or incurred (and not as money is received or paid) and recognised in the financial statements of the periods to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this statement.)

If the fundamental accounting assumptions, viz., Going concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

3

Preparation for an Audit

Learning objectives

After studying this chapter, you will be able to –

- ♦ Understand the preparation for an audit such as, auditor's engagement, audit process, audit techniques, procedures and planning.
- ♦ Draft audit programme, audit working paper, quality control of audit work and the elements of statistical sampling.
- ♦ Distinguish between different kinds of audit risk.

In the earlier chapter we have discussed the basic concepts of audit and the nature of evidence that is available to the auditor. Now we concern ourselves with how an auditor is to proceed for collection of evidence. Here starts the process of actual auditing. For effective work one has to frame a proper scheme of work and determine the techniques that are needed for collection of purposeful evidence. The scheme of auditing process envisages the following:

(1) Formulating audit programme on the basis of knowledge of client's business.

(2) Determination of the extent of checking on the basis of compliance procedures.

(3) Carrying out the steps in the procedure on the basis of programme and the extent of substantive checking that may be required.

(4) Keeping a record of notes and inquiries and maintenance of working papers.

(5) Formulation of opinion about financial statements and review with reference to accounting standards.

(6) Issuance of the audit report.

3.1 Auditor's Engagement

Accountancy and auditing are pursuits of a noble profession; the conduct of its members is governed by a set of the rules. One of the rules forbids chartered accountants to solicit clients. Clients must themselves find their auditors. A client is anybody or any entity which requires the service of a professional accountant for the audit of the accounts or for any other purpose. Clients may be individuals, partnership firms, companies, societies, clubs, trust, co-operative societies, government, etc.

3.1.1 Agreement on Audit Engagement Terms*:* Of these, the legal requirement to get the accounts audited so far extends only to companies, co-operative societies, and registered societies. In these cases the respective law governs the appointment of auditors and their duties. In all other cases, it is a matter of contract. The client tells the auditor the nature of service he requires and the auditor, if he is agreeable to undertake the assignment, specifies his terms. He must sign an agreement, if he accepts the work in terms of the agreement subject to professional standards. Clients who are not statutorily required to get their accounts audited may require preparation of accounts for tax-returns, checking of the sales tax-returns, etc. besides audit. There may be a misunderstanding about the exact scope of the work; the auditor may think that he is merely required to prepare accounts while the client may think audit of accounts is also covered. It is, therefore, of the greatest importance, both for the auditor and client, that each party should be clear about the nature of the engagement: it must be reduced in writing and should exactly specify the scope of the work. The audit engagement letter is sent by the auditor to his client which documents the objective and scope of the audit, the extent of his responsibilities to the client and the form of report. 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. Above all, he should bear in mind that all partners jointly and severally are his clients, though he might have been appointed by only one of them if so, authorised under the partnership deed. He must see that the individual interests of the partners have not been adversely affected in any manner and the provisions of the partnership deed regarding accounting have been fully given effect to.

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 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.

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.

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. The form and content of the audit engagement letter may vary for each entity.

An Engagement Letter may need to be entered into for each year of the period covered by the Eligibility Letter issued by the auditor under section 139 of the Companies Act, 2013 and the Appointment Letter received from the Company, to supplement / update for any subsequent changes. This may be required because the appointment would need to be ratified at each AGM under section 139 of the said Act.

Recurring Audits: In case of a recurring audit, the auditor may decide not to send a new engagement letter each period. However, the following factors may make it appropriate to send a new letter-

- Any indication that the client misunderstands the objective and scope of the audit.
- Any revised or special terms of the engagement.
- A recent change in senior management, board of directors or ownership.
- A significant change in nature or size of the client's business.
- Legal requirements or pronouncements of the Institute of Chartered Accountants of India, or changes in the existing ones.

3.1.2 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.

3.1.3 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 a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or 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, except where the 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.

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.

[Note: Provisions relating to appointment of Auditors, qualifications, disqualifications etc. as per the Companies Act, 2013 are discussed separately in Chapter 7]

3.2 Audit Process

One must take care to ensure that nothing is missed in the process which needs to be followed to achieve the audit objective. The following audit process in that order may be taken as a specimen:

(a) Formulating audit plan and laying down broad framework for conducting the work and method to ensure control over the quality of work.

(b) Examination and evaluation of the nature, extent and efficacy of the system of internal control. The nature, extent and timing of substantive procedures, would depend upon the extent of satisfaction an auditor obtains after evaluating the internal control system. The determination of extent of test checking would also depend upon the same.

(c) Ascertaining the arithmetical accuracy of the books of account by checking posting, casting, crass-casting, carry forwards, opening and closing balances, etc.

(d) Examining the documentary evidence (both internal and external) and the authority in support of the transaction, i.e. vouching.

(e) Checking the validity of transactions with reference to:

  (i) provisions affecting the accounts and audit in any Act or Rules;

  (ii) rules and regulations governing the constitution and management of the organisation i.e., the memorandum and articles of association in the case of a company, partnership deed in the case of a firm, trust deed in the case of a trust and bye-laws in the case of a co-operative society;

  (iii) minute books for appropriate sanction of the transactions by competent authority;

  (iv) other legal documents such as the prospectus, returns submitted to legal authorities, contracts and agreements *e.g.*, vendors' agreement, lease agreement, selling agency agreement, collaboration agreements, etc; and

  (v) well recognised accounting principles and practices *e.g.*, distinction between capital and revenue, accrual system of accounting, valuation principles, etc.

(f) Ensuring that there is adequate disclosure of information and, in particular, the annual accounts are prepared in such a manner as to convey the real picture about the assets and liabilities and of the operating result (profit or loss) of the organisation. For this purpose, the auditor must conform to the prescribed legal requirement, if any, as to the form of accounts and have due regard to the best current accounting practice. Reference to Schedule III of the Companies Act, 2013 in case of companies and compliance with accounting standards will have to be seen.

(g) Verification of existence, ownership, title and value of the assets and determination of the extent and nature of liabilities.

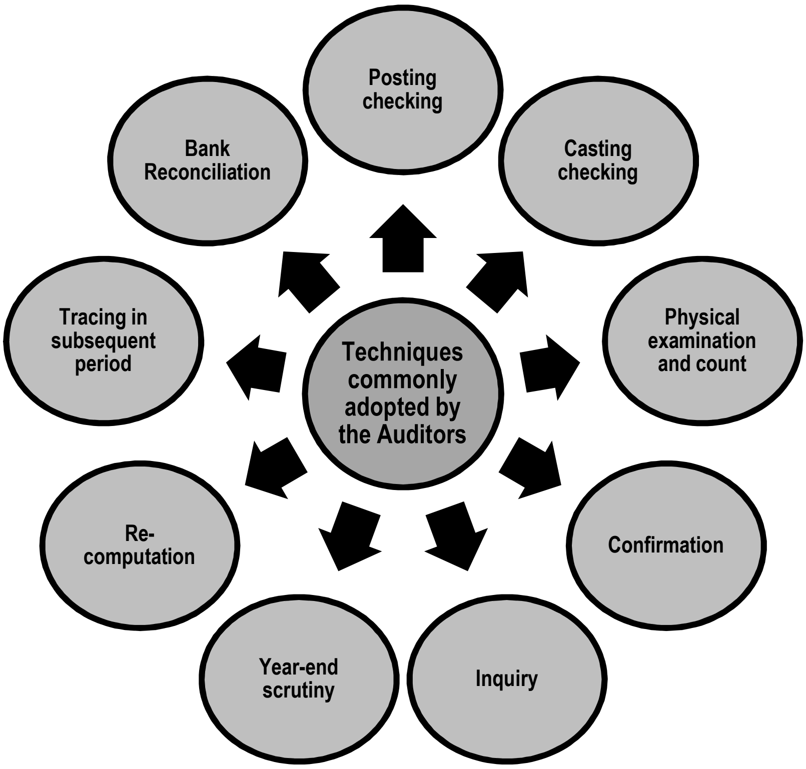
(h) Scrutiny of the accounts to establish reasonableness, consistency and compliance with the legal requirements.

(i) Application of various overall checks in order to test the overall reliability of the accounting records and the statements and to see whether the results of overall checks corroborate the findings already made.

(j) Determination of the significant accounting ratios and subjecting the accounts to ratio analysis to locate the areas showing departure from the expected state of affairs.

3.3 Audit Techniques

For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques.



Some of the techniques commonly adopted by the auditors are the following:

1. Posting checking
2. Casting checking
3. Physical examination and count
4. Confirmation
5. Inquiry
6. Year-end scrutiny
7. Re-computation
8. Tracing in subsequent period
9. Bank Reconciliation.

The two terms, procedure and techniques, are often used interchangeably. However, a distinction does exist. Procedure may comprise a number of techniques and represents the broad frame of the manner of handling the audit work; techniques stand for the methods employed for carrying out the procedure. For example, procedure requires an examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve techniques of inspection and checking computation of documentary evidence. Recall the audit procedures as discussed in Chapter 2 “Basic concepts in Auditing”.

3.4 Audit Planning

"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.

In establishing the overall audit strategy, the auditor shall:

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

(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.

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 auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

The overall audit plan and the audit programme, however, remain the auditor's responsibility.

3.4.1 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.

(b) The nature of the entity, including:

   (i) its operations;

   (ii) its ownership and governance structures;

   (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

   (iv) the way that the entity is structured and how it is financed;

   to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

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

(e) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgements regarding the appropriateness of accounting policies and disclosures.

3.4.2 Development of an Overall Plan: The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit-

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.

- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- The degree of reliance he expects to be able to place 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, if any, in the audit.
- The involvement of other auditors in the audit of subsidiaries or branches of the client.
- The involvement of experts.
- The allocation of work to be undertaken between joint auditors and the procedures for its control and review.
- Establishing and coordinating staffing requirements.

The auditor should document his overall plan. The form and extent of the documentation will vary depending on the size and complexity of the audit. A time budget, in which hours are budgeted for the various audit areas or procedures, can be an effective planning tool.

[Student may also refer SA 300, "Planning an Audit of Financial Statements" for better understanding]

3.4.3 Developing the Audit Programme: The auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan. 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.

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.

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.

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.

3.5 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 nothing but 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. 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. 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. Because 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.

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.

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. For 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 there under 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 mentioned earlier 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.

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.

For the purpose of programme construction, the following points should be kept in view:

(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.

Amplification is not necessary of the above points except the one under evidence: that 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.

By evidence we mean the material, documentary or otherwise, available to prove or disprove the assertions made in the statement of accounts through the entries in the books of account. For 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.

You may recall from chapter 2 on basic concepts in auditing that 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.

By "good evidence" we mean highly satisfactory evidence available without any special effort or cost. For cash in hand the best evidence is 'count'; in respect of investment pledged with a bank, the banker's certificate. 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.

For testing the authenticity of the client as regards amount lying with bank, the auditor adopts the following procedure:

(1) Examination of the counterfoils of cheques and paying-in-slips and comparing them with the entries in the concerned ledger account of the client.

(2) Checking the castings, carry over and balances of the ledger account.

(3) Comparison of the entries in the ledger with the bank statement (this is the reproduction of the ledger account maintained by the bank for recording the transactions with the client).

(4) Examination of the bank reconciliation statement to know the items that explain the difference, if any, between the balance shown by client’s ledger and the bank statement.

(5) Scrutiny of the subsequent period’s bank statement to ensure that items entering for reconciliation have been duly entered by the bank on clearance or presentation.

(6) Verification of official confirmation of the balance by the bank.

If you analyse these procedures, you will see that each provides the auditor with some evidence which by itself is not adequate even if the result is satisfactory. The first one proves that the entries conform to the underlying records, but the *prima facie* authenticity of the underlying record is corroborated by a checking of the bank statement. The second provides evidence of the arithmetical accuracy. Procedure under step four, screens the items of difference between the two records and the *bonafide* of that statement is proved by step five. Sixth and the last step is most significant because the reliability of the bank statement is much enhanced by confirmation of the balance on a specified date made by a responsible official of the bank. But all these cannot give the auditor a degree of confidence or conclusiveness because he has no access to the bank’s books and records. Therefore, he must be contended with the best available evidence to arrive at a reasonable opinion.

At times, the available evidence on a single assertion may be found to be contradictory. For example, sales in quantity and value, as evidenced by some of the procedures enumerated above, may not be corroborated by a quantitative analysis of the opening inventory, production, sales and closing inventory. In such a situation, it would be the duty of the auditor to call for the explanation of the management before he accepts or rejects any of the contra-dictory evidence for the purpose of formulation of his opinion on the particular matter. Only by properly considering and evaluating the explanation of the management, the auditor is in such a situation as would enable him to accept or reject any of the evidence.

Advantages and Disadvantages of the use 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 taking 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.

3.6 Methods of Work

In order that an audit may be carried out in a systematic and efficient manner, the following steps should be taken:

(1) Work must be carried on regularly and record kept of time of arrival/departure of the staff and also of the work done each day;

(2) As far as possible, a definite portion of the work should be completed each day so that loose ends are not left over for being tied up at a later date;

(3) Entries should be made in the audit note book and the audit programme initialed as a routine;

(4) Colored pencils and different type of ticks must be employed to indicate the various audit processes which have been applied and their significance must not be disclosed to the client;

(5) All the vouchers after examination must be immediately cancelled with an audit stamp;

(6) Staff members should refrain from discussing the client's affairs amongst themselves and with outsiders.

3.7 Continuous and Final Audit

Final or Completed or Periodical Audit: A final or completed audit is commonly understood to be an audit which does not begin until the books have closed at the end of the accounting period and thereafter is carried on continuously until completed. Whether an audit ought to be conducted continuously after the close of the financial year should be decided on a consideration of the size of the business and the extent of detailed checking required.

Advantages of such an audit are:

(i) Work can be carried on till the audit is over, thus, avoiding the necessity of having to return on separate occasions to complete the work.

(ii) The possibility of figures being altered after work has been done is also avoided.

(iii) Allocation of work for staff also becomes easier.

Disadvantages of final or completed audit include may be mainly on account of delay which may occur after the end of the financial period particularly if size of the business is large; accounting periods of several clients may end on the same date, and thus difficulties may be experienced in allocating audit staff.

Continuous Audit: A continuous audit is one in which the auditor's staff is engaged continuously in checking the accounts of the client the whole year round or when for this purpose the staff attends at intervals, fixed or otherwise, during the currency of the financial period. Strictly speaking, when auditor's staff attends the audit work at fixed intervals it may be strictly called interim audit. This is when an audit is conducted up to a particular date within the accounting period. The auditor may attend to audit the figures for a month or for a quarter, as the work may require. It would differ distinctly from the final audit in the extent of the work carried out; verification of assets, for example would be left until the final audit. In case of continuous audit, the work is conducted throughout the course of the financial year but is not taken to a specific accounting period, as is an interim audit. It might be that during the course of the continuous work interim figures are being audited, but the significant factor here is that the auditor will be engaged continuously on the audit throughout the financial period. Staff may be in residence throughout the period or may come and go at irregular intervals, but most of the time, the audit staff is present at the location. Thus, in case of continuous audit, the audit staff is present at the client's premises almost during the entire accounting period.

Advantages:

(1) Errors are discovered earlier with the result that there is adequate time for making the necessary rectification.

(2) Because of the frequent attendance of the auditor, the opportunities of committing frauds are reduced.

(3) Fraud, if perpetrated, is detected sooner with the result that size of the fraud is limited and also the chances of recovering the amount lost are improved.

(4) The attendance of the audit staff acts a moral check on the client's staff.

(5) The client's accounts are always kept up-to-date.

(6) Since audit can be carried on throughout the year, there is more time for detailed checking of the accounts when the audit is taken up at the close of the year.

(7) If the audit of routine transactions is completed before the close of the year, the final accounts can be prepared and reported upon much earlier.

(8) If the auditor carries on a continuous audit, he remains constantly in touch with the client's affairs thereby able to carry out his duties efficiently.

(9) In the case of continuous audit, the work of the auditor is greatly facilitated since he is in a better position to plan out his engagements and take up the job at his convenience, avoiding the pressure at the close of the financial year when most of the business firms usually close their accounts.

Disadvantages:

(1) There is a danger that the records of transactions after they have been audited may be altered either innocently or fraudulently.

(2) The examination of an item left incomplete on a visit for being undertaking on the next visit may be overlooked.

(3) A continuous audit may involve good deal of waste of time and effort if the size of the concern is small.

The disadvantages of a continuous audit can be avoided if the following precautions are taken:

(1) During the course of each visit, work should be completed upto a definite stage so as to avoid loose ends.

(2) At the end of each visit, important balances should be noted down and the same should be compared at the time of the next visit.

(3) The visits should be at irregular intervals of time so that the client's staff may not in advance know the exact date when the audit would be resumed and thus may be able to prepare themselves in advance for the same.

(4) The nominal accounts should be checked only at the time of final closing.

(5) The client's staff should be instructed not to alter or correct audited figures. The auditor should also device a special form of ticks for being placed against figures which have been altered and neither its purpose nor significance should be disclosed to the client's staff.

Thus, it is clear from the above that final or completed audit approach is advisable in case size of the entity is very small. On the other hand, continuous audit may be followed only in case size of the entity is very large and system of internal control is weak since the great disadvantage of continuous audit is that the cost would be very high and continuous presence of audit staff may impair auditor's independence. The interim audit conducted on quarterly or half-yearly basis is the most practicable solution.

3.8 Audit Planning and Materiality

As stated in the previous chapter, 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 mis-stated. 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. Students may note 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.

3.9 The Overall Audit Approach

The auditor must gather sufficient competent evidential matter as a basis for forming his opinion on:

(a) the truth and fairness of the accounts and also their compliance with the provisions of the related laws, rules and regulations;

(b) the proper keeping of the accounting records, and other records and related registers of the client.

These broad objectives may be amplified as follows:

To determine whether:

(1) all assets and liabilities are properly stated and classified on a basis consistent with that of the previous year;

(2) proper disclosure is made of securities for liabilities and of assets charged or secured;

(3) the client has complied with the provisions of the applicable laws and documents created under them, loan agreements and other documents to which he is a party;

(4) income and expenses are properly classified and disclosed and are properly matched. They relate to the period in which they are reported and have been determined on a basis consistent with that of the previous year;

(5) all contingencies and commitments are properly disclosed;

(6) no material omissions have been made in the financial statements;

(7) no material error or inaccuracy in reporting or disclosing income, expenses, assets and liabilities has been created in the financial statements;

(8) the books and records have been properly kept in accordance with the requirements of the client.

The expression of opinion on the overall balance sheet and statement of profit and loss involves initially forming an opinion on each of the balance sheet or profit and loss items; it is necessary first to decide what are the essential conditions or pre-requisites for each balance sheet or statement of profit and loss item in order to give a true and fair view of the particular assets or liabilities or item of income or expense being represented. These conditions are well established and may be illustrated by reference to the areas of trade receivables and sales revenues.

Trade Receivables: The audit of sundry trade receivables should be sufficiently comprehensive to enable the auditor to form an opinion as to whether:

(1) The amounts shown represent *bonafide* receivables of the company.

(2) The receivables are properly classified.

(3) Adequate provisions have been made for uncollectible receivables and for discounts and freight allowable, returns adjustments, etc.

(4) Any receivables have been pledged, discounted, assigned or sold, and if so whether they are properly disclosed.

Sales Revenues: Specific objectives in the audit of sales revenues are to determine whether:

(1) Sales accounting procedures are operating effectively to produce reliable sales revenue figures for the period.

(2) Sales revenues have been recorded in the proper accounting period and are not overstated through improper credits for fictitious sales of goods neither supplied nor set aside. Conversely, whether sales or other revenues are understated through deferring the recording thereof to subsequent periods or omitting to record sales despatched as sales.

(3) Allowance, returns and other sales deductions are fairly stated and properly treated in the financial statements and that adequate provisions have been made for any significant additional amount that may be anticipated to be paid but not yet finally settled.

(4) Non-operating revenues have been segregated from sales revenues and have been appropriately treated in the statement of profit and loss.

3.10 Audit Working Papers

The audit working papers constitute the link between the auditor's report and the client's records. According to SA-230 , 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). The objects of an auditor's working papers are to record and demonstrate the audit work from one year to another.

Audit documentation serves a number of purposes:

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

Working papers are varied in nature. They may be recorded on paper or on electronic or other media. Examples 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 working papers. Working papers, however, is not a substitute for the entity's accounting records.

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.

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 working papers.

The foundation of all working paper can be traced to:

(1) the basic constitutional documents like Memorandum and Articles of Association, Partnership Deed, Trust Deed, etc.;

(2) the contents of the minute books;

(3) the contents of the balance sheet and the statement of profit and loss; and

(4) the letter of engagement.

3.10.1 Form and Content of Working Papers: Working papers should record the audit plan, nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained.

The form, content and extent of working papers depend on factors such as:

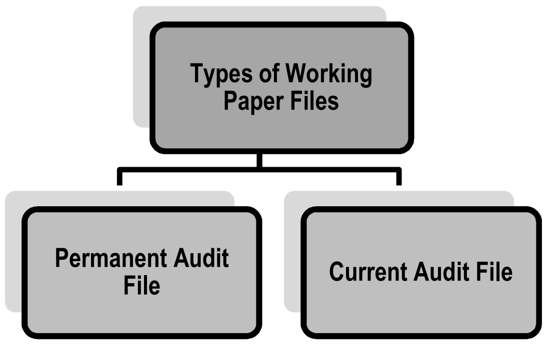
- The size and complexity of the entity.
- The nature of the audit procedures to be performed.
- The identified risks of material misstatement.
- The significance of the audit evidence obtained.
- The nature and extent of exceptions identified.
- The need to document a conclusion or the basis for a conclusion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

Working papers should be designed and properly organised to meet the circumstances of each audit and the auditor's needs in respect thereof. The standardisation of working papers (for example, checklists, specimen letters, standard organisation of working papers) improves the efficiency with which they are prepared and reviewed. It also facilitates the delegation of work while providing a means to control its quality. Working papers should be sufficiently complete and detailed for an auditor to obtain an overall understanding of the audit. The extent of the documentation is a matter of professional judgment since it is neither necessary nor practical that every observation, consideration or conclusion is documented by the auditor in his working papers.

All significant matters which require the exercise of judgment, together with the auditor's conclusion thereon, should be included in the working papers.

To improve audit efficiency, the auditor normally obtains and utilises schedules, analyses and other working papers prepared by the client. In such circumstances, the auditor should satisfy himself that these working papers have been properly prepared. Examples of such working papers are detailed analysis of important revenue accounts, receivables etc.

In the case of recurring audits, some working paper files may be classified as permanent audit files which are updated currently with information of continuing importance to succeeding audit, as distinct from current audit files which contain information relating primarily to the audit of a single period.



A permanent audit file normally includes:

- Information concerning the legal and organisational structure of the entity. In the case of a company, this includes the Memorandum and Articles of Association. In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions.
- Extracts or copies of important legal documents, agreements and minutes relevant to the audit.
- A record of the study and the evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
- Copies of audited financial statements for previous years.

- Analysis of significant ratios and trends.
- Copies of management letters issued by the auditor, if any.
- Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
- Notes regarding significant accounting policies.
- Significant audit observations of earlier years.

The current file normally includes:

- Correspondence relating to acceptance of annual reappointment.
- Extracts of important matters in the minutes of Board Meetings and General Meetings as relevant to audit.
- Evidence of the planning process of the audit and audit programme.
- Analysis of transactions and balances.
- A record of the nature, timing and extent of auditing procedures performed, and the results of such procedures.
- Evidence that the work performed by assistants was supervised and reviewed.
- Copies of communication with other auditors, experts and other third parties.
- Letters of representation or confirmation received from the client.
- Conclusions reached by the auditor concerning significant aspects of the audit, including the manner in which exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
- Copies of the financial information being reported on and the related audit reports.

3.10.2 Audit Note Book: An audit note book is usually a bound book in which a large variety of matters observed during the course of audit are recorded. It is thus a part of the permanent record of the auditor available for reference later on, if required. The audit note book also provides a valuable help to the auditor in picking up the links of work when the concerned assistant is away or the work is stopped temporarily because in it are recorded along with observations, the various queries, explanations obtained and evidence seen, while queries remaining undisputed of would be noted for follow up. It is more satisfactory in some ways, however, to use loose sheets for entering queries and notes which, subsequently, on being punched, may be filed in a special query file maintained for each client or along with the clients' accounts and papers, separately for each year.

Significant matters observed during the course of audit, a record of which should be kept in the Audit Note Book:

(a) Audit queries not cleared immediately *e.g.* missing receipts, vouchers, etc.

(b) The mistakes or irregularities observed during the course of audit *e.g.* cases of failure to comply with the requirements of the Companies Act, 2013 or the provisions contained in the Memorandum or Articles; a change in the basis of valuation of finished inventory and work-in-progress or in the computation of depreciation; failure to provide adequate depreciation, etc.

(c) Unsatisfactory book-keeping arrangements, costing method, internal or financial administration or organisation.

(d) Important information about the company which is not apparent from the accounts.

(e) Special points requiring consideration at the time of verification of final accounts.

(f) Important matters for future reference.

Specimen of entries in an Audit Note Book to indicate the manner in which entries in those books ought to be made:

Queries-Vouchers-Cash Book Payment

Voucher	*Account Debited*	*₹*	*Query*	*How disposed of*
38	Advertisement	2,01,600	Managing Director's sanction required	Sanction obtained
107	Rent	81,500	Rent bill & receipt required	Receipt & bill obtained
306	Das & Co.	5,23,474	Receipt required	Party reminded
42	Machinery	15,49,160	Board's sanction required	Sanction obtained minute dated 10-1-15
89	Stores	37,403	Invoice required	Party reminded
128	Raw material	83,457	Rates for items (i) & (ii) are different from those on the purchase order	Items of the quality ordered not being available, a better quality was accepted under purchase officer's approval.

The making of intelligent enquiries on the accounts under audit is an important part of the work of an auditor. However, to guard against the client's staff being required to provide explanation and information which are unnecessary or which could be ascertained otherwise junior members of the audit staff should be allowed to raise audit queries only after obtaining the prior approval of the senior in charge. Nonetheless, the enthusiasm of an intelligent and energetic junior should not go unrewarded and, as such, the queries he wishes to raise and which are not pertinent or important should be discussed and explained to him.

The audit notes constitute important evidence of matters considered by the auditor during the course of the audit, some of which may not find a place in his report submitted to the shareholders or directors, for the reason that on the basis of an explanation given to him by the management, he, on being satisfied, decided to drop them. As such, audit notes can be an important defence for the auditor in the event of an action for negligence in the discharge of his duties being subsequently brought against him.

In the past, these have been used for successfully defending a legal action brought against an auditor alleging negligence in performance of his duties. For instance in the case of *City Equitable Fire Insurance Company Limited* the auditor was greatly assisted in his defence by the well maintained record of work that had been carried out by him in regard to the audit. The necessity of maintaining a systematic record of audit queries also was greatly emphasised by Lord Justice Williams while delivering the judgment in the case of London and General Bank.

Audit notes can also serve as a guide in framing audit programme in the future as they indicate the weaknesses in the system of the client which specially need to be watched.

Also, it is desirable that the audit notes, whether they are kept in a book or in loose sheets, should bear a reference to the particular item of work in the audit programme, and as far as practicable, all notes relating to the particular work in the programme should be kept together in the systematic order.

3.10.3 Ownership and Custody of Working Papers: 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. Audit working papers are the property of the auditor and he is entitled to retain them. (*Chantery Martin & Co.* v. *Martin*).

***Retention Period*: Firms are required 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.**

***Documentation:* 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.

3.10.4 Importance of Working Papers

(i) It provides guidance to the audit staff with regard to the manner of checking the schedules.

(ii) The auditor is able to fix responsibility on the staff member who signs each schedule checked by him.

(iii) It acts as evidence in the court of law when a charge of negligence is brought against the auditor.

(iv) It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

Clarification on the Auditors' Rights where Clients and Other Auditors seek access to their Audit Working Papers:

(1) 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. SA 230 on "Audit Documentation" read with 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", 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) 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.

(3) Requests are sometime 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.

(4) 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 auditor. For this purpose, the term 'auditor' includes 'internal auditor'.

(5) As stated in Para 4 above, 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.

3.11 Quality Control for 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 also delegated by him 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 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.

Requirements

Leadership Responsibilities for Quality on Audits: The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

Relevant Ethical Requirements: 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.

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.

Independence*:* 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.

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, and shall determine that conclusions reached in this regard are appropriate.

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.

Assignment of Engagement Teams: 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.

Engagement Performance

Direction, Supervision and Performance*:* 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

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

Reviews*:* The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.

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.

Consultation: 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.

Engagement Quality Control Review

(1) 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.

(2) 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.

(3) 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.

Differences of Opinion: 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: 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.

Documentation: 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.

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.

(Note: Student may refer SA 220 reproduced in Auditing Pronouncements for better understanding of the topic)

3.12 Elements of Statistical Sampling

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 of 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.

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.

It has already been pointed out that 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. For 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.

3.12.1Test Checking: 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.

The auditor according to his best judgment, having regard to the nature, size and materiality of transactions, picks up the entries for examination. Normally, entries involving large amounts or relating to material accounts are seen exhaustively and entries are picked up for verification at random from the remainder according to a certain plan. Sometimes, entries are checked for a few specified months exhaustively and the rest go unchecked. Though it is stated that the technique is an adaptation of the sampling theory, it is in reality far from it. It lacks any acceptable basis and gives the auditor no idea about the degree of reliability that he can place on the findings for application to the whole set of entries. The so-called random picking is not random in the statistical sense. To be truly random, the selection should be free from any bias and that is possible only through a statistical process and by reference to the random number tables.

The only quality that this technique can claim lies in its keenness to cover larger amounts and material accounts. Even if errors, frauds etc., remain undetected in the part not checked, they are not likely to be too big as to upset the truth and fairness of the financial statement. But auditors cannot be certain about this even after checking 100% of transactions. The cost and time involved in conducting an audit has to be visualized in relation to benefits which shall accrue from such an approach. If fairly lesser amount of checking may lead to admit same conditions there is absolutely no point in checking entire transaction. Moreover, there are constraints within which audit has to be completed.

In any audit, the question of fact is more important because essentially the auditor's job is to test the assertions in financial statements by reference to available evidence, apart from the following aspects:

(i) presentation,

(ii) disclosure,

(iii) arithmetical accuracy,

(iv) adherence to accepted accounting principles, and

(v) compliance with the requirements of law.

An auditor is also concerned about the existence of errors and frauds in the financial accounts. The few matters listed above are fundamental questions affecting the true and fair concept and due consideration to these are given at the appropriate stage of audit. However, errors and frauds stand on a slightly different footing inasmuch as there is a need to eliminate them if they exist to affect truthfulness and fairness materially. It is therefore necessary that an auditor should have a fair idea about why error and frauds occur, how they are committed and what are the usual means to locate them.

3.12.2 Precautions to be taken in Adopting Test Checking Techniques: Generally, a large manufacturing concern is associated with a large volume of transactions. Also, the nature of the transactions is determined by the nature of the business. For example, one may find numerous purchases of raw materials, stores, spares, etc.; there may be thousands of workers to be paid wages on weekly basis; the wages again may be calculated on a job or time basis. Depending upon the product lines, the sales mechanics may be different for different products - some may be to dealers and agents, some to wholesalers and some others even to retailers and consumers directly. Sales and purchase operations may stretch even to overseas markets. There may be various forms in which such a concern can raise bank finance, like letter of credit, packing credit, overdraft, bills discounted, etc. Basically, in a large manufacturing concern the problem is the problem of volume and variety.

In the circumstances when necessarily the test check technique has got to be adopted for audit work, it should be done by taking certain precautions so that a reliable idea about the truth and fairness of the accounts can be obtained by the auditor.

The precautions that should be taken may be the following:

(i) The transactions of the concern should be classified under appropriate heads and may be stratified if wide variations are there between transactions of the same kind.

(ii) Systems and procedures for entering into and processing a transaction right from the beginning to the end should be studied in a sequential order. It involves questions of authorisations, documentation and recording and evidencing the same.

(iii) The whole of the system of internal control in the areas of accounts and finance should be studied and evaluated for its efficiency, soundness and capability for producing reliable accounting and financial data. This can be done by studying the controls and internal checks, evaluating their general soundness in the context of the business of the concern and testing their actual operation. If, and only if, the auditor is satisfied about soundness of the controls and their operation in actuality, can he decide to have test checks. For testing the operation of the control system, he should select a few transactions and check them in depth by the application of procedural tests.

(iv) A properly thought-out test check plan should be prepared and the objective of each check should be clearly understood by the auditing staff. For example, each voucher may be checked by the test check method for a number of objectives - one may be to ensure that the cash payments are properly authorised and acknowledged, others may be to see whether the amount actually payable has in fact been paid and whether the payment has been debited to the proper account. If there is a mix-up in the objectives or the objective is to test a number of variables in one test scheme, the result may not be helpful. Hence it requires a clear definition of the audit objective related to the particular test check plan.

(v) The transactions falling under each test-check plan should be selected in a manner so that bias cannot enter in the selection. For the purpose, selection should be made by reference to the random number tables.

(vi) Identification of the areas where test check may not be done. For example, if there are only 20 overseas sales in the year, it would be preferable to have them all thoroughly checked.

(vii) The number of transactions to be selected for each test-check plan should be predetermined. This can be done by deciding upon the degree of reliance that should be placed on the test-check result and the confidence that can be placed - the result to be obtained should be veering round the degree of reliance set up. Once the degree of reliance and the confidence level required in the audit for expression of the opinion have been decided, the number to be tested out of the given population can be easily known by reference to the statistical tables.

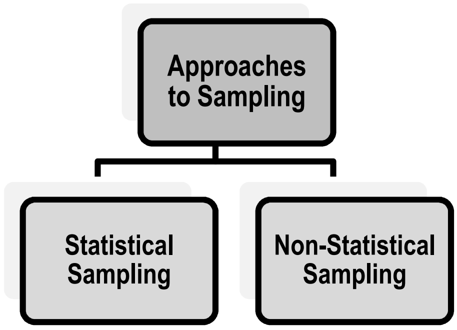
(viii) Errors that may be found may be material or immaterial in the context of the particular audit. Since errors of immaterial nature are not likely to distort the overall truth and fairness of the accounts, it is necessary to decide upon the criteria to judge what constitutes a material error. Further investigation of immaterial error may be avoided and only the material errors may be properly and thoroughly investigated.

3.12.3 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. 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.

Approaches to Sampling:



The approaches to sampling are: (1) Statistical sampling; and (2) Non-statistical sampling.

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.

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.

Statistical Sampling: 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.

Students may note that it is unnecessary for the auditor to gain in depth knowledge of statistics before making use of statistical sampling for audit testing since published statistical tables are available which indicate the sample size based on pre-determined criteria.

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 criticised on the grounds that it is neither objective nor scientific. The expected degree of objective 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.

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. In statistical sampling, the sample results are measurable as to the adequacy and reliability of the audit objectives.

Sample Design, Size and Selection of Items for Testing: 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. 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.

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.

Nature and Cause of Deviations and Misstatements: 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.

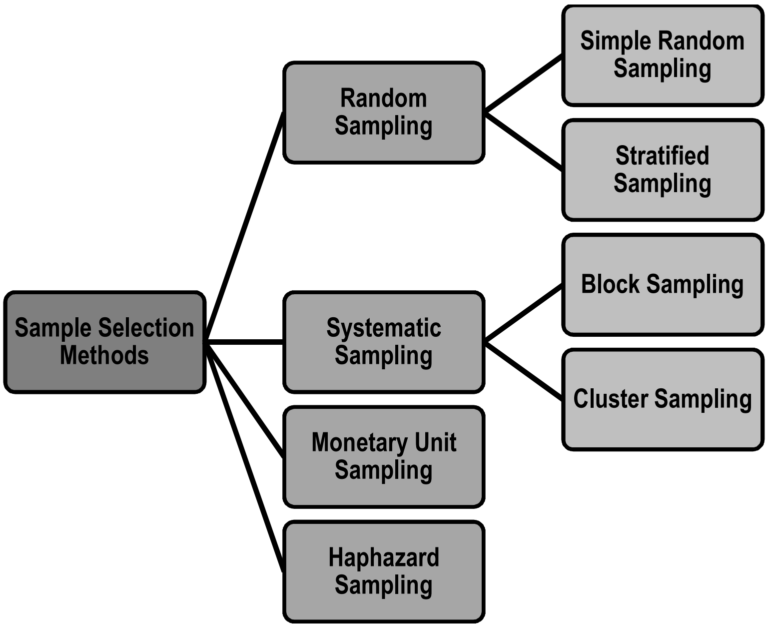
Projecting Misstatements: For tests of details, the auditor shall project misstatements found in the sample to the population.

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.

3.12.4 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. For 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. For 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 ₹ 7,75,000 to ₹ 10,00,000;

(c) balances in the range of ₹ 5,50,000 to ₹ 7,75,000;

(d) balances in the range of ₹ 2,25,000 to ₹ 5,50,000; and

(e) balances below ₹ 2,25,000.

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.

(2) **Interval sampling or systematic sampling:** It involves selecting items using a constant interval between selections, the first interval having a random start. The interval might be based on a certain number of items (for example every 20th voucher) or a monetary totals (for example every ₹ 10,000 in the cumulative value of the population). When using systematic selection, the auditor should determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For 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.

(*i*) ***Block Sampling*:** This method involves the selection of a defined block of consecutive items. For 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.

(*ii*) ***Cluster sampling*:** This method involves dividing the population into groups of items known as clusters. A number of clusters are randomly selected from all the clusters rather than individual items of the population. Cluster sampling can be used together with both unrestricted random and stratified sampling, for example 500 to 540, 2015 to 2055 etc. The first item *i.e.* 500, 2015 is randomly selected from random number tables. The items of selected cluster can either be checked completely or a randomly selected proportion of them can be examined.

The cluster is less effective for a given sample size than unrestricted random and stratified samples as items are not individually selected. However, the time saved can be utilised to have a larger sample to make the sample results more reliable.

As per SA 530, the auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

(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.

3.12.5 Advantages of Statistical Sampling in Auditing: 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.

(Note: Student may refer SA 530 reproduced in Auditing Pronouncements for better understanding of the topic)

3.13 Audit Risk

Students may recall that there is unavoidable risk that even some material misstatements may remain undiscovered due to the test nature and other inherent limitations of any system of internal control. SA-500 on "Audit Evidence" also makes it clear that the auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. An auditor's judgement as to what is sufficient and appropriate audit evidence is affected by the degree of risk of mis-statement. Therefore, it becomes significant that an auditor is aware of risks which are inherent in any audit with reference to materiality of transactions involved and accordingly test and evaluate internal control systems so as to assess the extent of risk. In the following paragraphs, first of all various facts of audit risks are discussed followed by relationship between materiality and audit risk.

Low-risk areas are those which require the application of routine "nuts and bolts" audit procedures in the ordinary course of vouching, casting, checking, etc., at both compliance and substantive stages, usually occupying up to 80% of all audit effort. High-risk areas are those which should be the primary concern of partners and senior managers, and will include such matters as:

(a) adequacy of provisions;

(b) full disclosure of liabilities, including contingent liabilities;

(c) interpretation of SAs and company legislation;

(d) post–balance sheet review of subsequent events;

(e) analytical reviews on draft financial statements;

(f) implications of tax legislation;

(g) detecting overstatement of assets, e.g. by capitalising expenditure;

(h) identifying high-value items and 'error-prone' conditions; and

(i) drafting the audit report itself.

3.13.1Concept of audit risk: Audit risk is the risk that an auditor may give an inappropriate opinion on financial information that is materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. For example, an auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated. Such risk may exist at overall level or while verifying various transactions and balance-sheet items. 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. 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.

[Note: Types of risk are discussed separately in this chapter.]

Identifying and Assessing the Risks of Material Misstatement: The auditor shall identify and assess the risks of material misstatement at-

(1) the financial statement level; and

(2) the assertion level for classes of transactions, account balances, and disclosures;

to provide a basis for designing and performing further audit procedures.

Thus, according to SA 315, 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.

(1) Assessment of Risks of Material Misstatement at the Financial Statement Level

(a) 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.

(b) 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.

(c) 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.

(d) 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.

(2) Assessment of Risks of Material Misstatement at the Assertion Level

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 Uses 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.

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.

Process of Identifying Risks of Material Misstatement: 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.

As per SA 200, 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. The nature of each of these types of risk and their interrelationship is discussed below-

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. It 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.

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. It 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 performed.

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.

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. 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 more persuasive the audit evidence required by the auditor.

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.

Interrelationship of the components of audit risk: Inherent and control risks differ from detection risk in that they exist independently of an audit of financial information. Inherent and control risks are functions of the entity's business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce an acceptable level of detection risk, thereby reducing audit risk to an acceptably low level.

3.13.2 Materiality and Audit Risk: SA-320 on "Materiality in Planning and Performing an Audit" states that 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. According to it, 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 about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered. It stresses that the assessment of what is material is a matter of professional judgement.

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.

After the auditor has assessed the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgment, select appropriate substantive audit procedures. If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high. The auditor reduces detection risk by performing substantive procedures - the more extensive the procedures performed, the lower the detection risk. The nature and timing of substantive procedures will also affect the detection risk, for example, confirmation with third parties will lead to lower detection risk than reliance on internal data, as will procedures carried out closer to year-end.

The auditor's assessment of audit risk may change during the course of an audit. For example, in planning the audit, the auditor may believe that he has low inherent and control risk based on his assessment of the probability of errors occurring and on his review and testing of the system of internal control. After performing audit procedures, however, the auditor may conclude that his earlier assessment was too low. In this case, he will have to carry out additional audit procedures in order to reduce the level of detection risk and achieve audit risk at the level originally planned.

(Note: Student may refer SA 320 reproduced in Auditing Pronouncements for better understanding of the topic)

3.14 Surprise Checks

The surprise checks also constitute an important part of normal audit procedures. Audit procedures cannot consist merely of any set of rules or precepts to be applied to all and every situation but must be allowed to develop in the light of experience with regard to the circumstances of each audit. An element of surprise can significantly improve the effectiveness of an audit and therefore, wherever practicable, an element of surprise should be incorporated into the audit programme.

The element of surprise in an audit can be both with regard to the time of the audit, that is the selection of the date at which the auditor visits the clients' office to carry out the audit and the selection of the items which are subjected to audit.

Surprise checks are mainly intended to ascertain whether the system of internal control is operating effectively and whether the accounting and other records are prepared concurrently and kept up-to-date. It has often been found that manipulations and frauds are facilitated under a system of book-keeping which does not give proper emphasis to the need to keep the books up-to-date. Errors in book-keeping are often indicative of weaknesses in internal control which may be taken advantage of in order to perpetrate frauds or manipulations. Surprise checks are a useful method of determining whether or not such errors exist and where they exist, of bringing the matter promptly to the attention of the management so that corrective action is taken immediately. Consequently, surprise visits by the auditor can exercise a good moral check on the client's staff.

While surprise checks would generally be appropriate in most cases, they are particularly appropriate in cases where the auditor is not satisfied with regard to the system of internal control, or where the company is a very large one or has diversified activities or numerous branches, leading to remoteness of control between top management and various persons in charge of the company's operations at different locations. Surprise checks are also particularly relevant in respect of certain items, for example, cash, investments, stores and inventories, statutory registers normally required to be examined for the purposes of audit, etc. They also have great relevance to ensure that the books of prime entry, for example, the cash book, sales and purchase journals etc. have been kept up-to-date. When computerized information system is being used, surprise checks, through the use of test-checks etc. are important to ensure that the programmes are operating satisfactorily.

The need for and frequency of surprise checks is obviously a matter to be decided having regard to the circumstances of each audit. It would depend upon the extent to which the auditor considers the internal control system as adequate, the nature of the clients' transaction, the locations from which he operates and the relative importance of items like cash, investments, stores etc. However, wherever feasible a surprise check should be made at least once in the course of an audit.

In the case of an audit of a company the auditor is appointed at the Annual General Meeting to hold office until the next Annual General Meeting. He is not appointed for a particular accounting year. Consequently, he has the right of examination of the accounts and records of the company at any time during the period covered by his appointment, insofar as it is necessary for the purposes of his report. He may, therefore, carry out surprise checks of transactions beyond the end of the accounting year for which he is reporting.

Surprise checks are a part of the normal audit and the results of such checks are therefore important primarily to the auditor himself in deciding the scope of his audit and submitting his report thereon. If the surprise check reveals a weakness in the system of internal control or any fraud or error or the fact that any book or register has not been properly maintained or kept up-to-date, the auditor should communicate the same to the management and ensure that action is taken on the matters communicated by him. It does not necessarily follow that all or any of the matters communicated to the management should form part of the auditor's report on the accounts. Whether the items should also be included in the auditor's report on the accounts is a matter for the auditor to decide in the light of the circumstances of each case. In arriving at his decision he must consider, *inter alia,* the magnitude of the amounts involved, whether the error or deficiencies pointed out have been rectified or the weaknesses in the internal control system corrected and the extent to which the accounts reported upon are affected by the matters stated by him in his report to the management.

The Council therefore makes the following recommendations:

(1) Surprise checks should be considered as a desirable part of each audit.

(2) The areas over which surprise checks should be employed would depend upon the circumstances of each audit but should normally include:

   (a) Verification of cash and investments.

   (b) Test-verification of stores and inventories and the records relating thereto.

   (c) Verification of books of prime entry and statutory registers normally required to be examined for the purposes of audit.

(3) The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.

(4) The results of the surprise checks should be communicated to the management if they reveal any weakness in the system of internal control or any fraud or error or deficiency in the maintenance of records.

(5) The auditor should satisfy himself that adequate action is taken by the management on the matters communicated by him.

(6) It is not necessary in all cases for the results of the surprise checks to be included in the auditors' report on the accounts. They should, however, be included if in the opinion of the auditor they are material and affect a true and fair view of the accounts on which he is reporting.

3.15 Obtaining Certificate from Management

While conducting an audit, the auditor comes across various matters in respect of which he is not able to obtain sufficient appropriate audit evidence. One such area involves verification of liabilities, in general, and contingent liabilities in particular. In such cases, it is advisable for the auditor to obtain a written representation from the management as to the fact whether all contingent liabilities have been disclosed and are complete in all respects. Even in normal circumstances, obtaining a certificate from the management would provide a corroborating evidence to support the evidence obtained from other sources. In any case, the fact remains that it is the management which is responsible for preparation of financial information. Therefore, it would be in order to obtain an appropriate certificate from the management that it has approved the financial information prepared by them. Now section 134(5) of the Companies Act, 2013 provides that the Board shall have to give a statement that financial statements are their responsibility.

SA-580, "Written Representations", deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance. 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. 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.

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.

It makes it absolutely clear that written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available. For example, a representation by management as to the quantity, existence and cost of inventories is no substitute for adopting normal audit procedures regarding verification and valuation of inventories. If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter.

(Note: Student may refer SA 580 reproduced in Auditing Pronouncements for better understanding of the topic)

4

Internal Control

Learning Objectives

After reading this chapter student should be able to –

- Understand the concept of Internal Control in detail along with its objectives & control environment.
- Explain about understanding the entity & its environment, including entity's Internal Control.
- Understand the factor relevant to the auditor's judgement about whether a control is relevant to the audit.
- Explain inherent limitations of Internal Control.
- Understand aims of Internal Control so far as financial & accounting aspects are concerned.
- Explain Relationship of Internal Control & Management.
- Understand the responsibilities of auditor to communicate weaknesses of Internal Control to management.
- Understand how review of internal control would help the auditor.
- Understand the importance of testing of Internal Control & examination in depth.
- Explain the relationship between the assessments of Inherent & Control Risks.
- Understand the Internal Control & Computerized Information System environment.
- Understand Internal check and Internal Audit.
- Explain the relationship between statutory & the Internal Auditors.

Control is a basic human requirement and it has existed throughout the ages in different facets of human activity. Business as such is a complex process and has grown even more complex with the technological advancement of the society. The formalisation of the concept of internal control in the sphere of business administration is a comparatively recent phenomenon.

In the sphere of a business, control is an accepted device for optimum utilisation of the resources and opportunities for maximisation of profits. All operations of a business are carried on with the help of human agents and equipment; both these factors need supervision so that the tasks assigned to them are properly carried out and avoidable wastes and losses do not occur to eat up the fruit of the enterprise.

The internal control required by a sole proprietor of small business is not identical with that required for a large industrial organisation. A small trader having a grocery shop hardly needs more than one or two assistants. He decides the work to be done by the assistants. He always knows his own inventory, cash and bank position. He has the knowledge of daily sales. He himself knows the sources for purchases. He arranges transport and makes the purchases. He keeps the record of the trade receivables and trade payables. The assistants merely help him in delivering goods to customers or to arrange the goods in proper order.

From the above, it can be observed that control is entirely centralised with the owner and there is no significant delegation of duties. However, as the business grows in size it soon reaches a stage where the owner can no longer keep him intimately informed about the detailed operations of his business, activities of the employees and the discharge of their responsibilities. To cope with the increasing size and volume of business, he has to employ more and more people and for systematically carrying on the business, he has to specify the tasks for each person. For remote operations he has also to rely upon these people, for carrying out the work, for the custody of the materials, documents and equipments entrusted to them. He has also to ensure that the equipment and facilities are properly maintained. For this purpose, he has to give shape to a form of organisation from which he would be in a position to know the broad details of the work involved and the persons responsible for such work. Also, he has to work out a plan of delegation of duties and authority for the simple reason that, for anything and everything, people need not come to him for advice or decision, because, under such circumstances, he would not be able to find time to apply his mind to matters of more importance.

Human behaviour is such that if it is not under some sort of regulation or control, it often tends to depart from the proper path. It needs to be kept under systematic watch not only for ensuring that the employee does his work, but also to see that he does it in the manner laid down for the purpose and handles the material and equipment with proper care.

4.1 Concept 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.

4.2 Understanding the Entity and Its Environment, Including the Entity's Internal Control

The Entity and Its Environment: The auditor shall obtain an understanding of the following-

(i) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.

(ii) The nature of the entity, including:

  (a) its operations;

  (b) its ownership and governance structures;

  (c) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

  (d) 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.

(iii) 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.

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

(v) The measurement and review of the entity's financial performance.

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.

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.

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-*

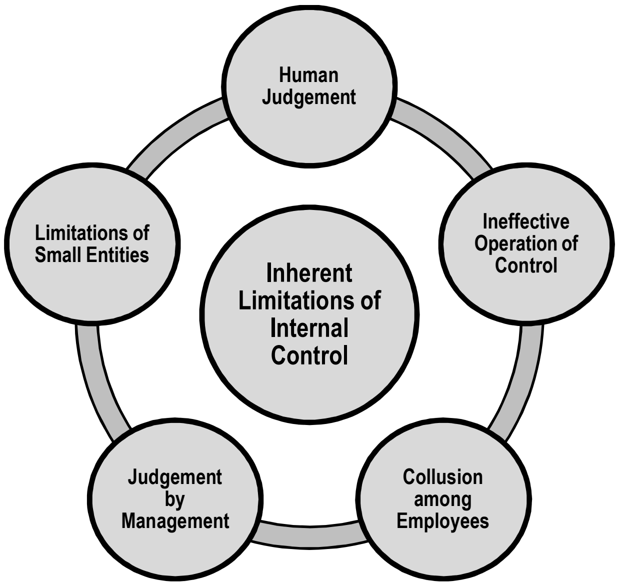
- *The reliability of the entity's financial reporting;*
- *The effectiveness and efficiency of its operations;*
- *Its compliance with applicable laws and regulations; and*
- *Safeguarding of assets.*

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

Limitations of Internal Control: *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-*

(i) Role of Human Judgement: 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.

(ii) Ineffective Operation of 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.



(iii) Collusion among Employees: ***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.***

(iv) Judgement 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.

(v) Considerations specific to Smaller Entities: 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-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.

Division of Internal Control into Components: 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; and

(e) Monitoring of controls.

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.*

(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.

Controls Relevant to the Audit: 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.

(i) 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.

(ii) Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit.

(iii) 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.

(iv) An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered.

(v) 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:

(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.

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.

Control Environment: The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether-

(i) Management, with the oversight of those charged with governance, 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, and whether those other components are not undermined by deficiencies in the control environment.

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.

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

(i) Communication and enforcement of integrity and ethical values – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.

(ii) 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.

(iii) 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.

(iv) 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.

(v) Organisational structure – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

(vi) 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.

(vii) Human resource policies and practices – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

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.

Monitoring of Controls: 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.

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.

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.

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.

4.3 Accounting and Financial Control

Internal control, so far as financial and accounting aspects are concerned, aims at:

(i) Providing the flow of work through various stages.

(ii) Breaking the chain of the work in a manner so that no single person can handle a transaction from the beginning to the end.

(iii) Segregation of accounting and custodial functions.

(iv) Securing proper documentation at each stage.

(v) Specifying authority to enter into the various transactions and for every action connected therewith.

(vi) Recording the transactions in the books of account correctly.

(vii) Safeguarding of assets.

(viii) Making errors and frauds difficult.

(ix) Fixing responsibility for the work and the responsibility for deviations.

(x) Building up a system to locate the deviations and departures from the prescribed procedures and to detect frauds and errors automatically without much loss of time.

(xi) Elimination of conflicting responsibilities.

(xii) Evolving standardised records.

(xiii) Providing account charts and the accounting manual.

(xiv) Preparation of periodical accounting and financial report.

(xv) Making the work simpler as far as practicable.

(xvi) Minimising loss and wastage.

(xvii) Encouraging employees to do willing and good work.

(xviii) Discouraging employees from non-compliance with the prescribed procedures.

(xix) Appraisal of the operations.

(xx) Employment of persons of quality.

(xxi) Formulating a cut-off procedure to separate transactions of two consecutive years.

4.4 Internal Control and Management

Before any discussion on the effect of internal control on the auditor's work is undertaken it is necessary to appreciate that devising and installation of internal control is the responsibility of the management. In any business, the management is vested with the responsibility of carrying on the business, safeguarding its assets and recording the transactions in the books of account and other records. 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". It should also be appreciated that in every business organisation, small or big, simple or complex, some sort of control is perceptively or otherwise in operation. It ensures uniform treatment and operation. It outlines the broad line of authority and specifies each one's task. The form and details, however, may vary from organisation to organisation. It is also important to bear in mind that the system installed needs review by the management to ascertain:

(i) whether the prescribed management policies are being properly interpreted by the employees and are faithfully implemented;

(ii) whether the prescribed procedures need a revision because of changed circumstances or whether they have become obsolete or cumbersome; and

(iii) whether effective corrective measures are taken promptly when the system appears to break down.

It is desirable that the management also installs an internal audit system as an independent function to check, amongst other things, the actual operation of the internal control system and report to it the deviations and non-compliances.

4.5 Internal Control and the Auditor

The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control.

If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies.

The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.

The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis:

(a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and

(b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention.

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

(a) A description of the deficiencies and an explanation of their potential effects; and

(b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that:

    (i) The purpose of the audit was for the auditor to express an opinion on the financial statements;

    (ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and

    (iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

4.6 Review 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. 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.

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. For 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.

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.

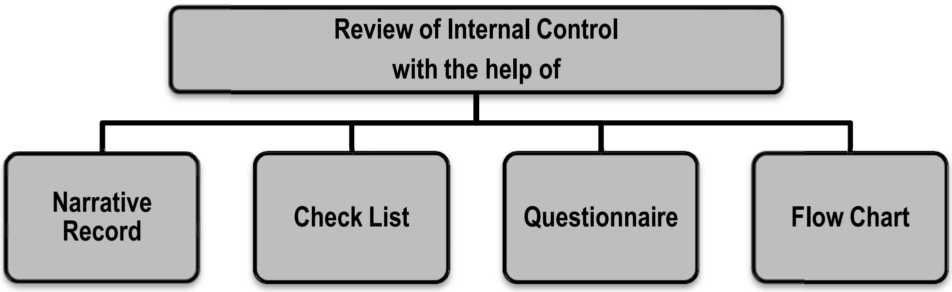
To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following to help him to know and assimilate the system and evaluate the same:

(i) Narrative record;

(ii) Check List;

(iii) Questionnaire; and

(iv) Flow chart.



4.6.1 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.

4.6.2 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. 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:
    (i) custody of work;
    (ii) receipt of inventory;
    (iii) inspection of inventory; and
    (iv) 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.

4.6.3 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.

4.6.4 A 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.

4.7 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.

Tests of Control: Tests of control are performed to obtain audit evidence about the effectiveness of the:

(a) design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and

(b) operation of the internal controls throughout the period.

Tests of control include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk.

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.

Tests of control may include:

- Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
- Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
- Re-performance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
- Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

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. For example, the procedure for sales requires the following:

(i) 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.

(ii) 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.

(iii) 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.

(iv) The rate at which the order has been accepted and other terms about transport, insurance, etc., should be clearly specified.

(v) 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.

4.8 Examination in Depth

It implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction, i.e., from initiation to the completion of the transaction by receipt of payment of cash and delivery or receipt of the goods. This examination consists of studying the recording of transactions at the various stages through which they have passed. At each stage, relevant records and authorities are examined; it is also judged whether the person who has exercised the authority in relation to the transactions is fit to do so in terms of the prescribed procedure. For example, if payment to a creditor is to be verified "in depth", it would be necessary to examine the following documents:

(a) The invoice and statement of account received from the supplier.

(b) The entry in the inventory record showing that the goods were received.

(c) The Goods Received Note and Inspection Certificate showing that the goods on receipt were verified and inspected.

(d) The copy of the original order and authority showing that the goods in fact were ordered by an authority which was competent to do so.

It is to be emphasised that, so far as the management is concerned, the internal control should have willing acceptance at the hands of the employees and there should exist proper mechanism for such motivation.

4.9 Relationship between the Assessments of Inherent and Control Risks

Management often reacts to inherent risk situations by designing accounting and internal control systems to prevent or detect and correct misstatements and therefore, in many cases, inherent risk and control risk are highly interrelated. In such situations, if the auditor attempts to assess inherent and control risks separately, there is a possibility of inappropriate risk assessment. As a result, audit risk may be more appropriately determined in such situations by making a combined assessment.

The level of detection risk relates directly to the auditor's substantive procedures. The auditor's control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk, and therefore audit risk, to an acceptably low level. Some detection risk would always be present even if an auditor was to examine 100 percent of the account balances or class of transactions because, for example, most audit evidence is persuasive rather than conclusive.

The auditor should consider the assessed levels of inherent and control risks in determining the nature, timing and extent of substantive procedures required to reduce audit risk to an acceptably low level. In this regard the auditor would consider:

(a) the nature of substantive procedures, for example, using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity, or using tests of details for a particular audit objective in addition to analytical procedures;

(b) the timing of substantive procedures, for example, performing them at period end rather than at an earlier date; and

(c) the extent of substantive procedures, for example, using a larger sample size.

There is an inverse relationship between detection risks and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable detection risk needs to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level.

While tests of control and substantive procedures are distinguishable as to their purpose, the results of either type of procedure may contribute to the purpose of the other. Misstatements discovered in conducting substantive procedures may cause the auditor to modify the previous assessment of control risk.

The assessed levels of inherent and control risks cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. Regardless of the assessed levels of inherent and control risks, the auditor should perform some substantive procedures for material account balances and classes of transactions.

The auditor's assessment of the components of audit risk may change during the course of an audit, for example, information may come to the auditor's attention when performing substantive procedures that differs significantly from the information on which the auditor originally assessed inherent and control risks. In such cases, the auditor would modify the planned substantive procedures based on a revision of the assessed levels of inherent and control risks.

The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. When the auditor determines that detection risk regarding a financial statement assertion for a material account balance or class of transactions cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.

4.10 Communication of Weaknesses in Internal Control

As a result of obtaining an understanding of the accounting and internal control systems and tests of control, the auditor may become aware of weaknesses in the systems. The auditor should make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to the auditor's attention. The communication to management of material weaknesses would ordinarily be in writing. However, if the auditor judges that oral communication is appropriate, such communication would be documented in the audit working papers. It is important to indicate in the communication that only weaknesses which have come to the auditor's attention as a result of the audit have been reported and that the examination has not been designed to determine the adequacy of internal control for management purposes.

4.11 Internal Control in the Small Business

The auditor needs to obtain the same degree of assurance in order to give an unqualified opinion on the financial statements of both small and large entities. However, many controls which would be relevant to large entities are not practical in the small business. For example, in small business, accounting work may be performed by only a few persons. These persons may have both operating and custodial responsibilities, and segregation of functions may be missing or severely limited. Inadequate segregation of duties may, in some cases, be offset by owner/manager supervisory controls which may exist because of direct personal knowledge of the business and involvement in the business transactions. In circumstances where segregation of duties is limited or evidence of supervisory controls is lacking, the evidence necessary to support the auditor's opinion on the financial information may have to be obtained largely through the performance of substantive procedures.

4.12 Internal Control and the Computerised Information System (CIS) Environment

The principal object of an audit is to ensure that the accounts on which the auditor is reporting to show a true and fair view of the state of affairs at a given date and of the results for the period ended on that date. The essential features of an audit, appropriate for medium or large sized concern, are:

(a) an evaluation of the system of accounting and internal control to ascertain whether they are appropriate for the business and properly record all transactions;

(b) the making of such tests and enquiries as are considered necessary to determine whether the systems are being operated correctly;

(c) an examination of the accounts in order to verify:

    (i) the title, existence and value of the assets appearing in the balance sheet and to verify that all liabilities are correctly included therein;

    (ii) that the results shown by the profit and loss account are fairly stated;

and to ensure that such accounts are in accordance with the underlying records and comply with the appropriate statutory requirements.

The overall objective and scope of an audit does not change in CIS environment. However, the use of a computer changes the processing and storage of financial information and may affect the organization and procedures employed by the entity to achieve adequate internal control. Accordingly, the procedures followed by the auditor in his study and evaluation of the accounting system and related internal controls and nature, timing and extent of his other audit procedures may be affected by CIS environment.

Skills and Competence: When auditing in CIS environment, the auditor should have an understanding of computer hardware, software and processing systems sufficient to plan the engagement and to understand how CIS affects the study and evaluation of internal control and application of auditing procedures including computer-assisted audit techniques. The auditor should also have sufficient knowledge of CIS to implement the auditing procedures, depending on the particular audit approach adopted.

Work Performed by Others: The auditor is never able to delegate his responsibility for forming important audit conclusions or for forming and expressing his opinion on the financial information. Accordingly, when he delegates work to assistants or uses work performed by other auditors or experts, the auditor should have sufficient knowledge of CIS to direct, supervise and review the work of assistants with CIS skills or to obtain reasonable assurance that the work performed by other auditors or experts with CIS skills is adequate for his purpose, as applicable.

Planning: The auditor should gather information about the CIS environment that is relevant to the audit plan, including information as to:

- How the CIS function is organized and the extent of concentration or distribution of computer processing throughout the entity.
- The computer hardware and software used by the entity.
- Each significant application processed by the computer, the nature of the processing (e.g. batch, on-line), and data retention policies.
- Planned implementation of new applications or revisions to existing applications.
- When considering his overall plan the auditor should consider matters, such as:
    - Determining the degree of reliance, if any, he expects to be able to place on the CIS controls in his overall evaluation of internal control.
    - Planning how, where and when the CIS function will be reviewed including scheduling the works of CIS experts, as applicable.
    - Planning auditing procedures using computer-assisted audit techniques.

Accounting System and Internal Control: During the review and preliminary evaluation of internal control, the auditor should acquire knowledge of the accounting system to gain an understanding of the overall control environment and the flow of transactions. If the auditor plans to rely on internal controls in conducting his audit, he should consider the manual and computer controls affecting the CIS function (general CIS controls) and the specific controls over the relevant accounting applications (CIS application controls).

Audit Evidence: A CIS environment may affect the application of compliance and substantive procedures in several ways.

The use of computer assisted audit techniques may be required because:

- The absence of input documents (e.g. order entry in on-line systems) or the generation of accounting transactions by computer programs (e.g. automatic calculation of discounts) may preclude the auditor from examining documentary evidence.
- The lack of a visible audit trail will preclude the auditor from visually following transactions through the computerized accounting system.
- The lack of visible output may necessitate access to data retained on files readable only by the computer.

The timing of auditing procedures may be affected because data may not be retained in computer files for a sufficient length of time for audit use, and the auditor may have to make specific arrangements to have it retained or copied.

The effectiveness and efficiency of auditing procedures may be improved through the use of computer-assisted audit techniques in obtaining and evaluating audit evidence, for example:

(i) Some transactions may be tested more effectively for a similar level of cost by using the computer to examine all or a greater number of transactions than would otherwise be selected.

(ii) In applying analytical review procedures, transactions or balance details may be reviewed and reports printed of unusual items more efficiently by using the computer than by manual methods.

4.12.1 Organizational Structure in the CIS Environment: In a CIS environment, an entity will establish an organizational structure and procedures to manage the CIS activities. **Characteristics of a CIS organizational structure include-**

(a) Concentration of functions and knowledge—although most systems employing CIS methods will include certain manual operations, generally the number of persons involved in the processing of financial information is significantly reduced. Furthermore, certain data processing personnel may be the only ones with a detailed knowledge of the interrelationship between the source of data, how it is processed and the distribution and use of the output. It is also likely that they are aware of any internal control weaknesses and, therefore, may be in a position to alter programs or data while stored or during processing. Moreover, many conventional controls based on adequate segregation of incompatible functions may not exist, or in the absence of access and other controls, may be less effective.

(b) Concentration of programs and data—transaction and master file data are often concentrated, usually in machine-readable form, either in one computer installation located centrally or in a number of installations distributed throughout an entity. Computer programs which provide the ability to obtain access to and alter such data are likely to be stored at the same location as the data. Therefore, in the absence of appropriate controls, there is an increased potential for unauthorized access to, and alteration of, programs and data.

Nature of Processing: The use of computers may result in the design of systems that provide less visible evidence than those using manual procedures. In addition, these systems may be accessible by a larger number of persons. System characteristics that may result from the nature of CIS processing include:

(a) Absence of input documents—data may be entered directly into the computer system without supporting documents. In some on-line transaction systems, written evidence of individual data entry authorization (e.g. approval for order entry) may be replaced by other procedures, such as authorization controls contained in computer programs (e.g. credit limit approval).

(b) Lack of visible transaction trail—certain data may be maintained on computer files only. In a manual system, it is normally possible to follow a transaction through the system by examining source documents, books of account, records, files and reports. In a CIS environment, however, the transaction trail may be partly in machine-readable form, and furthermore it may exist only for a limited period of time.

(c) Lack of visible output—certain transactions or results of processing may not be printed. In a manual system, and in some CIS systems, it is normally possible to examine visually the results of processing. In other CIS systems, the results of processing may not be printed, or only summary data may be printed. Thus, the lack of visible output may result in the need to access data retained on files readable only by the computer.

(d) Ease of access to data and computer programs—data and computer programs may be accessed and altered at the computer or through the use of computer equipment at remote locations. Therefore, in the absence of appropriate controls, there is an increased potential for unauthorized access to, and alteration of, data and programs by persons inside or outside the entity.

Design and Procedural Aspects: The development of CIS systems will generally result in design and procedural characteristics that are different from those found in manual systems. These different design and procedural aspects of CIS systems include:

(a) Consistency of performance—CIS systems performed functions exactly as programmed and are potentially more reliable than manual systems, provided that all transaction types and conditions that could occur are anticipated and incorporated into the system. On the other hand, a computer program that is not correctly programmed and tested may consistently process transactions or other data erroneously.

(b) Programmed control procedures—the nature of computer processing allows the design of internal control procedures in computer programs. These procedures can be designed to provide controls with limited visibility (e.g. protection of data against unauthorized access may be provided by passwords). Other procedures can be designed for use with manual intervention, such as review of reports printed for exception and error reporting, and reasonableness and limit checks of data.

(c) Single transaction update of multiple or data base computer files—a single input to the accounting system may automatically update all records associated with the transaction (e.g. shipment of goods documents may update the sales and customers' accounts receivable files as well as the inventory file). Thus, an erroneous entry in such a system may create errors in various financial accounts.

(d) Systems generated transactions—certain transactions may be initiated by the CIS system itself without the need for an input document. The authorization of such transactions may not be evidenced by visible input documentation nor documented in the same way as transactions which are initiated outside the CIS (e.g., interest may be calculated and charged automatically to customers' account balances on the basis of pre-authorized teams contained in a computer program).

(e) Vulnerability of data and program storage media—large volumes of data and the computer programs used to process such data may be stored on portable or fixed storage media, such as magnetic disks and tapes. These media are vulnerable to theft, or intentional or accidental destruction.

4.12.2 Internal Controls in the CIS Environment: The internal controls over computer processing, which help to achieve the overall objectives of internal control, include both manual procedures and procedures designed into computer programs. Such manual and computer control procedures comprise the overall controls affecting the CIS environment (general CIS controls) and the specific controls over the accounting applications (CIS application controls).

General CIS Controls: The purpose of general CIS controls is to establish a framework of overall control over the CIS activities and to provide a reasonable level of assurance that the overall objectives of internal control are achieved.

General CIS controls may include:

(a) Organization and management controls—designed to establish an organizational framework over CIS activities, including:

 ✓ Policies and procedures relating to control functions.

 ✓ Appropriate segregation of incompatible functions (e.g. preparation of input transactions, programming and computer operations).

(b) Application systems development and maintenance controls—designed to provide reasonable assurance that systems are developed and maintained in an authorized and efficient manner. They also typically are designed to establish control over:

 ✓ Testing, conversion, implementation and documentation of new or revised systems.

 ✓ Changes to application systems.

- ✓ Access to systems documentation.
- ✓ Acquisition of application systems from third parties.

(c) Computer operation controls—designed to control the operation of the systems and to provide reasonable assurance that:

- ✓ The systems are used for authorized purposes only.
- ✓ Access to computer operations is restricted to authorized personnel.
- ✓ Only authorized programs are used.
- ✓ Processing errors are detected and corrected.

(d) Systems software controls—designed to provide reasonable assurance that system software is acquired or developed in an authorized and efficient manner, including:

- ✓ Authorization, approval, testing, implementation and documentation of new systems software and systems software modifications.
- ✓ Restriction of access to systems software and documentation to authorized personnel.

(e) Data entry and program controls—designed to provide reasonable assurance that:

- ✓ An authorization structure is established over transactions being entered into the system.
- ✓ Access to data and programs is restricted to authorized personnel.

There are other CIS safeguards that contribute to the continuity of CIS processing. These may include:

- Offsite back-up of data and computer programs.
- Recovery procedures for use in the event of theft, loss or international or accidental destruction.
- Provision for offsite processing in the event of disaster.

CIS Application Controls: The purpose of CIS application controls is to establish specific control procedures over the accounting applications in order to provide reasonable assurance that all transactions are authorized and recorded, and are processed completely, accurately and on a timely basis. CIS application controls include:

(A) Controls over input—designed to provide reasonable assurance that:

- ✓ Transactions are properly authorized before being processed by the computer.
- ✓ Transactions are accurately converted into machine readable form and recorded in the computer data files.
- ✓ Transactions are not lost, added, duplicated or improperly changed.
- ✓ Incorrect transactions are rejected, corrected and, if necessary, resubmitted on a timely basis.

(B) Controls over processing and computer data files—designed to provide reasonable assurance that:

- ✓ Transactions, including system generated transactions, are properly processed by the computer.
- ✓ Transactions are not lost, added, duplicated or improperly changed.
- ✓ Processing errors are identified and corrected on a timely basis.

(C) Controls over output—designed to provide reasonable assurance that:

- ✓ Results of processing are accurate.
- ✓ Access to output is restricted to authorized personnel.
- ✓ Output is provided to appropriate authorized personnel on a timely basis.

4.12.3 Review of Internal Controls: Review of General CIS Controls - The general CIS controls which the auditor may wish to test are described above. The auditor should consider how these general CIS controls affect the CIS applications significant to the audit. General CIS controls that relate to some or all applications are typically inter-dependent controls in their operation is often essential to the effectiveness of CIS application controls. Accordingly, it may be more efficient to review the design of the general controls before reviewing the application controls.

Review of CIS Application Controls - Control over input, processing, data files and output may be carried out by CIS personnel, by users of the system, by a separate control group, or may be programmed into application software. CIS application controls which the auditor may wish to test include:

(A) Manual controls exercised by the user—if manual controls exercised by the user of the application system are capable of providing reasonable assurance that the systems' output is complete, accurate and authorized, the auditor may decide to limit tests of control to these manual controls (e.g. the manual controls exercised by the user over a computerized payroll system for salaried employees could include an anticipatory input control total for gross pay, the test checking of net salary output computations, the approval of the payments and transfer of funds, comparison to payroll register amounts, and prompt bank reconciliation). In this case, the auditor may wish to test only the manual controls exercised by the user.

(B) Controls over system output—if, in addition to manual controls exercised by the user, the controls to be tested use information produced by the computer or are contained within computer programs, it may be possible to test such controls by examining the system's output using either manual or computer-assisted audit techniques. Such output may be in the form of magnetic media, microfilm or printouts (e.g. the auditor may test controls exercised by the entity over the reconciliation of report totals to the general ledger control accounts and may perform manual tests of those reconciliations). Alternatively, where the reconciliation is performed by computer, the auditor may wish to test the reconciliation by re-performing the control with the use of computer-assisted audit techniques.

(C) Programmed control procedures—in the case of certain computer systems, the auditor may find that it is not possible or, in some cases, not practical to test controls by examining only user controls or the system's output (e.g. in an application that does not provide printouts of critical approvals or overrides to normal policies, the auditor may want to test control procedures contained within the application program). The auditor may consider performing tests of control by using computer-assisted audit techniques, such as test data, reprocessing transactions data or, in unusual situations, examining the coding of the application program.

Evaluation - The general CIS controls may have a pervasive effect on the processing of transactions in application systems. If these controls are not effective, there may be a risk that misstatements might occur and go undetected in the application systems. Thus, weaknesses in general CIS controls may preclude testing certain CIS application controls; however, manual procedures exercised by users may provide effective control at the application level.

4.12.4 Approaches to Audit in CIS Environment: Changes in hardware and software have changed the conceptual approach to auditing. An early approach consisted of essentially ignoring the computer, treating it as a black box, and auditing around it. The increasing sophistication of computers, however, has since led to computers being used in two ways; (1) as a tool of the auditor aiding in the performance of the audit, such as printing confirmation requests, and (2) as the target of the audit where data are submitted to the computer and the results are analyzed for processing reliability and accuracy of the computer program.

The auditor must plan whether to use the computer to assist the audit or whether to audit without using the computer. The two approaches are commonly called "auditing around the computer" and "auditing through the computer".

The work of an auditor would be hardly affected if "Audit Trail" is maintained i.e. if it were still possible to relate, on a 'one-to-one' basis, the original input with the final output. A simplified representation of the documentation is a manually created audit trail.

From this Figure I the particular credit notes may be located by the auditor at any time he may wish to examine them, even months after the balance sheet date. He also has the means, should he so wish, of directly verifying the accuracy of the totals and sub-totals that feature in the control listing, by reference to individual credit notes. He can, of course, check all detailed calculations, casts and postings in the accounting records, at any time.

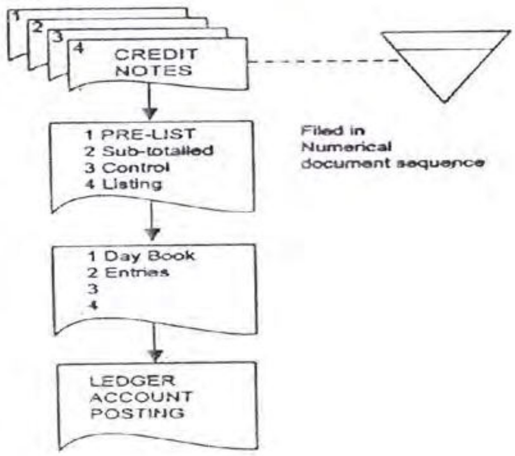


Diagram I Manually created audit trail

In first and early second-generation computer systems, such a complete audit trail was generally available, no doubt, to management's own healthy skepticism of what the new machine could be relied upon to achieve - an attitude obviously shared by the auditor. The documentation in such a trail might again be portrayed as shown, in an over-simplified way, in Figure I.

It is once again clear from the diagram that there is an abundance of documentation upon which the auditor can use his traditional symbols of scrutiny, in the form of colored ticks and rubber stamps. Specifically:

(1) The output itself is as complete and as detailed as in any manual system.

(2) The trail, from beginning to end, is complete, so that all documents may be identified by locating for purposes of vouching, totalling and cross-referencing.

Any form of audit checking is possible, including depth testing in either direction.

The execution of normal audit tests on records which are produced by computer, but which are nevertheless as complete as indicated above, is usually described as audit testing round the machine.

Auditing around the Computer - Auditing around the computer involves arriving at an audit opinion through examining the internal control system for a computer installation and the input and output only for application systems. On the basis of the quality of the input and output of the application system, the auditor infers the quality of the processing carried out. Application system processing is not examined directly. The auditor views the computer as a black box.

The auditor can usually audit around the computer when either of the following situations applies to application systems existing in the installation:

(1) The system is simple and batch oriented.

(2) The system uses generalized software that is well-tested and used widely by many installations.

Sometimes batch computer systems are just an extension of manual systems. These systems have the following attributes:

(1) The system logic is straightforward and there are no special routines resulting from the use of the computer to process data.

(2) Input transactions are batched and control can be maintained through the normal methods, for example, separation of duties and management supervision.

(3) Processing primarily consists of sorting the input data and updating the master file sequentially.

(4) There is a clear audit trail and detailed reports are prepared at key processing points within the system.

(5) The task environment is relatively constant and few stresses are placed on the system.

For these well-defined systems, generalized software packages often are available. For example, software vendors have developed payroll, accounts receivable, and accounts payable packages. If these packages are provided by a reputable vendor, have received widespread use, and appear error-free, the auditor may decide not to test directly the processing aspects of the system. The auditor must ensure, however, that the installation has not modified the package in any way and that adequate controls exist, to prevent unauthorized modification of the package.

Not all generalized software packages make application systems amenable to auditing around the computer. Some packages provide a set of generalized functions that still must be selected and combined to accomplish application system purposes. For example, database management system software may provide generalized update functions, but a high-level program still must be written to combine these functions in the required way. In this situation the auditor is less able to infer the quality of processing from simply examining the system's input and output.

The primary advantage of auditing around the computer is simplicity. Auditors having little technical knowledge of computers can be trained easily to perform the audit.

There are two major disadvantages to the approach. First, the type of computer system where it is applicable is very restricted. It should not be used for systems having any complexity in terms of size or type of processing. Second, the auditor cannot assess very well the likelihood of the system degrading if the environment changes. The auditor should be concerned with the ability of the system to cope with a changed environment. Systems can be designed and programs can be written in certain ways so that a change in the environment will not cause the system to process data incorrectly or for it to degrade quickly.

Auditing through the Computer - The auditor can use the computer to test: (a) the logic and controls existing within the system and (b) the records produced by the system. Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor.

There are several circumstances where auditing through the computer must be used:

(1) The application system processes large volumes of input and produces large volumes of output that make extensive direct examination of the validity of input and output difficult.

(2) Significant parts of the internal control system are embodied in the computer system. For example, in an online banking system a computer program may batch transactions for individual tellers to provide control totals for reconciliation at the end of the day's processing.

(3) The logic of the system is complex and there are large portions that facilitate use of the system or efficient processing.

(4) Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

The primary advantage of this approach is that the auditor has increased power to effectively test a computer system. The range and capability of tests that can be performed increases and the auditor acquires greater confidence that data processing is correct. By examining the system's processing the auditor also can assess the system's ability to cope with environment change.

The primary disadvantages of the approach are the high costs sometimes involved and the need for extensive technical expertise when systems are complex. However, these disadvantages are really spurious if auditing through the computer is the only viable method of carrying out the audit.

4.13 Internal Check

Internal check has been defined by the Institute of Chartered Accountants of England and Wales as the "checks on day-to-day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud". Internal check is a part of the overall internal control system and operates as a built-in device as far as the staff organisation and job allocation aspects of the control system are concerned. A system of internal check in accounting implies organisation of system of book keeping and arrangement of staff duties in such a manner that no one person can completely carry through a transaction and record every aspect thereof. The essential elements of a goods system of internal check are:

(i) Existence of checks on the day-to-day transaction.

(ii) Which operate continuously as a part of the routine system.

(iii) Whereby the work of each person is either proved independently or is made complementary to the work of another.

Its objective is to prevent and to bring about a speedy detection of frauds, wastes and errors. The system is based on the principle that when the performance of each individual in an organisation, normally and automatically, is checked by another, the chances of occurrence of errors, or their remaining undetected, are greatly reduced; also that, when two or more persons essentially must combine either to receive or to make a payment, there will be lesser possibility of a fraud being perpetrated by them.

For instance, let us consider the simple case of a trading concern. It would have a cashier to receive cash who also shall issue receipts. There would be separate persons to write the cash book and ledgers, the stores accounts would be maintained by the store-keeper, and so on; there would be thus a large number of functionaries. In such an organisation, for putting through a transaction of sale, first of all a bill would be prepared and the same would be checked and authorised by the sales manager; afterwards the cashier would collect the sale price and finally the store-keeper would issue the goods, on being satisfied that each of the functionaries earlier to him had carried out his part of duties.

Such a division of responsibilities is made on the broad principle that persons having physical custody of assets should not have access to the books of account. Also apart from accounting control, the physical and financial records of important assets should be reconciled periodically.

The scope of the statutory or professional audit is limited by the both the cost and the time factors. Therefore, it is increasingly being recognised that for an audit to be effective, especially when the size of a concern is large, the existence of a system of internal check is essential. The auditor can rely on it and, on that consideration, reduce the extent of detailed checking to be carried out by him but only after he has checked its effectiveness by the application of procedural tests. It must, however, be added that in the event of any mistake or fraud being discovered subsequently in the area of accounts which the statutory auditor has accepted to be correct, he may be guilty of negligence regardless of the fact that he had tested the internal check in operation before he has accepted it to be correct.

General Considerations in Framing a System of Internal Check:

(i) No single person should have an independent control over any important aspect of the business. All dealings and acts of every employee should, in the ordinary course, come under the review of another.

(ii) The duties of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.

(iii) Every member of the staff should be encouraged to go on leave at least once in a year. Experience has shown that frauds successfully concealed by employees are often unearthed when they are on leave.

(iv) Persons having physical custody of assets must not be permitted to have access to the books of account.

(v) There should exist an accounting control in respect of each important class of assets; in addition, these should be periodically inspected so as to establish their physical condition.

(vi) To prevent loss or misappropriation of cash, mechanical devices, such as the automatic cash register, should be employed.

(vii) A majority of business concerns now-a-days work according to some kind of budgetary control. It enables them to review from time to time the progress of their trading activities. Such business houses should have a separate staff for the collection of statistical figures which later on should be checked with the corresponding figures from the financial books. If wide discrepancies are observed, these should be reconciled.

(viii) For inventory-taking, at the close of the year, trading activities should, if possible, be suspended. The task of inventory-taking, and evaluation should be done by staff belonging to several sections of the organisation. It may prove dangerous to depend exclusively on the inventory section staff for these tasks, since they may be tempted to under or over-state the inventory.

(ix) The financial and administrative powers should be distributed very judiciously among different officers and the manner in which these are actually exercised should be reviewed periodically.

(x) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

(xi) Accounting procedures should be reviewed periodically, for, even well-designed and carefully installed procedures, in course of time, cease to be effective.

Tutorial Note: Since verification of the internal check is an important function of an audit, it is recommended that students should study the nature and details of the audit forms of internal check and their application on examining their operation in various business organisations the accounts of which they have an opportunity to audit. Examiners often require students to define internal check and also to suggest the internal checks which would be applicable for one or more operations of a business or to explain the consequences which would result if the internal checks in respect of one or more operations did not exist. Before attempting such a question, it is advisable that the student should visualize the various processes through which each transaction would pass before it is recorded, comprehend the exact nature of documents on the basis of which the transaction would be recorded and the sequences in which the entries would be made in the books of account. Once this is done, it would be possible for him to suggest the appropriate internal checks that should be introduced or the consequences if they are not introduced provided the student has knowledge of the fundamentals of the subject, the channels through which the money and goods normally flow and the various stages at which a record of their movements is kept.

4.14 Internal Audit

It is also worthwhile to know the modern concept of internal auditing. The Institute of Internal Auditors, USA defined internal auditing "as an independent appraisal function, established within an organisation to examine and evaluate its activities as a service to the organisation. The objective of internal auditing is to assist members of the organisation in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed". According to proponents of modern internal auditing, it embraces not only the operational audit of various operating activities in the organisation but also includes the audit of management itself. Recently, the Institute of Internal Auditors revised the definition of Internal Auditing as under:

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process."

The main thrust of the revised definition is to remphasise the increasing scope of internal audit with a view to achieving maximum organisational effectiveness. It is felt that if such an activity is an integral part of the organisation, it shall go a long way to maximise the organisational goals. As students, if you trace the emergence of internal auditing over a period of time since early forties in the twentieth century, the scope of internal auditing increased considerably from financial to non financial activities. With the passage of time, the internal audit came to be recognised as a valuable resource to achieve overall growth objectives of the organisation.

"Internal Audit is 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 risk management and internal control system."

The objects of internal audit can be stated as follows:

(i) To verify the accuracy and authenticity of the financial accounting and statistical records presented to the management.

(ii) To ascertain that the standard accounting practices, as have been decided to be followed by the organisation, are being adhered to.

(iii) To establish that there is a proper authority for every acquisition, retirement and disposal of assets.

(iv) To confirm that liabilities have been incurred only for the legitimate activities of the organisation.

(v) To analyse and improve the system of internal check; in particular to see that it is (a) working; (b) sound; and (c) economical.

(vi) To facilitate the prevention and detection of frauds.

(vii) To examine the protection afforded to assets and the uses to which they are put.

(viii) To make special investigations for management.

(ix) To provide a channel whereby new ideas can be brought to the attention of management.

(x) To review the operation of the overall internal control system and to bring material departures and non-compliances to the notice of the appropriate level of management ; the review also generally aims at locating unnecessary and weak controls for making the entire control system effective and economical.

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 activities of the internal audit function may include one or more of the following:

- **Monitoring of internal control**. The internal audit function may be assigned specific responsibility for reviewing controls, monitoring their operation and recommending improvements thereto.
- **Examination of financial and operating information**. The internal audit function may be assigned to review the means used to identify, 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.
- **Risk management**. The internal audit function may assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.
- **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.

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.

Who can be appointed as Internal Auditor? As per section 138, the internal auditor shall either be a chartered accountant whether engaged in practice or not or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The auditor may or may not be an employee of the company.

To be effective, the internal auditor must be regarded as part of the management and not merely as an assistant thereto. He must have authority to investigate from the financial angles, every phase of the organisational activity under any circumstances. In recent years, there has been a growing tendency in Western countries to make the internal auditor responsible directly to the Board of Directors for the maintenance of adequate accounting procedures and for the preparation of financial statements and reports as regards the functioning of the business. His main responsibility, however, must be to maintain adequate system of internal control by a continuous examination of accounting procedures, receipts and disbursements and to provide adequate safeguards against misappropriation of assets. In carrying out these functions, he must operate independently of the accounting staff and must not in any way divest himself of any of the responsibilities placed upon him. He should also not involve himself in the performance of executive functions in order that his objective outlook does not get obscured by the creation of vested interest.

It may be further pointed out that internal auditors who are qualified accountants, because of their training and experience, can be of great assistance to the management even in fields other than accounting. They can observe facts and situations and bring them to notice of authorities who would otherwise never know them; also, they critically appraise various policies of the management and draw its attention to any deficiencies, wherever these require to be corrected. In order that an internal auditor may be able to play such a role in the field of management, he must be closely associated with it and his knowledge must be kept up to date by his being kept informed about all important occurrences and events affecting the business, as well as the changes that are made in business policies. Also, he must enjoy an independent status.

In addition, the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

It may also be noted that the Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

Internal Audit vs. Internal Check: Internal audit is a review of the operations and records, sometimes continuously undertaken, within a business, by specially assigned staff. But internal audit must not be confused with internal check. Internal check consists of a set of rules or procedures that are part of the accounting system, introduced so as to ensure that accounts of a business shall be correctly maintained and the possibility of occurrence of frauds and errors eliminated. On the other hand, internal audit is a thorough examination of the accounting transactions as well as that of the system according to which these have been recorded, with a view to reassuring the management that the accounts are being properly maintained and the system contains adequate safeguards to check any leakage of revenue or misappropriation of property or assets and the operations have been carried out in conformity with the plans of the management. However, the routine processes by which an internal audit is carried out are broadly the same as those followed for professional audit. But internal audit often differs in its scope and emphasis: it is more managerial than accounting; also its form is varied, depending on the size of the organisation. For instance, whereas a professional auditor is primarily concerned with the legality or validity of transactions entered into by a business, an internal auditor in addition is expected to ensure that the standards of economy and efficiency are being maintained. On that account, the internal auditor must ascertain that orders for the purchase of inventory are placed only after inviting tenders, sales are affected at the highest ruling rates, standard procedures as regards requirement of staff are followed, and losses in manufacturing process suffered during the period under review are not higher than those in the earlier periods and so on. He must further confirm that there has been no leakage of inventories or revenue, overpayment of expenditure or pilferage or misappropriation of inventories or of any other asset, reconciling the physical accounting records and physical balance. The nature and extent of checking that the auditor should carry out also would depend on the size and type of the business organisation.

4.15 Relationship between the Statutory and the Internal Auditors

The function of an internal auditor being an integral part of the system of internal control. It is statutory requirement too as per section 138 of the Companies Act, 2013 where the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. However, it is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor. For the purpose, he should examine the Internal Audit Department of the organisation, the strength of the internal audit staff, their qualification and their powers. Afterwards the procedures should be studied; also the scope of the audit examination carried out should be ascertained on referring to audit programmes, reports submitted, points raised in audit and how these had been dealt with subsequently. The extent of independence exhibited by the internal auditor in the discharge of his duties and his status in the organisation are important factors for determining the effectiveness of his audit. In a large business, it has been increasingly recognised that, if their functions and those of statutory auditors could be integrated, it might not be necessary for the statutory auditors to go over the same facts and figure as have been previously examined by a competent and trustworthy internal audit staff. But so far, the practice of audit being conducted jointly by the internal auditors is of great assistance to statutory auditors.

If the statutory auditor is satisfied on an examination of the work of the internal auditor, that the internal audit has been efficient and effective, he often decides to curtail his audit programme by dispensing with some of the detailed checking already carried out by the Internal Audit Department after or without testing the work already done. He, at times, also decides to entrust certain items of work to the internal auditor. Given below are items of audit work in regard to which the statutory auditor accepts the checking that has already been carried out by the internal auditor;

(i) Verification of the system of internal control;

(ii) Verification of assets, e.g., inventory in trade, fixed assets, book debts, etc.; and

(iii) Verification of amounts provided for expenses as well as amounts adjusted as prepaid expenses.

It must however be mentioned that the area of co-operation between the statutory and the internal auditor is limited by the fact that the statutory auditor and the internal auditor owe their allegiance to separate authorities, the shareholders in one case and the management in the other. Therefore, the former is not protected against the liability for negligence which may arise in such a case.

4.15.1 General Evaluation of Internal Audit Function: The external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. The external auditor should document his evaluation and conclusions in this respect.

As per SA-610, "Using the Work of an Internal Auditor", in determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, the external auditor shall evaluate:

(a) The objectivity of the internal audit function;

(b) The technical competence of the internal auditors;

(c) Whether the work of the internal auditors is likely to be carried out with due professional care; and

(d) Whether there is likely to be effective communication between the internal auditors and the external auditor.

Factors that may affect the external auditor's determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include:

Objectivity

- The status of the internal audit function within the entity and the effect such status has on the ability of the internal auditors to be objective.
- Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal auditors have direct access to those charged with governance.
- Whether the internal auditors are free of any conflicting responsibilities.
- Whether those charged with governance oversee employment decisions related to the internal audit function.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance.
- Whether, and to what extent, management acts on the recommendations of the internal audit function, and how such action is evidenced.

Technical competence

- Whether the internal auditors are members of relevant professional bodies.
- Whether the internal auditors have adequate technical training and proficiency as internal auditors.
- Compliance with the mandatory/ recommendatory Standards on Internal Audit (SIAs) issued by Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI).
- Whether there are established policies for hiring and training internal auditors.

Due professional care

- Whether activities of the internal audit function are properly planned, supervised, reviewed and documented.

- The existence and adequacy of audit manuals or other similar documents, work programs and internal audit documentation.

Communication

Communication between the external auditor and the internal auditors may be most effective when the internal auditors are free to communicate openly with the external auditors, and:

- Meetings are held at appropriate intervals throughout the period;
- The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal auditors when such matters may affect the work of the external auditor; and
- The external auditor informs the internal auditors of any significant matters that may affect the internal audit function.

4.15.2 Coordination: Having decided in principle that the external auditor intends to rely upon the work of the internal auditor, it is desirable that the external auditor ascertains the internal auditor's tentative plan for the year and discusses it with him at as early a stage as possible to determine areas where he considers that he could rely upon the internal auditor's work. Where internal audit work is to be a factor in determining the nature, timing and extent of the external auditor's procedures, it is desirable to plan in advance the timing of such work, the extent of audit coverage, test levels and proposed methods of sample selection, documentation of the work performed, and review and reporting procedures.

Coordination with the internal auditor is usually more effective when meetings are held at appropriate intervals during the year. It is desirable that the external auditor is advised of, and has access to, relevant internal audit reports and in addition is kept informed, along with management, of any significant matter that comes to the internal auditor's attention and which he believes may affect the work of the external auditor. Similarly, the external auditor should ordinarily inform the internal auditor of any significant matters which may affect his work.

The external auditor shall determine:

(a) Whether the work of the internal auditors is likely to be adequate for purposes of the audit; and

(b) If so, the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures.

In determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, the external auditor shall evaluate:

(a) The objectivity of the internal audit function;

(b) The technical competence of the internal auditors;

(c) Whether the work of the internal auditors is likely to be carried out with due professional care; and

(d) Whether there is likely to be effective communication between the internal auditors and the external auditor.

In determining the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures, the external auditor shall consider:

(a) The nature and scope of specific work performed, or to be performed, by the internal auditors;

(b) The assessed risks of material misstatement at the assertion level for particular classes of transactions, account balances, and disclosures; and

(c) The degree of subjectivity involved in the evaluation of the audit evidence gathered by the internal auditors in support of the relevant assertions.

Further, it may be useful to agree in advance the following matters with the internal auditors:

- The timing of such work;
- 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;
- Documentation of the work performed; and
- Review and reporting procedures.

Using Specific Work of the Internal Auditors: In order for the external auditor to use specific work of the internal auditors, the external auditor shall evaluate and perform audit procedures on that work to determine its adequacy for the external auditor's purposes. The nature, timing and extent of the audit procedures performed on specific work of the internal auditors will depend on the external auditor's assessment of the risk of material misstatement, the evaluation of the internal audit function, and the evaluation of the specific work of the internal auditors. Such audit procedures may include:

- Examination of items already examined by the internal auditors;
- Examination of other similar items; and
- Observation of procedures performed by the internal auditors.

To determine the adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether:

(a) The work was performed by internal auditors having adequate technical training and proficiency;

(b) The work was properly supervised, reviewed and documented;

(c) Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;

(d) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and

(e) Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

Documentation: When the external auditor uses specific work of the internal auditors, the external auditor shall document conclusions regarding the evaluation of the adequacy of the work of the internal auditors, and the audit procedures performed by the external auditor on that work.

Inventory Appendices

Internal Control Questionnaires

Extract from Internal Control Questionnaire published by the Institute of Chartered Accountants of India (Note: Columns Yes, No, N.A. and Explanatory Notes have been omitted here)

I - Purchases and Trade payables

1. Are purchases centralised in the Purchase Department?
2. (a) Are purchases made only from approved suppliers?
   (b) Is a list of approved suppliers maintained for this purpose?
   (c) Does the master list contain more than one source of supply for all important materials?
3. Are the purchase orders based on valid purchase requisitions duly signed by persons authorised in this behalf?
4. (a) Are purchases made on behalf of employees?
   (b) If so, is the same procedures followed for other purchases?
5. Is special approval required for:
   (a) Purchase from employees, directors and companies in which directors are interested?
   (b) Purchases of capital goods?
6. Are purchases based on competitive quotations from two or more suppliers?
7. Is comparative quotation analysis sheet drawn before purchases are authorised?
8. If the lowest quotation is not accepted, is the purchase approved by senior official?
9. If the price variation clauses is included, is it approved by a senior official?
10. Are purchase orders pre-numbered and strict control exercised over unused forms?
11. Are purchase orders signed only by employees authorised in this behalf?
12. Do purchase orders contain the following minimum information:
    (a) Name of supplier? (b) Delivery terms?
    (c) Quantity? (d) Price?
    (e) Freight terms? (f) Payment terms?
13. Is revision of terms of purchase orders duly authorised?

14. (a) Are copies of purchase orders and revisions forwarded to Accountants and Receiving Departments?

    (b) If 'Yes', do the copies show the quantities ordered?

    (c) If 'no', is there an adequate procedure for the Receiving Dept., to be notified to accept deliveries?

15. Is a list of pending purchase orders compiled by the Purchase Dept., at least once every quarter?

16. Are all materials, suppliers, etc., received only in the Receiving Department?

17. If they are received directly by User Department/Processors/Customers, is there a procedure of obtaining acknowledgments for the quantity received and the condition of the goods?

18. Are persons connected with receipt of materials and the keeping of receiving records denied authority to issue purchase orders or to approve invoices?

19. Are materials, suppliers, etc., inspected and counted, weighed or measured in the Receiving Department?

20. Are quantities and description checked against purchase order (or other form of notifications) and goods inspected for condition?

21. (a) Does the Receiving Dept. deliver or supervise the delivery of each item received to the proper Stores or Department Location?

    (b) Are acknowledgments obtained from suppliers for goods/containers returned to them?

22. Are all receipts of materials evidenced by pre-numbered Goods Received Note?

23. Are copies of Goods Received Notes forwarded to Accounts Department and list of goods received to purchase department?

24. Are all cases of materials returned, shortages and rejections advised to the Accounts Department, for raising Debit Memoes on suppliers or claim bills on carriers/insurance companies, as the case may be?

25. Are all debit notes etc.

    (a) pre-numbered?

    (b) numerically controlled?

    (c) properly recorded (in the financial accounts or in memorandum registers as the case may be)?

26. (a) Are all suppliers' invoices routed direct to the Accounts Department?

    (b) Are they entered in a Bill Register before submitting them to other department for check and/or approval?

    (c) Are advance and partial payments entered on the invoices before they are submitted to other departments?

27. Does the system ensure that all invoices and credit notes are duly processed?

28. In respect of raw materials and supplies, are reconciliations made of quantities and/or values received, as shown by purchase invoices with receipts into inventory records?

29. Are duplicate invoices marked immediately on receipt to avoid payment against them?

30. If payment are made against duplicate invoice even occasionally, are adequate precautions taken to avoid duplicate payments?
31. Does the Accounts Department match the invoices of supplies with Goods Received Notes or acknowledgments received as per Q 17 and purchase orders?
32. (a) Are Goods Received Notes and Receiving records regularly received for items for which no invoices have been received?
    (b) Are all such items investigated and is provision made for the liability in respect of such items?
    (c) In such review/investigation done by persons independent of those responsible for the receipt and control of goods?
33. Do all invoices bear evidence of being checked for prices, freight terms, extensions and additions?
34. Is the relative purchase order attached to the invoice for payment?
35. Where the client both buys from and sells to a person regularly, is a periodic review made of all amounts due from that person to determine whether any set-off is necessary?
36. (a) Is a special request used for making payments in advance or against documents through bank?
    (b) Thereafter, are the invoices made in the normal course?
37. (a) Are all advance payments duly authorised by persons competent to authorise such payments?
    (b) Is a list of pending advances made at least every quarter and is a proper follow-up maintained?
38. Are all adjustments to trade payables accounts duly approved by those authorised in this behalf?
39. Is a list of employees by designation with limits of authority in respect of several matters referred to in this section maintained?
40. Are all supplier's statements compared with ledger account?
41. Is there any follow-up action to investigate difference, if any between the suppliers' statements and the ledger accounts?
42. Is a list of unpaid trade payables prepared and reconciled periodically with the General Ledger Control Account?
43. Is there a system of ensuring that cash discounts are availed of whenever offered?

II - Sales and Trade receivables

1. Are standard price lists maintained?
2. Are prices which are not based on standard price lists, required to be approved by a senior executive outside the State Department?
3. Are written orders from customers received in all cases?
4. If oral/telephonic orders are received, are they recorded immediately in the client's standard forms?
5. Is there a numerical control of all customer's orders?

6. Are credit limits fixed in respect of individual customers?
7. Are these limits approved by an official independent of the Sales Department?
8. Are credit limits reviewed periodically?
9. Are customers' credit limits checked before orders are accepted?
10. Is this done by a person independent of the Sales Department?
11. If sales to employees are made at concessional prices:
    (a) Is there a limit to the value of such sales?
    (b) Is there an adequate procedure to see that these limits are not exceeded?
    (c) Are the amounts recovered in accordance with the terms of sale?
12. Are despatches of goods authorised only by Despatch Notes/Gate Passes or similar documents?
13. Do such Despatch Notes/Gate Passes or similar documents bear pre-printed numbers?
14. Are they under numerical control?
15. Are they prepared by a person independent of:
    (a) the Sales Department?
    (b) the processing of invoices?
16. Except when all documents are prepared in one operation, are the Despatch Notes/ Gate Passes matched with:
    (a) Excise Duty records?
    (b) Sales invoices?
    (c) Freight payable to carriers (where applicable)?
17. Are unmatched Despatch Notes/Gate Passes reviewed periodically?
18. Are the goods actually despatched checked independently with the Despatch Notes/Gate Passes and Customer's Orders?
19. Are acknowledgments obtained form the customers for the goods delivered?
20. Are the customers' orders marked for goods delivered?
21. Are shortages in goods delivered to the Customers investigated?
22. Are credits to customers for shortages, breakages and losses in transit matched with claims lodged against carriers/insurers?
23. Are sales invoices pre-numbered?
24. Are all invoice numbers accounted for?
25. Are invoices checked for:
    (a) prices?
    (b) calculations (including excise duty and sales tax)?
    (c) terms of payment?
26. Are 'no charge' invoices authorised by a person independent of the custody of goods or cash?

27. Are invoices mailed direct to the customers promptly?
28. Are credits to customers for remittances posted only from the entries in the cash book (or equivalent record)?
29. Does cashier notify immediately:
    (a) Sales Department,
    (b) Trade receivables' Ledger Section and
    (c) Credit Controller;
        (i) of all dishonoured cheques or other negotiable instruments?
        (ii) of all documents sent though band but not retired by the customers?
30. Is immediate follow up action taken on such notification?
31. Are bills of exchange (or other negotiable instruments) accepted by customers recorded?
32. Are the bills of exchange, etc. as per such record periodically verified with the bills on hand?
33. (a) Is a record of customers' claims maintained?
    (b) Are such claims properly dealt with in the accounts?
34. Does the Receiving Department count, weigh or measure the goods returned by customers?
35. Does the Receiving Department record them on a Sales Returns Note?
36. Are copies of Sales Returns Notes sent to:
    (a) Customer? (b) Sales Department? (c) Trade receivables Ledger Section?
37. Are the returned goods taken into inventory immediately?
38. Is a Credit Note issued to the customer for the goods returned?
39. Are all Credit Notes pre-numbered?
40. Are Credit Notes numerically controlled?
41. Are Credit Notes authorised by a person independent of:
    (a) Custody of goods? (b) Cash receipts? (c) Trade receivables' Ledger?
42. Are Credit Notes:
    (a) compared with Sales Returns Notes or other substantiating evidence?
    (b) checked for prices?
    (c) checked for calculations?
43. Are corresponding recoveries of sales commissions made when Credit Notes are issued to customers?
44. Are units of sales (as per sales invoices) correlated and reconciled with the purchases (or production) and inventories on hand?
45. Is the Sales Ledger balanced periodically and tallied with the General Control Account?
46. Are ageing schedules prepared periodically?
47. Are they reviewed by a responsible person?

48. Are statements of accounts regularly sent to all customers?
49. Are the statements checked with the Trade receivables' Ledger before they are issued?
50. Are the statements mailed by a person independent of the ledger keeper?
51. Are confirmations of balances obtain periodically?
52. Are the confirmations verified by a person independent of the ledger-keeper and the person preparing the statement?
53. Is special approval required for:
    (a) payments of customers' credit balances?
    (b) writing off bad debts?
54. Is any accounting control kept for bad debts written off?
55. Is any follow up action taken for recovering amounts written off?
56. In the case of export sales:
    (a) Is a record maintained of import entitlements due?
    (b) Does the record cover the utilisation disposal of such entitlements?
    (c) Is there a procedure to ensure that claims for incentives etc., receivable are made in time?
57. Are sales of scrap and wastage subject to the same procedures and controls as sales of finished goods?

III - Inventory

1. Are inventories stored in assigned areas?
2. If so, is access to these areas limited?
3. Are inventories insured against the following risks:
    (a) fire? (b) strike, riot and civil commotion?
    (c) flood? (d) hail damage where applicable?
4. If the answer to any of the above is negative, is it due to specific decision taken by a senior official?
5. Is a record maintained for the insurance polices?
6. Is the record reviewed periodically?
7. Is there an official who decides on the value for which the inventories are to be insured?
8. Is the adequacy of the insurance cover reviewed periodically?
9. Are perpetual inventories records kept for:
    (a) raw materials? (b) work-in-progress?
    (c) finished goods? (d) stores?
10. Are they periodically reconciled with accounting records?
11. Is there a system of perpetual inventory for inventories of:
    (a) raw materials? (b) work-in-progress?

(c) finished goods? (d) stores?

12. Where there is a system of perpetual inventory count:
    (a) Is there a periodical report of shortages/excess?
    (b) If so, are these differences investigated?
    (c) Are these differences adjusted in the inventory records and in the financial accounts?
    (d) Is written approval obtained from a responsible official to adjust these differences?
13. Are there norms for inventory levels to be held?
14. Is there a periodic reporting of:
    (a) Slow-moving items? (b) Damaged items?
    (c) Obsolete items? (d) Over-stocked items?
15. Is there a well-laid out written procedure for inventory count?
16. (a) Are inventories physically verified once in a year?
    (b) Is this done by a person independent of persons who are responsible for maintaining these records or the storekeeper?
    (c) Are written instructions prepared for guidance of employees engaged in physical inventory taking to cover:
        (i) Proper identification and arrangement of inventories?
        (ii) Cut-off points of receipts and deliveries?
        (iii) Recording of the condition of the inventories?
        (iv) Compliance with the conditions warranties in the relative insurance policies?
17. Are the physical inventory records, such as tags, cards, tally sheets, under numerical control?
18. Are the clerical steps in the preparation of inventory sheets checked independently for:
    (a) Summarisation of quantities? (b) Unit rates?
    (c) Additions? (d) Extensions?
    (e) Unit conversions? (f) Summarisation of cards and/or sheets?
19. Are the quantities shown in the inventory sheets compared with the quantities declared to banks or insurers, where possible?
20. If there are significant variations between the actual inventories and book inventories :
    (a) Are they investigated?
    (b) Is a recount made where necessary?
    (c) Is the inventory book corrected with proper authority?
21. Are the following inventories checked:
    (1) Physically by the company's staff?
    (2) With certificates from concerned holders of the inventories?
        (a) Inventory in public warehouses?

(b) Inventories with consignees?

(c) Inventories with sub-contractors for fabrication, etc.?

(d) Inventories with customers, on approval?

(e) Inventories in bonded warehouses?

(f) Inventories pledged with third parties?

22. Is inventory on hand relating to third parties, such as customer's inventories and consignments physically segregated or properly identified?
23. Are the procedures relating to record keeping and inventory-taking made applicable to third also?
24. Are confirmations obtained from the third parties for inventories held on their behalf?
25. Are records maintained for:

    (a) Scrap available for sale?

    (b) By-products?

    (c) Returnable containers?
26. Is there an adequate recording procedure for:

    (a) Inventories with outsides?

    (b) Inventories of outsiders held by the company?
27. Is there a system of job/production orders for control of production?
28. Does the storekeeper issue raw materials, stores etc., only against Requisition Notes signed by properly authorised officials?
29. Does the storekeeper acknowledge in writing the quantity of finished goods received from the Factory?
30. Is the inventory record periodically checked with such acknowledgments?
31. Does the cost system provide for obtaining units or job order costs for:

    (a) Work-in-progress?

    (b) Finished goods?
32. Is the cost system integrated with/or reconciled to General Ledger controls as regards:

    (i) Material? (ii) Labour?

    (iii) Overheads?
33. Does the cost system provide for detailed units or job order costs in terms of:

    (i) Raw material costs? (ii) Direct labour?

    (iii) Overheads? (iv) Physical quantities?

    (v) Unit rates?
34. Are similar records kept for service departments also?
35. Are overhead rates:

    (a) Reviewed periodically by designated employees?

(b) Adjusted in the light of current experience?

36. Are separate control accounts maintained for inventory of:

    (a) Work-in-progress? (b) Finished goods?

37. In a job order industry, are the estimates of costs compared with actual costs?

38. If standard cost system exists:

    (i) Are variances investigated?

    (ii) Are standards reviewed periodically?

IV. Cash and Bank Receipts

1. Is inward mail opened by persons not connected with handling cash or the Accounts Department?
2. Is the inward mail date stamped?
3. Is there a detailed record of receipts prepared?
4. Are all cheques specially crossed by employees opening mail?
5. Are bank deposits prepared and made by some one other than those responsible for cash receipts and/or personal ledger?
6. Are duplicate (or counterfoils of) receipted deposit slips received from the bank?
7. Is there any comparison of items listed on the duplicate (or counterfoils of) deposit slips with the amounts of cheques recorded in the cash receipts records?
8. Are receipts given for over-the-counter collections”
9. Is the reconciliation of such proofs of collection with amounts banked?
10. Are collections of branch offices and sales offices deposited in special bank accounts, subject to withdrawal only by the Head Office?
11. If collections are made by representatives of the company in cash, have serially numbered receipts been issued to them?
12. Is there a system of issuing permanent receipts in lieu of the Temporary/Provisional receipts issued by bill collectors, etc.?
13. Are such collections promptly received and banked?
14. Are the receipt forms:

    (a) serially numbered?

    (b) kept in safe custody?

    (c) controlled by register?

    (d) unused inventories checked regularly?

    (e) made out by one employee and despatched by another?

    (f) accounted for, including those cancelled?

    (f) in respect of partially used receipt books not intended to be used, cancelled?

15. Are cancelled receipts preserved?
16. If post-dated cheques are received, are they held in safe custody until deposited?

17. Are such cheques entered in a separate register?
18. Is the opening of bank accounts authorised by the Board of Directors?
19. Are sundry items, such as dividends, interest, rent, commissions, etc. regularly checked by responsible official to satisfy himself that correct amounts are received?
20. Is there a procedure to ensure that Hundi borrowings are only by cheques crossed “Accounts Payee”?
21. Is the cash balance verified frequently?
22. Incoming money orders, VPP receipts etc.:
    (a) Are they signed by any official other than the cashier?
    (b) Are they listed immediately?
    (c) Are such lists compared with the Cash Book regularly?
    (d) Is there an arrangement with the Postal authorities to receive cheques instead of cash?
23. Are the cashier’s duties taken over for a few days, by some one else, occasionally?
24. If a rough cash book is maintained:
    (a) Is the fair cash book written up promptly?
    (b) Is the fair cash book checked with the rough cash book, by a person other than the cashier?

V. Cash and Bank Payments

1. Does the company’s policy prohibit disbursements directly from cash receipts?
2. Are all disbursements made by cheques?
3. Are the names of officials and the limits upto which they are authorised to sign cheques, specified?
4. Are all cheques payable ‘to order” and crossed ‘Account Payee Only” except cheques for wages and petty cash?
5. Are cheque protectors used?
6. Are unused cheques under proper physical control?
7. Are cancelled cheques mutilated?
8. Is the practice of signing cheques in blank, prohibited?
9. Are payments made only against original invoices (or equivalent documents?
10. Are cheques accompanied by vouchers when presented for signature?
11. Do vouchers contain evidence of examination by persons signing cheques and/or those authorising vouchers for payment?
12. Is the accounting distribution on the voucher checked at the time of payment?
13. Are all supporting documents properly defaced and identified by cheque number at the time of signature?
14. Is there a method to check if cheques are despatched immediately?

15. Are remittances by bank transfers or letters of instructions (e.g., TTs, MTs, standing instructions) subject to the same controls as cheque payments?
16. Is there an effective system in force for following up receipts from payees and filling complete vouchers?
17. When "stop-payment" instructions are issued, are the original entries reversed immediately?
18. Is there a schedule of dates in each month for the recurring payments such as P.F., Tax deducted at source. Telephone bills, Electricity bills. etc.?
19. In respect of bills accepted?
    (a) is there a record of such bills?
    (b) are they signed by official authorised to do so?
20. Are bank loans or overdrafts (including temporary overdrafts) arranged only by officials authorised by the Board?

VI. Fixed Assets

Purchases and Disposal

1. Are budgets for capital expenditure approved by the Board?
2. Are approved budgets communicated in writing to:
    (a) Purchase Department?
    (b) Accounts Department?
    (c) Department originating the request?
3. Are written authorisations required for incurring capital expenditure for items included in the Budget?
4. Is the authority to incur capital expenditure restricted to specified officials?
5. Are purchases of capital items subject to same controls as are applicable to purchases of raw materials, stores, etc.?
6. Are receipts of capital items subject to same procedures as applicable to raw materials, stores, etc.?
7. Is there proper check to see that amounts expended do not exceed the amount authorised?
8. Are supplemental authorities required for excess expenditures?
9. Is there any established procedure for moving plant and machinery from one location to another?
10. (i) Is written authority required for:
        (a) scrapping fixed assets?
        (b) selling fixed assets?
    (ii) Is the authority to permit scrapping/selling of fixed assets restricted to specified officials?
    (iii) Are limits specified in this regard?
    (iv) Are sales of fixed assets subject to same procedures as are applicable to sales of finished goods?

11. Are reports issued promptly in respect of:
    (a) units sold?
    (b) units scrapped?
    (c) units moved from one location to another?

Records:

12. Are fixed assets under construction:
    (a) subject to separate control account in General Ledger?
    (b) controlled by job number?
13. Is expenditure on wages, materials and stores charged to capital account on reasonable basis?
14. Is there any official responsible for ensuring that allocation of expenditure between capital and revenue is in accordance with the company's accounting policy?
15. Is a register of all fixed assets (including fully depreciated assets) maintained?
16. Is the register regularly written up throughout the year?
17. Is the register periodically tallied with the financial accounts?
18. Is the following information available, in the register?
    (a) Supplier's name
    (b) Date of purchase
    (c) Cost (including additions, improvements, exchange rate adjustments etc.)
    (d) Location and identification number
    (e) Rate of depreciation and estimated life
    (f) Accumulated depreciation
    (g) Estimated salvage value
19. Is a record maintained of equipment used by the company, but owned by others?
20. Is the register of patents or trade marks maintained up-to-date?
21. Is there a list of title deeds for the landed properties and buildings?
22. Are title deeds of properties kept in safe place?
23. If they are lodged as security, are certificates obtained to that effect periodically?
24. Are registration books of vehicles periodically verified?

Verification:

25. Are fixed assets verified periodically?
26. Is there a written procedure for such verification?
27. Does the procedure provide for verification/confirmation of fixed assets with third parties?
28. Does the procedure provide for verification of compliance with the warranties and conditions in the relevant insurance policies?
29. Are reports prepared on such verification?

30. Do such reports indicate damaged/obsolete items of fixed assets?
31. (a) Are discrepancies disclosed by such reports investigated?
    (b) Are the records and financial accounts corrected, with proper authority?
32. Are damaged/obsolete items disclosed by such reports, removed from the records and financial accounts with proper authority?

Moulds, Patterns, Jigs, Fixtures, Tools etc.

33. Is there satisfactory control over the acquisition and write-off of such items?
34. Are there physical safeguards against theft or loss of tools and other movable equipment?
35. Are records maintained for:
    (a) items treated as inventory?
    (b) items treated as fixed assets?

Insurance:

36. (i) Are the following risks covered in respect of buildings and machinery:
        (a) Fire
        (b) Strike, riot and civil commotion
        (c) Flood
        (d) Earthquake
        (e) Nuclear risks
        (f) Malicious damage
        (g) War risks
    (ii) If the answer to any of the above is negative, is it due to a specific decision taken by a senior official?
37. Is there an adequate procedure to ensure that assets acquired between two renewal dates are also covered by insurance?
38. Is there an official who decides on the value for which policies are taken?
39. Are the fixed assets insured at re-instatement basis?
40. Does the official, who decides on the value for which policies are taken, review periodically the adequacy of the insurance cover?
41. (i) Is there loss-of-profits insurance cover?
    (ii) Is there machinery-breakdown insurance cover?
    (iii) If the answer to (i) or (ii) is negative is it due to a specific decision taken by a senior official?

VII. Bank Balances

1. Are bank statements opened by a person other than the person signing cheques, recording cash and receiving or disbursing?
2. Are the bank accounts reconciled at regular intervals?

3. Is Bank reconciliation statement drawn by a person independent of cash receipt and disbursement function?
4. Does the reconciler compare each item in the deposit and withdrawal columns of the bank statement with amount deposited or withdrawn as shown by the cash records both as regards date and amount?
5. Is there a periodic follow-up of old:
   (i) outstanding deposits?
   (ii) outstanding payments?
   (iii) outstanding stop-payment advices?
6. Are the items under reconciliation reviewed by a responsible official promptly or upon completion?
7. Are confirmations of balances obtained periodically in respect of all bank balances and compared with the bank statements?
8. Is there a periodic review of balances held as security, for letters of Credit, Guarantees, etc., to ensure the need for their continuance?
9. Are Fixed Deposit Receipts held in safe custody?
10. Is there a register of Fixed Deposits showing maturity dates, rates of interest and dates for payment of interest?
11. Is there a follow-up system to ensure that interest on Fixed Deposits is received on due dates?
12. Is a Certificate obtained from the bank for Deposit Receipts lodged as security?

5

Vouching

Learning Objectives

After studying this chapter, you will be able to –

- ♦ Gain knowledge on vouching of cash and trade transactions
- ♦ Understand types of accounts and various procedures of vouch of each account specifically.
- ♦ Prepare the bank reconciliation statement.

The act of examining vouchers is referred to as vouching. It is the practice followed in an audit with the objective of establishing the authenticity of the transactions recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of the transaction on its inclusion in the final statements of account. On these considerations, the essential points to be borne in mind while examining a voucher are:

(i) that the date of the voucher falls within the accounting period;

(ii) that the voucher is made out in the client's name;

(iii) that the voucher is duly authorised;

(iv) that the voucher comprised all the relevant documents which could be expected to have been received or brought into existence on the transactions having been entered into, i.e., the voucher is complete in all respects; and

(v) that the account in which the amount of the voucher is adjusted is the one that would clearly disclose the character of the receipts or payments posted thereto on its inclusion in the final accounts.

After the examination is over, each voucher should be either impressed with a rubber stamp or initialed so that it may not be presented again in support of another entry.

5.1 Audit of Cash Transactions

5.1.1 General Considerations: In any business probably cash transactions account for the largest bulk of transactions. Cash, being a highly liquid asset, is exposed to frauds of various types. Therefore, it is essential for an auditor to satisfy himself that the cash transactions entered into by the client have been correctly recorded in the books of account and all the procedures laid down for entering into such transactions have been complied with.

To verify cash transactions, more than anything else, it is necessary that the system of accounting and internal control operating in the organisation should be reviewed; also the recording of each transaction should be checked. It should also be seen that each relevant voucher has documentary evidence which is valid and that the statement is authorised by a competent official. Further, on its inclusion in the final accounts, its nature would be truly disclosed.

(i) **Internal Control System:** It is a combination of several procedures adopted by an entity designed-

(a) to give protection against losses through fraud, waste, mistakes, etc.,

(b) to ensure that the transactions entered into shall be correctly recorded; and

(c) to enable the concern to take policy decision as regards planning and operation of the business at the appropriate time.

Steps involved in the verification of the system of Internal Control:

(a) Study the system according to which accounting routines are being carried out to ensure that these do not leave any receipt of cash, material or any other asset remaining unaccounted for, permit any payment of money being made without relevant goods or services having been received or tendered or any property being given away without its price having been received or being accounted for.

(b) Examine the financial power vested in different persons and the conditions under which they can exercise them.

(c) Confirm whether the supervision over various managerial and accounting functions, exercised by different members of the staff to whom these duties have been assigned, is adequate.

(d) Ascertain whether any mechanical aids are being employed to ensure proper accounting of receipts and prevention of pilferage of cash, stamps, etc.

(e) Observe the working of the accounting system and routine and determine, by application of procedural tests, whether checks and counter-checks envisaged by the system of internal control are being properly applied.

(f) Confirm that there is a system according to which the physical existence of different forms of assets is being periodically reconciled with their balances in the books of account or stores records and discrepancies noticed are reported and adjusted; also that balances of account receivables, account payables, bankers and persons with whom securities are deposited are reconciled periodically. Further, those persons who are in custody of valuable assets have furnished bonds of adequate value which would protect the company in the event of any misappropriation or misapplication thereof by such persons.

(g) Ascertain that the system of internal control is reviewed periodically and, where necessary, a change in procedures made to plug in any loopholes which might have been observed on such a review. Also, that policy decisions which are taken from time to time are translated into actual practice.

Students should remember that, unless the system of internal control is comprehensive it may fail to provide the protection expected of it. For example, if printed receipts with counterfoils are issued in respect of amounts collected, but there is no check against cash being collected by unauthorised persons, there will be no certainty that all amounts collected have been accounted for.

(ii) **Correctness of book-keeping records:** The audit of cash transactions entails detailed checking of the record of transactions for verifying that entries have been made in the books of account according to the system of accounting which is being regularly followed and the books of account balance as under-

(a) Vouching;

(b) Posting;

(c) Casting, cross-casting and tracing;

(d) Reconciliation, scrutiny, confirmation; etc.

When accounts are checked in the foregoing manner, they may disclose one or more mistakes or manipulations in the accounts of different types stated below:

✓ Errors of omission or commission which are accidental, e.g., failure to enter some sales invoices, mistakes made in computing amounts payable for purchase, etc.

✓ Cases of deliberate omission or commission:

♦ to cover up a defalcation of cash, e.g., amount received from A having been posted to the account of B and subsequently, the amount paid by B having been misappropriated.

♦ to overstate profit or assets, e.g., no provision having been made for outstanding liabilities or the goods already sold before the close of the year having been included in closing inventory.

♦ to overstate liabilities and understate assets, with a view to providing a basis for effecting fictitious payments in the former case and misappropriation of the sale proceeds in the latter case.

- Errors of principle such as revenue expenditure having been charged to capital.
- Compensation errors, e.g., "Furniture Account", having been under cast by ₹ 100 and "Repairs Account" overcast by the same amount.

(iii) **Observance of accounting principles:** It is of utmost importance that the transactions should be recorded in the books of accounts having regard to the principles of accounting. The principles include-

(a) Distinction being drawn between capital expenditure and revenue expenditure;

(b) Distinction being drawn between capital receipts and revenue receipts;

(c) The expenses or cost should be matched to the income or benefit;

(d) The expenditure and income should be treated on accrual basis;

(e) That the fixed assets should be depreciated on a consistent basis;

(f) That book debts should be valued only at realisable amounts;

(g) That fictitious assets are written off at the earliest; and

(h) Outstanding assets and liabilities have been properly adjusted.

(iv) **Evidence of Transactions:** Entries in the account books are usually made on the basis of some kind of documentary evidence. It generally exists in a variety of forms e.g., payee's receipts, suppliers' invoices, statements of account of parties, minutes of Board of Directors or of the shareholders, contracts, documents of title, entries in subsidiary ledger etc. The process of verification of entries in the books of account with the documentary evidence is referred to as vouching. As stated earlier, documentary evidence is of two types: (1) Internal; and (2) External. Documents which are part of the records of the concern, and have been prepared in the normal processes of accounting constitutes internal evidence, e.g., counterfoils of receipts, carbon copies of cash memos or invoices, wages books, etc. On the other hand, a document issued by a person with whom some business transaction had been entered into or who paid or was advanced an amount constitutes external evidence, e.g., a payee's receipt, an invoice for purchases, a court decree, a lease agreement, a bank statement, etc. because these documents are issued by persons not belonging to the concern. External evidence, in respect of certain transactions, sometimes may have to be obtained directly by the auditors, e.g., certificate as regards bank balances, or confirmation balances of account receivables and account payables, etc.

The auditor, obviously, should endeavour in the course of his examination to get as much external evidence as possible since such evidence ordinarily provides confirmation. When, however, it is not possible to obtain external evidence and he is obliged to accept internal evidence, he should first satisfy himself on a careful consideration of the position whether the evidence which has been produced to him can be reasonably assumed to have come into existence in the normal course of working of the business and that there exists a system of internal check which would act as a safeguard against its being altered subsequently.

External evidence should be preferred, since the likelihood of its being duplicated or fabricated is much less. This is because it requires collusion with an outsider which normally is not practicable. However, every evidence 'whether internal or external' should be subjected to appropriate scrutiny and corroboration should be obtained, if possible. The auditor will always keep in mind the circumstances of the case and see whether the evidence is *prima facie* authentic and correct.

Note: Students should observe carefully in the course of their practical training, the various forms in which documentary evidence usually exists in support of different types of transactions and also the sources from which further evidence can be mustered because it is more re-assuring to verify a transaction from two or more sources which are mutually independent.

(v) **Validity of Transactions:** It is also the function of audit to establish that payments have been made validly to persons who are shown to be recipients. For example, it must be verified that salaries to partners were paid according to a provision contained in the partnership deed and the directors fees were paid according to the provisions in that regard in the Articles of Association or the resolution passed by members of the company at a general meeting. For checking the validity of a transaction, it is usually necessary to refer to documentary evidence. It may exist in any of the following forms-

- ✓ The legal provisions, if any, having bearing on the accounts of the entity under audit.
- ✓ The rules or regulations governing the internal working of the organisation, e.g., the Articles of Association, Partnership Deed, Trust Deed, etc.
- ✓ Minutes of the proceedings of a meeting of members of the company, that of the directors or that of the Managing committee.
- ✓ Copy of an agreement, e.g., Managing Director's agreement, Lease Deed, vendor's agreement, agency agreement, contract with an employee, etc.

An auditor should have a clear and precise knowledge of legal provisions under which the concern was registered or is functioning, as well as those which constitutes the basis of various transactions entered into, more particularly the provisions as regards maintenance and audit of its accounts. He should also study the rules, if any, framed for regulating the internal management of the entity; these may be embodied in some of the documents mentioned above. If he has any doubt on any legal point, by way of guidance, he should call for legal opinion. However, unless he is convinced of the reasonableness of the legal opinion, he should not act on it. In the case of *Republic of Bolivia Exploration Syndicate Ltd.* [1914], it was held that auditors are *prima facie* responsible for *ultra vires* payments made on the faith of their balance sheet but whether, and to what extent, they are considered responsible for not having discovered them in their audit would depend upon the circumstances of each case. An auditor is responsible for detecting payments that are *ultra vires* the company (*Leed Estate Building & Investment Society v. Shepherd).*

(vi) **Disclosure in the Final Accounts:** The object of audit ultimately is that the statements of account prepared from books of account which have been checked should present a true and fair picture of the financial position of the entity. This particular objective should be kept in view while checking the grouping of accounts. The auditor must see that not only items of a like nature be grouped together but also the description of each account truly reflects the nature of the amounts accumulated therein. Unless this is verified, the classification of income and expenditure and that of assets and liabilities would be misleading. For example if director's fee and salaries to staff have been added together or advances to directors have been covered up by being amalgamated with book debts, the nature of these payments would be obscured. Fundamentally, care should be taken to ensure that no material fact is suppressed or stated in a manner that it may mislead anyone. If it is found that owing to costing or managerial requirements, certain items of expenditure or receipts have not been classified by the company in the way as would meet the requirements of the Companies Act, 2013 the client's staff at the end of the year should be required to re-classify them. Nevertheless such a re-classification of expenditure should be checked by the assistant of the auditor to confirm that it has been correctly made and that no item requiring re-classification has been left out. In the case of a company, Schedule III to the Companies Act, 2013 has laid down requirements in regard to the disclosure.

5.1.2 Casting or Totalling: Sometimes the totals of a wage bill are inflated by over totalling the column in which the wages payable are entered. Such a fraud can be detected only if the totals of the wage bill are checked. Similarly, a cashier may misappropriate receipts from account receivables by under-totalling the receipts column of the cash book. At times, shortages in cash have been also covered up by over totalling. Such frauds can be detected only if the totals of the cash book and the general ledger are checked. On these considerations, where totals of the cash book or the ledger are found to have been made in pencil, the book keeper should be asked to ink the totals before their verification is commenced. This would deter him from altering the totals on the totalling mistakes being discovered.

Sometimes a fraud is committed in the following manner:

(a) under casting the receipt side of the cash book;

(b) over casting the payment side of the cash;

(c) fictitious entries being made in the cash column to show that amounts have been deposited in the account when, in fact, no deposit has been made;

(d) posting an amount of cash sale to the credit of a party and subsequently withdrawing the amount; and

(e) wrong totals or balances being carried forward in the cash book or in the ledger.

Note: Students are expected to think several other devices where amounts can be misappropriated either by making wrong entries or by failing to make an entry in the accounts.

5.1.3 Bank Reconciliation Statement: Bank reconciliation is an important accounting control. It is expected the students will be familiar with the method of preparing Bank Reconciliation Statement. A copy of the statement duly signed by the accountant of the client after it has been checked should be kept in record by the auditor along with other working papers, for future reference. The position of cheques and other remittances shown in the statement as outstanding should be ascertained on a reference to the Bank Pass Book. Where it is found that a number of cheques have been deposited in the bank immediately before the close of the year, which subsequently were dishonoured, it should be investigated whether these were fictitious which had been deposited merely to inflate the bank balance or to show parties' balances outstanding against whom balances were infact irrecoverable. Generally, it is advisable that the position of all amounts deposited in the bank, which were outstanding for realisation at the close of the year, should be ascertained.

5.2 Audit of Payments

Under the Indian Stamp Act, 1899, instruments whereby payment is acknowledged, should bear a revenue stamp. An auditor, therefore, should see that the receipts produced in evidence of payments, shown to have been made are properly stamped. The date of issue of a stamp paper from the stamp office is entered on its back. The design on revenue stamp also is changed from time to time. Such information sometimes may provide a clue leading to the discovery that a receipt has been forged or agreement has been ante-dated. It is the practice with some big companies to have a receipt form printed on the back of their cheques, so that the endorsement on the cheque may be accepted as an evidence of payment. Such cheque forms are specially printed by the bank under an agreement with the account receivable. The system has a drawback from the point of view of the auditor in so far as that such a receipt is only an evidence of the fact that the amount has been paid by the bank; but not that of the identity of the party to whom the payment is purported to have been made. As a safeguard, the auditor should see that adequate precautions to prevent payments being made to wrong persons were being taken by the client's office (One precaution could be that all cheque forms should have "Account payee only" printed on them). It would also be advisable for him to refer other connected documents, viz., invoices, debit notes, etc. against which payments have been made before accepting such receipts as evidence of payment of money. In such cases, the auditor would be well advised to obtain confirmation of balances of personal accounts and, wherever practicable, these should be obtained directly by him.

5.2.1 Purchase of Goods: Cash purchases should be verified by reference to cash memos or receipted invoices by suppliers. Payments made against credit purchases should be vouched with the receipts issued by the suppliers and the credit to their accounts on the basis of invoices entered in the Purchases Day book. There must be also evidence of the goods having been received through an entry in the Goods Inward Books or inventory ledger.

It is necessary, however, to make a distinction between a payment for goods and an advance against supplies to be made in future; the latter should be classified as advance recoverable in cash or in kind or for value to be received. Since the amount shown as an advance paid against goods may be only a camouflage for assistance to a party, it is necessary for the auditor to confirm that the advance was paid pursuant to a normal trade practice and supplies were, subsequently, received with a reasonable period of the advance.

Certain concerns issue invoices in duplicate. In such a case, there can be a possibility of an invoice being paid twice; first by its being entered in the Purchase Day Book and the account of the supplier being credited and the second time by the duplicate copy of the invoice being paid as a cash purchase. On this account, on noticing a receipted invoice, the auditor should verify that neither the original nor the duplicate thereof has been already entered in the Purchase Day Book. In the case of goods purchased at the end of year, it should be further verified that even though not received or entered in inventory before the close of the year, they have been included in the closing inventory. To confirm that all the goods, payment for which have been made, have been received and entered in inventory, all invoices for purchases made during one week preceding the close of the year should be traced into the Goods Received Book maintained by the Receiving Section, also it should be verified that every purchase invoice is stamped with the date of receipt of goods in inventory and the ledger folio at which invoice has been entered.

For a more detailed discussion on vouching of credit purchases, students may refer to Audit of Trading Transactions.

5.2.2 Transactions with Related Party: As per Section 188 of the Companies Act, 2013 read with Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014, no company shall enter into any contract or arrangement with a related party except with the consent of the Board of Directors given by a resolution at a meeting of the Board with respect to:-

(a) sale, purchase or supply of any goods or materials;

(b) selling or otherwise disposing of, or buying, property of any kind;

(c) leasing of property of any kind; availing or rendering of any services;

(d) appointment of any agent for purchase or sale of goods, materials, services or property;

(e) such related party's appointment to any office or place of profit in the company, its subsidiary company or associate company; and

(f) underwriting the subscription of any securities or derivatives thereof, of the company.

The above provision is subject to the following conditions, namely:-

(1) The agenda of the Board meeting at which the resolution is proposed to be moved shall disclose-

  (a) the name of the related party and nature of relationship;

(b) the nature, duration of the contract and particulars of the contract or arrangement;

(c) the material terms of the contract or arrangement including the value, if any;

(d) any advance paid or received for the contract or arrangement, if any;

(e) the manner of determining the pricing and other commercial terms, both included as part of contract and not considered as part of the contract;

(f) whether all factors relevant to the contract have been considered, if not, the details of factors not considered with the rationale for not considering those factors; and

(g) any other information relevant or important for the Board to take a decision on the proposed transaction.

(2) Where any director is interested in any contract or arrangement with a related party, such director shall not be present at the meeting during discussions on the subject matter of the resolution relating to such contract or arrangement.

(3) Where a member of the company is a related party, he shall not vote on such special resolution to approve any contract or arrangement which may be entered into by the Company.

(4) Prior approval of the company by a special resolution is required for entering into transaction(s) with any related party, where transaction(s) to be entered into:-

(a) are contracts or arrangements, with criteria as mentioned below-

(i) sale, purchase or supply of any goods or materials directly or through appointment of agents exceeding 10% of the turnover of the company or ₹ 100 crore, whichever is lower;

(ii) selling or otherwise disposing of or buying property of any kind, directly or through appointment of agents, exceeding 10% of net worth of the company or ₹ 100 crore, whichever is lower;

(iii) leasing of property of any kind exceeding 10% of the net worth of the company or 10% of turnover of the company or ₹ 100 crore, whichever is lower;

(iv) availing or rendering of any services directly or through appointment of agents exceeding 10% of the turnover of the company or ₹ 50 crore, whichever is lower;

It may be noted that the limits specified above shall apply for transaction(s) to be entered into either individually or taken together with the previous transactions during a financial year.

(b) is for appointment to any office or place of profit in the company, its subsidiary company or associate company at a monthly remuneration exceeding ₹ 2.5 lakh;

(c) is for remuneration for underwriting the subscription of any securities or derivatives thereof of the company exceeding 1% of the net worth.

It may be noted that the Turnover or Net Worth referred above shall be computed on the basis of the Audited Financial Statement of the preceding financial year. In case of wholly owned subsidiary, the special resolution passed by the holding company shall be sufficient for the purpose of entering into the transactions between wholly owned subsidiary and holding company.

Proviso to Section 188(1) of the Companies Act, 2013 provides that no provision to this section shall apply to any transactions entered into by the company in its ordinary course of business which are on an arm's length basis.

Such consent or approval should be ratified by a resolution at a Board Meeting or by a special resolution in the general meeting before the contract is entered into or within three months thereof. In case compliance is not undertaken, then such contract or arrangement shall be voidable at the option of the Board.

It is also necessary to refer in the Board's report to the shareholders about every contract or arrangement entered into under sub-section (1) of section 188 with the justification for entering into such contract or arrangement.

Further, every director of a company who is in any way, whether directly or indirectly, concerned or interested in a contract or arrangement entered into or one proposed to be entered into by the company, must disclose the nature of his concern or interest to the company at the Board Meeting (Section 184). An interested director is also restrained from taking part in such meeting. If the director of the company, who is concerned or interested in any way, whether directly or indirectly, does not disclose his interest or, participate in Board meeting in which the contract or arrangement is discussed, the contract or arrangement entered into by the company shall be voidable at the option of the company. There are certain exceptions to these provisions contained in sub-section (5) of Section 184 of the Companies Act, 2013.

5.2.3 Remuneration paid to Directors: The following points must be considered while vouching the directors' remuneration in case of a public company–

(i) Examine the Entitlement: The directors are not automatically entitled to remuneration. It is paid either according to the terms of articles of association or in accordance with a resolution of the general meeting.

(ii) Examine Adherence to Legal Provisions: The auditor should examine adherence to relevant sections of the Act such as –

- ✓ Section 197(6) which deals with manner of payment of managerial remuneration.
- ✓ Section 197(5) which deals with payment of listing fees.
- ✓ Section 197(1), which has prescribed the overall limit to managerial remuneration.
- ✓ Schedule V to the Act that has laid down conditions for payment of remuneration for companies having no profits or inadequate profits and companies having negative effective capital.

- ✓ Proviso to Section 197(1) which provides for increase in remuneration with the approval of the Central Government.

5.2.4 Payment for Acquisition of Assets: The purchase of an asset must be duly supported by the receipt for the amount paid. In case of an immovable property the auditor must also inspect the title deeds. The title of an immovable property passes only on registration. It is therefore essential for an auditor to see that property has been registered in the purchaser's name as required by the Transfer of Property Act, 1882 and also that the title of the transfer to sell property has been verified by a solicitor or an advocate.

In the case of movable property requiring registration of ownership, e.g., a car or a ship, it must be verified that such a registration has been made in favour of the purchaser. It is necessary for the auditor to satisfy himself generally as regards existence, value and title of the assets acquired. It must also be verified that the assets were purchased only by a person who had the authority to do so. Section 179 of the Companies Act, 2013 provides that only the Board of Directors can invest the funds of the company. Thus the Board alone can sanction the purchase of a fixed asset. If the benefit of an item of expense has been acquired by the purchaser along with the asset, its value should be debited to a separate account, e.g., when a motor car has been purchased on which certain taxes and insurance charges were paid by the seller for a period that had not expired. In the case of an asset constructed or manufactured by the client himself, e.g., where a building has been constructed or a plant or machinery manufactured by the concern with its labour and materials, it must be verified that the cost of labour, materials and other direct expenses incurred has been charged as cost of the asset on a proper allocation of the total expenditure debited under these heads. This is because, if a larger sum is capitalised than warranted in the circumstances, it would inflate the profit and if a smaller amount is debited, it would have the effect of unduly reducing the profit. Also corresponding values of assets would not be properly recorded. It must also be seen that neither expenses on repairs and maintenance have been capitalised nor the cost of additions to assets charged off as revenue expenses.

5.2.5 Payments controlled by the Companies Act, 2013:

In the case of a company, payments or transactions, directly or indirectly, have been controlled/restricted by the Companies Act, 2013 (hereinafter referred as the Act). This may be understood with some of the provisions of the Act as discussed below-

(i) Only such expenses which are incurred related to the business of the company are chargeable to statement of profit and loss. The auditor is, therefore in terms of section 143(1)(e) of the Act, required to inquire whether personal expenses have been charged to the revenue account. In case of any special comments to the said inquiry, he is also required to report on the same.

(ii) Section 180 of the Act specifically restricts the powers of the Board *i.e.* the Board of Directors of a company can exercise the following powers but only with the consent of the company by a special resolution, namely -

(a) sell, lease or otherwise dispose of the whole or substantially the whole of the undertaking of the company or where the company owns more than one undertaking, of the whole or substantially the whole of any of such undertakings.

(b) invest otherwise in trust securities the amount of compensation received by it as a result of any merger or amalgamation.

(c) borrow money, where the money to be borrowed, together with the money already borrowed by the company will exceed aggregate of its paid-up share capital and free reserves, apart from temporary loans obtained from the company's bankers in the ordinary course of business.

It is provided that the acceptance by a banking company, in the ordinary course of its business, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise, shall not be deemed to be a borrowing of monies by the banking company within the meaning of this clause.

(d) remit, or give time for the repayment of, any debt due from a director.

(iii) Under section 181, the Board of Directors of a company can contribute to the *bonafide* charitable and other funds any amount in any financial year. However, prior permission of the company in general meeting is required if the aggregate of such contribution exceeds 5% of its average net profits for the three immediately preceding financial years.

(iv) Section 182 deals with prohibition and restriction regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three financial years cannot contribute any amount directly or indirectly to any political party. In other cases, contribution in any financial year should not exceed 7½% of average net profits during the three immediately preceding financial years.

(v) Section 183 permits the Board and other person to make contributions to the National Defence Fund or any other Fund approved by the Central Government for the purpose of National Defence to any extent as it thinks fit.

5.2.6 Assets acquired on Hire Purchase Basis

(i) Examine the Board's Minute Book approving the purchase on hire-purchase terms.

(ii) Examine the hire-purchase agreement carefully and note the description of the machinery, cost of the machinery, hire purchase charges, terms of payment and rate of purchase.

(iii) Assets acquired under Hire Purchase System should be recorded at the full cash value with corresponding liability of the same amount. In case cash value is not readily available, it should be calculated presuming an appropriate rate of interest.

(iv) Hire purchased assets are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof. The interest payable along with each installments, whether separately or included therein should be debited to the interest account and not to the asset account.

5.2.7 Assets Acquired on Lease

(i) Examine the terms and conditions of the lease deed.

(ii) If a part of the leasehold property has been sublet, examine the tenant's agreements.

(iii) Verify relevant document to check the cost of property.

(1) In case acquisition of an asset is on **operating lease**, lease payment should be recognized as an expense in the Statement of Profit and Loss on a straight line basis over the lease term.

(2) In case acquisition of an asset is on **finance lease**, ensure all the substantial risks and rewards incidental to ownership are transferred, considering the indication as prescribed in AS-19. The lessee should recognise the lease as an asset and as a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. Ensure contingent rents are recognised as expense in the Statement of Profit and Loss for the period.

(iv) Ensure assets acquired under finance lease are segregated from the assets owned.

(v) Ensure that the assets under lease have been properly disclosed as per the requirements of Schedule III to the Companies Act, 2013.

5.2.8 Payment of Expenses: Normally, every item of expenditure has to be written off in the year in which it is incurred. But, considering the requirement of AS 10 and AS 26, the expenses relating to tangible and intangible assets can be capitalised if recognition criteria are met. It may be noted that with the issuance of AS 26, "Intangible Assets", the concept of deferred revenue expenditure is no more in existence.

If the provision for outstanding expenses made in a past year turns out to be insufficient and the amount is material, proper disclosure of such a fact should be made in the accounts of the year in which any further amount is charged on that account. This is done either by showing the amount separately in the inner column and explaining its nature or by including it in the Appropriation Section of the Statement of Profit and Loss.

Only expenses incurred for the purpose or for the benefit of business are chargeable to it. The auditor therefore, should make certain, as far as practicable, that no personal expenses are charged to the business. In the case of a company, as has been stated earlier, personal expenses, if charged, have to be reported, particularly those which are not covered by commercial practices or contractual obligation.

It should be verified that all expenses incurred, whether paid or payable, have been included in the accounts and that where any part of an item of expenses relates to the period that extends beyond the close of the year, a proportionate amount thereof has been adjusted as prepaid expense.

Where some of the expenses are found to have been adjusted in a lump-sum especially at the close of the year, these might be fictitious items introduced merely to reduce profits. These, therefore, should receive special attention of the auditor.

Requirements as stated in Schedule III to the Companies Act, 2013, related to disclosure of expenses in case of Companies are:

(i) A Company shall disclose aggregate of the following expenses separately on the face of the Statement of Profit and Loss-

Item IV. Expenses:

(a) Cost of Materials Consumed

(b) Purchases of Stock-in-trade

(c) Changes in Inventories of Finished Goods, Work-in-progress and Stock-in-trade

(d) Employee Benefits Expense

(e) Finance Costs

(f) Depreciation and amortization expense

(g) Other Expenses

(ii) A Company shall disclose separately by way of notes on the face of the Statement of Profit and Loss additional information regarding aggregate expenses as under:-

(a) Consumption of stores and spare parts;

(b) Power and fuel;

(c) Rent;

(d) Repairs to buildings;

(e) Repairs to machinery;

(f) Insurance;

(g) Rates and taxes, excluding, taxes on income;

(h) Miscellaneous expenses.

5.2.9 Payment of Taxes: 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. Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid. 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.

Nowaday, 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. The assessee 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. It is not necessary for the assessee 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.

5.2.10 Customs and Excise Duties: The audit procedures for custom duties are listed below-

(i) **Examine Cash Book:** Examine the payment of custom duties in the cash book with reference to bill of entry.

(ii) **Examine the Bill of Entry:**

- ✓ Check the amount of custom duty was calculated correctly, i.e., in accordance with the applicable rate for dutiable goods.
- ✓ If the duty has been paid by dealing and forwarding agent, examine bill of entry with reference to agent's bill.
- ✓ If the duty has been paid by the client directly, examine bill of entry together with receipt evidencing payment of customs duty.

(iii) **Examine Disputed Cases Carefully:** In case of a dispute about the amount of duty payable, a provisional payment may have been made. The auditor should determine the duty payable and ensure any additional duty to be paid or refund expected should have been adjusted.

(iv) **Verify for Duty Drawback:** Duty drawback refers to a scheme under which central excise and customs duties paid for raw-materials and other inputs used in the manufacture of the product prior to its export are refunded to the exporter. The auditor should verify the claim of duty drawback with reference to acknowledgement issued by the Directorate of duty drawback.

Excise duty becomes payable at the time of releasing of excisable goods from the factory/godown to the manufacturer. Normally, the excise duty payable is deposited with the designated bank to the credit of the controller of excise and one copy of the challan is forwarded to him for obtaining the permit and another copy is sent to the dispatch department evidencing payment of required duty. The auditor may adopt the following procedures to vouch the payment of excise duties:

(i) Verify payment of excise duties by examining the duly paid as per Challans with reference to the quantity of goods in respect of which issue permits have been received.

(ii) Test check the accuracy of the amount of duty paid by multiplying the rate of excise duty with the value of goods issued as per the client's inventory register.

(iii) In respect of excisable goods manufactured but remaining to be released, ensure that necessary provision for unpaid excise duty has been made.

(iv) Ensure that in every case CENVAT credit has been adjusted and only net excise duty has been paid.

5.2.11 Travelling Expenses: Travelling expenses are normally payable to staff according to rules approved by directors or partners. Where no rules exist, the auditor should recommend that these be framed for controlling the expenditure. In the absence of T.A. Rules, the expenditure should be vouched on the basis of actual expenditure incurred. A voucher should be demanded for all items of expenses incurred, except those which are capable of independent verification.

As regards travelling expenses claimed by directors the auditor should satisfy himself that these were incurred by them in the interest of the business and that the directors were entitled to receive the amount from the business.

The voucher for travelling expenses should normally contain the under mentioned information:

(i) Name and designation of the person claiming the amount.

(ii) Particulars of the journey.

(iii) Amount of railway or air fare.

(iv) Amount of boarding or lodging expenses or daily allowance along with the dates and times of arrival and departure from each station.

(v) Other expenses claimed, e.g., porterage, tips, conveyance, etc.

If the journey was undertaken by air, the counterfoil of the air ticket should be attached to the voucher; this should be inspected. For travel by rail or road, the amount of the fare claimed should be checked from some independent source. Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified. The evidence in regard to sundry expenses claimed is generally not attached to T.A. bills. So long as the amount appears to be reasonable it is usually not questioned. All vouchers for travelling expenses should be authorised by some responsible official. In the case of foreign travel or any extraordinary travel, the expenses, before being paid, should be sanctioned by the Board. The travelling advance taken, if any, should be settled on receipt of final bills. At the year end, the amount not settled should be shown appropriately in the Balance Sheet.

Unless the articles specifically provide or their payment has been authorised by a resolution of shareholders, directors are not entitled to charge travelling expenses for attending Board Meetings.

5.2.12 Repairs to Assets: Since the line demarcating repairs from renewals is slender, usually it is not a simple matter to determine the amount of the expenditure, if any, included as charges for repairs, which should be considered as that incurred for renewal of an asset and added to its cost. It may sometimes be possible to determine this on a consideration of the nature of repairs carried out. The proportion of the charges which had the effect of increasing the value of an asset or enhancing its capacity or life should be treated as capital expenditure.

Where, however, it is not possible to form an opinion accurately on the basis of evidence as regards the nature of repairs, a certificate from the engineer under whose supervision the repairs were carried out, confirming the classification of expenditure should be obtained. It should be ensured that Repairs to 'Certain Assets' like Building and Machinery have been separately disclosed as per the requirements of Schedule III.

5.2.13 Preliminary Expenses: The expenditure incidental to the creation and floating of a company includes stamp duties, registration fees, legal costs, accountant's fees, cost of printing, etc. The contracts relating to preliminary expenses should be examined. If preliminary expenses incurred by promoters have been reimbursed to them by the company, the resolution of the Board of Directors and the power in the Articles to make such re-imbursement should be seen. The bills and statements supporting each item of preliminary expenses should be checked. It should be seen that no expenses other than those which constitutes preliminary expenses are booked under this head. The auditor can cross check the amount of preliminary expenses with that disclosed in the prospectus, statutory report and the balance sheet. Any amount paid in excess of the amount disclosed in the prospectus should have been approved by the shareholders. Expenditure in connection with the preliminary expenses should be treated as an expense in the year of incurring and not to be carry forwarded for writing off in future years as per the compliance of AS 26. Underwriting commission and brokerage paid for shares and debentures should not be included under the head preliminary expenses.

5.2.14 Salaries and Wages: Payments on account of salaries and wages need to be vouched carefully, since amounts which were either not due or in excess of those due may have been paid by the client. The evidence in support of such payments generally is internal. It can, therefore, be relied upon only if it has been produced in the normal course of business and there exists an efficient system of internal control which could be expected to prevent it from being fabricated.

Therefore, before proceeding to verify payment made on account of salaries and wages, the auditor should examine the internal control procedure as regards the following:

(a) Appointment, promotion, transfer and discharge of employees.

(b) Recording attendance of workers engaged on the time basis, as well as particulars of jobs performed by piece workers.

(c) Arrangement for the preparation of wages and salaries bills and their analysis.

(d) Sanctioning the disbursement of wages and salaries.

(e) Arrangement for disbursement of wages and salaries for workers and employees not present on the pay day.

(f) Custody of the wages records.

He should also verify that the system of internal control provides for the following matters:

(a) Mechanical recording of attendance of workmen by time recording clocks installed at the factory gate, as well as in each department and the reconciliation of the total labour force with the total of workmen in different departments; also the recording of attendance of the staff departmentally in separate registers.

(b) Preparation of wages and salary bills by members of the staff, who are not connected with maintaining a record of engagement of workers, recording of their attendance or fixation of their wages.

(c) Rotation of duties of different clerks employed for preparation of wages and salaries bills so that calculations, additions and extensions are not carried out by the same clerk every month. Also, signing of the statement by persons who have prepared them and indication by each person so employed of the nature of work carried out by him.

(d) Verification of salaries and wages bills in case of newly appointed persons by reference to orders for appointment, promotions or transfer made during each month and of those payable to old employees by reference to old records and on reference to the record of attendance.

(e) Verification of the amount of total wages paid with the amount adjusted in the costing record.

(f) Checking and authorising the overtime and piece work payment by officers who are not associated with the Wages Department.

(g) Withdrawal by a single cheque from the bank of the exact amount of wages and salaries payable as are entered in the wages and salaries bill, depositing in the bank the undisbursed amounts.

(h) Recording of unclaimed wages and salaries immediately in the Unpaid Wages and Salaries Register, and their subsequent payment on the employee's claim to them.

(i) Payment of advances in lieu of wages and salaries to persons who go on leave on short notice before the end of the month through the Petty Cash.

(j) Disbursement of wages in the presence of an official who is in a position to identify the worker and ensure that wages are not being paid to persons other than the workmen except under a proper authority.

Provided that the system of internal control has built-in safeguards against payments being made in excess, the auditor should check the wages and salaries bills for one month as follows:

(a) Check the bill in detail by reference to the record of attendance, schedule of rates, sanctioned by the management for different classes of workers and employees and the sanction for their payment.

(b) Check the computation of wages and salaries payable to different workers and employees by taking into account the deduction and other factors on a consideration of the following-

(i) Absence;

(ii) Leave with pay;

(iii) Loans and advances;

(iv) Increments;

(v) Fines and penalties;

(vi) Deduction on account of Provident Fund and Income-tax;

(vii) Deduction on account of contribution towards Employees' State Insurance, etc.

(c) Verify the addition, extension and classifications of wages and salaries for distributing them among different accounts.

(d) Confirm that all payments to workers and other employees have been acknowledged and amounts which have remained undisbursed have been deposited back in the bank and credited to the Unpaid Wages and Salaries Account. Also, check disbursement of unpaid wages and salaries made during the month.

(e) See that wage sheets are signed by the persons who have prepared wage sheets and disbursed wages; also that they have indicated precisely the nature of work carried out by them.

(f) Test the correctness of the amount paid by reference to the Annual Return of Salaries, etc., submitted to the Income-tax Authorities and that of wages with Employee's State Insurance Cards.

(g) Trace recoveries out of loans and advances, outstanding against employees into the Employees Loans and Advances Register.

(h) See that names of the same persons do not always appear on the list of unpaid wages if their wages are not, from time to time, adjusted against their loans and advances to prevent their absence being noticed at the time wages are paid. It might provide a clue that the workmen are dummies.

If the aforementioned checking does not disclose significant mistakes, either in the preparation of wages and salaries bill or in their disbursements, the auditor could verify the wages and salary bills for the rest of the period by the application of the following checks:

(a) Test checking the amount of wages and salaries, shown as payable in the bill, to a selected list of employees by reference to their attendance record as well as Employees Insurance Cards ; also verifying the rate of wages and salaries at which the amount due have been computed on an inspection of the authority under which they were engaged.

(b) Verifying the disbursement of all wages and salaries by reference to receipts furnished by employees or their authorised representatives on the salaries and wages bill.

(c) Verifying the amounts withdrawn each month from the bank for payment of the salaries and wages bill.

(d) Reconciling the amounts deposited in the bank each month with that undisbursed shown in the relevant bill.

(e) Vouching all payment made on account of wages and salaries that had remained unclaimed on the pay day.

5.2.15 Schedule III- Disclosure requirement to the Statement of Profit & Loss:

A Company shall disclose separately by way of notes on the face of the Statement of Profit and Loss additional information regarding aggregate expenditure on Employee benefits expenses as under:

Employee Benefits Expense

- Salaries and Wages
- Contribution to Provident and Other Funds
- Expenses on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP)
- Staff Welfare Expenses.

5.2.16 Petty Cash: Payments from petty cash should be verified as follows:

(i) Trace the amounts advanced to the petty cashier for meeting petty office expenses from the Cash Book in the Petty Cash Book.

(ii) Vouch payments with docket vouchers which must be supported, wherever possible, by external evidence e.g., payee's receipted bill or invoices, cash memo, etc.

(iii) Trace payments made for the purchase of postage stamps recorded in the Postage Book. The totals of the Postage Book should be test checked. The amounts of postage stamps in hand, at the end of the year, should be credited to Postage Account by debiting the amounts to Postage in Hand Account. It should be seen that the amount paid for postage stamps is not unduly large and the Postage Book is normally checked by the petty cashier from time to time before the amount of imprest is reimbursed. Confirm that the postage expenses for the year are reasonable as compared with that in the postage expenses from month to month.

(iv) See where a columnar Petty Cash Book is maintained, that the extension have been carried forward into appropriate amount columns.

(v) Check the column totals and cross totals.

(vi) Trace posting of the various columns in which payments are classified to the respective ledger accounts.

(vii) Verify the cash balance in hand.

(viii) Auditor should also verify whether the amount of petty cash imprest is fixed. Is this amount reasonable considering the total amount of petty cash payments made during a month or so?

5.2.17 Advertisement Expenses: The advertisement expenses will be vouched in the following manner:

(i) Ascertain the nature of advertisement expenses to ensure that the same have been charged properly.

(ii) Obtain the complete list of advertisement, media wise, i.e., newspapers, slides, hoardings, magazines, television, radio, etc. showing the dates, exact location, timings, etc., along with the amounts paid in respect of each category.

(iii) See that advertisement expenses relate to the client's business.

(iv) Ascertain whether there is a regular contract with an advertising agency. See that regular statements are obtained from the agency showing the advertising media and amounts debited to the client. Discounts, if any, should be properly adjusted and disclosed in the bills.

(v) Check the receipts for amounts paid for the advertising expenses incurred.

(vi) See that outstanding advertising expenses have been properly disclosed on the liabilities side of the balance sheet.

5.2.18 Payment of Dividends

(i) Examine special provisions, if any, in the Memorandum and Articles of Association regarding payment of dividends.

(ii) See that in declaring dividends, provisions of the Companies (Declaration and payment of Dividend) Rules, 2014 have been complied with.

(iii) Examine the Board's minutes regarding rate of dividends.

(iv) Examine the company's procedure for payment of dividends including unclaimed dividends and ensure that they are not paid without adequate safeguards as to identification of the payee, checking of the payee's claims etc. In this connection, internal control of the company should be examined.

(v) Verify the shareholders' register and ensure that the names of all shareholders who are entitled to receive dividends have been included.

(vi) Check the computation of dividends with reference to rate of dividends and number of shares held.

(vii) See counterfoils of cheques for amounts paid to shareholders.

(viii) Examine, whether all the conditions for payment and source of dividend as specified under the Companies Act, 2013, have been complied with.

5.2.19 Retirement Gratuity to Employees

(i) Examine the basis on which the gratuity payable to employees is worked out. The liability for gratuity may either be worked out on actuarial rules or agreement or on the presumption that all employees retire on the balance sheet date.

(ii) Ensure that the basis of computing gratuity is valid.

(iii) Verify computation of liability of gratuity on the aggregate basis.

(iv) Check the amount of gratuity paid to employees who retired during the year with reference to number of years of service rendered by them.

(v) See that the annual premium has been charged to Statement of Profit and Loss in case the concern has taken a policy from LIC.

(vi) Ensure that the accounting treatment is in accordance with AS-15 "Employee Benefits".

(vii) Ensure that the following disclosure requirements of Schedule III to the Companies Act, 2013 have been followed-

In respect of Statement of Profit and Loss, a Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items: ***(i) (a) Employee Benefits Expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses];***
➢ ***Long-term provisions: The amounts shall be classified as: (a) Provision for employee benefits; (b) Others (specify nature)***
➢ ***Short-term provisions: The amounts shall be classified as: (a) Provision for employee benefits; (b) Others (specify nature).***

5.3 Cash Receipts

The function of audit in respect of cash receipts being much the same as that in the case of cash payments, the procedure stated at the beginning of this Chapter should be applied for their verification. But the internal check in respect of cash receipts should be closer and stricter, primarily because these have to be verified generally only by reference to the internal evidence which, if it is not in existence or is manipulated, would not be of any assistance for the detection of incomes that either have not been credited or have been credited only partially. For example, if in respect of sale proceeds of goods or an item of miscellaneous income no bill or voucher has been prepared, audit would not disclose that the amount has been misappropriated. Similarly, if the amount on the copy of a cash memo has been cleverly altered from ₹ 50 to ₹ 5 and the latter amount only has been entered in the

Cash Book, unless the alteration is detected and the fact that it has been altered is established, it would not be possible for the auditor to know that part of the cash sales has been misappropriated.

On this account, it is essential that the auditor before starting the audit of cash receipts should examine the internal check in operation and bring to the attention of the management any weakness therein, as well as to the possible consequence that might follow if it is not removed. If he fails to do so, he may be held responsible at some later date for not having detected a defalcation or misappropriation in cash, the cause of which was the absence/inadequacy of the internal check.

Cash receipts are usually checked with counterfoils of the receipts issued. But the issue of receipts with counterfoils in respect of amounts collected by it would not ensure that all the amounts collected have been fully accounted for or have been correctly adjusted. For instance, a receipt might be issued for a larger amount than entered on its counterfoils. Again, only one receipt might have been issued for two or more amounts collected from a party while the counterfoils may show that separate receipts have been issued in respect of each amount collected and the one or more receipts forms, thus saved, may have been used for issuing a receipt of another amount collected which have been misappropriated. Therefore, before accepting counterfoils or receipts as evidence or the correctness of the amount collected, the auditor should satisfy himself that there exists an efficient system of internal check which would prevent any receipt from being misappropriated. For the purpose, the auditor should make the following enquiries:

(i) Who opens letter, what record is kept, and whether all cheques and postal orders are immediately endorsed to bankers and crossed 'Account Payee Only'?

(ii) Whose duty is to enter cash, cheques and other forms of remittance in the Pay-in-Slip and who deposited it in the bank?

(iii) Are receipts banked daily?

(iv) Who prepares receipts and who countersigns the same before these are issued to the parties from whom the amounts have been received?

(v) Whether printed receipts with counterfoils, numbered serially by a machine, are used and who maintains the inventory of unused receipts?

(vi) Are the receipt books kept in safe custody and are they issued only when the current receipt book has been used up?

(vii) What internal check is being exercised over the collection of cash sales and miscellaneous income?

(viii) Are travelling salesmen allowed to collect any advance against orders booked and what control exists over such collections?

(ix) How often are the bank statements checked and compared with the Cash Book?

(x) Who controls the preparation and dispatch of monthly statements of account to account receivables?

(xi) Are ledgers posted by the cashier or some other person?

There are certain firms which insist upon a receipt furnished to them on their own forms. In such a case, this fact should be noted on the counterfoil of the receipt which has been issued and the unused receipt form cancelled, as an additional precaution, balances in such account receivable's account should be get confirmed periodically.

While vouching cash receipts, it should be seen that the date of each receipt as it is entered in the cash memo or the counterfoil of the receipt issued in respect thereof corresponds with the date on which it is entered in the Cash Book. If there is a time lag between them, it is possible that the person who had collected the amount had failed to deposit it with the cashier immediately thereafter. When such a discrepancy is observed, the cause thereof should be ascertained.

5.3.1 Cash Sales: Primarily, the system of internal check should be examined with the objective of finding out loopholes therein, if any, whereby cash sales could be misappropriated. Further, the practice followed in the manner cash memos are issued should be ascertained. Because in case, cash memos are issued not only for cash sales but also for credit sales, the amount whereof if collected long after, there would be no guarantee that all the amount of cash sales has been collected before the close of year or that some of the amounts collected have not been misappropriated.

Cash sales usually are verified with carbon copies of cash memos. If sales are quite voluminous then a Cash Sales Summary Book is maintained and the cash memos are traced into it; the totals of the Summary Book are verified and the daily totals of the Summary book traced into the Cash Book. One of the matters, to which attention of the auditor should be paid in the process, is that the dates on the cash memos should tally with those on which cash collected in respect thereof has been entered in the Cash Book.

To verify that price of goods sold has been calculated correctly; the computation of the sales should be ascertained. If a cash memo has been cancelled, its original copy should be inspected, for it could be that the amount thereof has been misappropriated.

5.3.2 Receipts from Account receivables: Receipt of cash from the account receivables against price of goods sold are checked with the counterfoils of receipt issued to them. At the same time, it is also verified that there is a system of internal check in operation which acts as a safeguard against amounts collected being misappropriated.

One of the common devices for misappropriating cash collections from account receivables is the one known as *Teeming* and *Lading.* Such a fraud, usually, remains undetected for long since the cashier is able to make good the amounts misappropriated before the cash balance is checked. At times, the cashier who has committed such a fraud may cover up the amounts misappropriated, by raising a fictitious debit in an expense account.

When such a fraud is suspected, the first step in its investigation should be making comparison of the entries of amounts deposited in the bank account with those on counterfoils of the Pay-in-Slip Book. If the composition of the deposits is different from that shown on the counterfoils of the Pay-in-Slip Book, it would be a *prima facie* evidence of the fact that the amounts collected were not deposited as soon as these were received. Another evidence of the existence of such a fraud can be the fact that debits in account receivables' accounts, which ought to have collected in whole, are cleared in small instalments.

If such evidence exists, the matter should be investigated further. This can be done by all the account receivables being requested to send statements of account from their books, for the period during which the fraud is suspected to have been in progress. On comparing items in each statement, with the entries in the account receivable's accounts, it would be possible to locate amounts which were not deposited on the day these were collected, but subsequently.

5.3.3 Income from Investments: If the investments are many, the client generally would have an Investment Register. In such a case, the dividend income is first vouched by reference to the counterfoils of Dividend Warrants and the interest on securities by reference to the tax-deduction certificates, issued by the Reserve Bank. Afterwards the amounts collected are traced into the Investment Register; it is scanned to find out whether interest or dividend, relating to any investment, has remained unrealised. If so, the reasons thereof are ascertained. In order that the gross amount of interest are disclosed in the Statement of Profit and Loss, the tax deducted out of interest is debited to the Income-tax Account and credited to Interest Account. The auditor should verify that this has been done.

The auditor should examine the separate ledger accounts kept for each investment or loan given. The dates on which dividends or interest payments generally fall due should also be noted. The counterfoil of dividend warrants should be seen. These should be tallied with the records of investment. Where investments are sold ex-dividend, it should be seen that the dividends are subsequently received. Similarly when a purchase is on cum dividend basis, the receipt of dividend should be checked. In case of interest on deposit with banks, verification should be done by reference to the bank statement and the agreed rate of interest. The receipts of dividends and interest should be addressed to the bank statement for encashment. It should be ensured that the interest and dividend received are credited to the respective account in full i.e., before deduction of tax at source and the tax deducted at source should be debited to an appropriate account. It should be further seen that the certificate for tax deducted at source exists in each case.

5.3.4 Rental Receipts: Before proceeding to vouch rental receipts, copies of bills issued to tenants should be test checked by reference to copies of tenancy agreements and bills of charges paid by the landlord on behalf of the tenants, *i.e.,* house tax, water tax, tax deducted at source, electricity consumed, etc. The entries in the Rental Register in respect of rents accrued afterwards should be verified by reference to copies of rental bills. The amounts collected from tenants on account of rent should be checked by reference to receipts issued to them. These afterwards should be traced into the Rental Register.

At the end, the register should be scrutinized to find amount or rents which have not been recovered and are considered bad or irrecoverable, for deciding whether these should be written off or as provision against the same should be made.

An overall check over rental receipts is also necessary. For this purpose, particulars of total accommodation available for being let out, in different buildings, belonging to the client, should be ascertained. It should be verified that every available accommodation has been let out and rental income has been duly accounted for. If it is reported that one or more tenements have remained vacant a certificate in respect thereof should be obtained from the client.

5.3.5 Bankruptcy Dividends: When an account receivable has been sued for bankruptcy it is necessary to prove that the debt is due from him to the Official Receiver or Assignee before any amount can be recovered from his estate. The amounts of claim admitted are received subsequently, usually in parts, which are referred to, somewhat euphemistically, as dividends.

For the verification of these part amounts, it is necessary to refer to the correspondence with the Official Receiver or Assignee to find particulars of part amounts already collected and the balance outstanding at the beginning of the year. The advice, if any, received from the same authority along with the payment should be referred to.

5.3.6 Sale of Investments: Only the person who is authorised to purchase an investment can sell an investment. Thus, in the case of a company, an investment can be sold only by the Board of Directors and in the case of a trust by the trustees acting together. The normal method of selling investment is through Stock Broker, either directly or through a bank; the sale proceeds of investments are vouched by reference to Brokers' Sold Note. On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the Statement of Profit and Loss. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment. AS-13 requires disclosures of amounts included in Statement of Profit and Loss for:

- interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid;
- profits and losses on disposal of current investments and changes in the carrying amounts of such investments; and
- profits and losses on disposal of long term investments and changes in the carrying amount of such investments.

5.3.7 Loans: Primarily, the authority under which a loan has been raised should be verified. An unauthorised loan cannot be treated as a liability of the concern. The copy of the loan agreement should be referred to find out the rate of interest, the terms of repayment and the conditions as to security agreed to by the client. If any guarantee has been provided for the repayment of the loan the particulars thereof should be ascertained for the purpose of disclosure in the balance sheet.

5.3.8 Bills Receivable: The amount collected in respect of bills receivable are verified by reference to Bills Receivable Book. When bills are purchased, a provision for the amount of the discount, not earned till the close of the year is made in the accounts, in the case of bank. If the bills have been discounted, the contingent liability in respect of the discounted bill is disclosed in the balance sheet; also bills which have since been paid off are shown separately. Enquiries should be made from the client as regards the position of a bill or bill receivable dishonoured and if it is suspected that the amount due on a bill may not be recovered, a provision thereof should be made.

5.3.9 Sale of Assets: In this case also, as in the case of sale of investments, the authority for sale is most important. It is, therefore, a matter which should receive the attention of the auditor. Another important aspect which requires consideration is the basis of sale, whether by auction or by negotiation, for determining that the asset was sold at the maximum price that could be contained for it and that the sale proceeds of the asset have been fully accounted for. It should further be confirmed that sale proceeds have been credited to an appropriate head of account and the amount of profit arising out of it has been segregated between revenue profits and capital profits, if any, accordingly appropriate accounts are credited, where there is a loss, the same should be written off.

5.3.10 Royalties received: The auditor should see the relevant contract and examine the important provisions relating to the conditions of payment of royalty. In particular, the rate of royalty, mode of calculation and the due dates should be noted. The periodical statements received from the publisher and the calculation of the royalty should be checked. If there is any deduction on account of recoupment of royalty for the past period, the records for earlier royalty receipts should be seen to ensure that the amount of deduction is as per the contract. Royalties due but not yet received should have been properly accounted for.

5.3.11 Insurance Claims: Insurance claims may be in respect of fixed assets or current assets. While vouching the receipts of insurance claims, the auditor should examine a copy of the insurance claim lodged with the insurance company. Correspondence with the insurance company and the insurance agent should also be seen. Counterfoils of the receipts issued to the insurance company should also be seen. The auditor should also determine the adjustment of the amount received in excess or short of the value of the actual loss as per the insurance policy. The copy of certificate/report containing full particulars of the amount of loss should also be verified. The accounting treatment of the amount received should be seen particularly to ensure that revenue is credited with the appropriate amount and that in respect of claim against an asset, the Statement of Profit and Loss is debited with the shortfall of the claim admitted against the book value. If the claim was lodged in the previous year but no entries were passed, entries in the Statement of Profit and Loss should be appropriately described.

5.3.12 Sale Proceeds of Junk Materials

(i) Review the internal control on junk materials, as regards its generations, storage and disposal and see whether it was properly followed at every stage.

(ii) Ascertain whether the organisation is maintaining reasonable records for the sale and disposal of junk materials.

(iii) Review the production and cost records for the determination of the extent of junk materials that may arise in a given period.

(iv) Compare the income from the sale of junk materials with the corresponding figures of the preceding three years.

(v) Check the rates at which different types of junk materials have been sold and compare the same with the rates that prevailed in the preceding year.

(vi) See that all junk materials sold have been billed and check the calculations on the invoices.

(vii) Ensure that there exists a proper procedure to identify the junk material and good quality material is not mixed up with it.

(viii) Make an overall assessment of the value of the realisation from the sale of junk materials as to its reasonableness.

5.3.13 Recovery of Bad Debts written off: Recovery of bad debts written off is verified with reference to relevant correspondence and proper authorisation.

(i) Ascertain the total amount lying as bad debts.

(ii) Ensure that all recoveries of bad debts have been properly recorded in the books of account.

(iii) Examine notification from the Court or from bankruptcy trustee. Letters from collecting agencies or from account receivables should also be seen.

(iv) Check Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly.

(v) Vouch acknowledgement receipts issued to account receivables or trustees.

5.3.14 Refund of General Insurance Premium paid: The refund of insurance premium may be because of earlier provisional payment of premium or may be a policy might have been cancelled at a later date. The auditor should take following steps while vouching such refunds:

(i) Ascertain the reasons for refund of insurance premium.

(ii) Examine insurance policy or cover note to find out the amount of premium.

(iii) Verify advice of refund received from the insurance company. When refund is admitted, the insurance company sends the advice. This will be evidence as a covering letter to the cheque for the refund. Sometimes, a cheque is issued after a receipt is sent in advance to the insurance company.

(iv) Scrutinise correspondence between the insurance company and the client.

(v) Check entries in the bank book or the bank statement. If necessary, the counterfoil of the pay-in-slips can also be verified.

5.3.15 Discounted Bills Receivable Dishonoured

(i) Obtain the schedule of discounted bills receivable dishonoured.

(ii) Check the entry in bank statement regarding the amount of bills dishonoured and see that the bank has debited the account of client.

(iii) Verify the bills receivable returned by the bank alongwith bank's advice.

(iv) See that the dishonoured bills have been noted and protested by following the proper procedure and the account of the drawee or the account receivable is also debited.

(v) Check that bank commission, if any, charged by the bank has been recovered from the party.

5.3.16 Schedule III- Disclosure requirement to the Statement of Profit & Loss:

(i) A Company shall disclose separately by way of notes on the face of the Statement of Profit and Loss-

Item II. Other Income

Classification of Other Income into:

- Interest Income (except for a finance company)
- Dividend Income
- Net gain / loss on sale of Investments
- Other Non-Operating Income (net of expenses directly attributable to such income)

(ii) A Company shall disclose separately by way of notes on the face of the Statement of Profit and Loss additional information regarding aggregate income as under:-

- Adjustments to the carrying amount of investments
- Net gain on foreign currency transactions and translations (other than considered as Finance Costs)
- Interest Income
- Dividend Income

- Net gain on sale of investments
- Any item of income which exceeds 1% of the revenue from operations or ` 1 lakh, whichever is higher.

5.4 Verification of Bank Balance and Cash-In-Hand

5.4.1 Verification of bank balance: Apart from comparing the entries in the cash book with those in the Pass Book the auditor should obtain a certificate from the bank confirming the balance at the close of the year as shown in the Pass Book. If the bank account is overdrawn, the auditor should obtain from the bank particulars of assets on which a charge has been created to secure the overdraft. The auditor should examine the bank reconciliation statement prepared as on the last day of the year. He may also examine the reconciliation statement prepared as on the last day of the year. He may also examine the reconciliation statements as at other dates during the year. It should be examined whether (i) cheques issued by the entity but not presented for payment, and (ii) cheques deposited for collection by the entity but not credited in the bank account, have been duly debited/credited in the subsequent period. For this purpose, the bank statements of the relevant period should be examined. If the cheques issued before the end of the year have not been presented within a reasonable time, it is possible that the entity might have prepared the cheques before the end of the year but not delivered them to the parties concerned. In such a case, the auditor should examine that the entity has reversed the relevant entries. Where the auditor finds that post-dated cheques are issued by the entity, he should verify that any cheques pertaining to the subsequent period have not been accounted for as payments during the period under audit. The auditor should pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment/ write-off. The auditor should be alert to the possibility that even though the balance in an apparently inoperative account may have remained stagnant, transactions may have taken place in that account during the year.

Where a large number of cheques have been issued/deposited in the last few days of the year, and a sizeable proportion of such cheques have subsequently remained unpaid/uncleared, this may indicate an intention of understating account payables/account receivables or understating/overstating bank balances. In such a case, it may be appropriate for the auditor to obtain confirmations from the parties concerned, especially in respect of cheques involving large amounts. The auditor should also examine whether a reversal of the relevant entries would be appropriate under the circumstances. In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements. In respect of fixed deposits or any type of deposits with banks, the relevant receipts/certificates, duly supported by bank advices, should be examined. Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases. The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year. Where material amounts are held in bank accounts which are blocked, e.g., in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases. Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances. The following areas may also be considered by the auditor:

(i) In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements.

(ii) In respect of fixed deposits or any other type of deposits with banks, the relevant receipts/certificates, duly supported by bank advices, should be examined.

(iii) Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases.

(iv) The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.

(v) Where material amounts are held in bank accounts which are blocked, e.g., in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases.

(vi) Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances.

5.4.2 Verification of Cash-in-hand: The auditor should carry out physical verification of cash at the date of the balance sheet. However, if this is not feasible, physical verification may be carried out, on a surprise basis, at any time shortly before or after the date of the balance sheet. In the latter case, the auditor should examine whether the cash balance shown in the financial statements reconciles with the results of the physical verification after taking into account the cash receipts and cash payments between the date of the physical verification and the date of the balance sheet. Besides physical verification at or around the date of the balance sheet, the auditor should also carry out surprise verification of cash during the year.

All cash balances in the same location should be verified simultaneously. Where petty cash is maintained by one or more officials, the auditor should advise the entity to require the officials concerned to deposit the entire petty cash on hand on the last day with the cashier. The auditor should enquire whether the cashier also handles cash of sister concerns, staff societies, etc. In such a case, cash pertaining to them should also be verified at the same time so as to avoid chances of cash balances of entity being presented as those of another.

If IOUs ('I owe you') or other similar documents are found during physical verification, the auditor should obtain explanations from a senior official of the entity as to the reasons for such IOUs/other similar documents remaining pending. It should also be ensured that such IOUs/other similar documents are not shown as cash-on-hand.

The quantum of torn or mutilated currency notes should be examined in the context of the size and nature of business of the entity. The auditor should also examine whether such currency notes are exchanged within a reasonable time.

If, during the course of the audit, it comes to the attention of the auditor that the entity is consistently maintaining an unduly large balance of cash- on-hand, he should carry out surprise verification of cash more frequently to ascertain whether the actual cash-on-hand agrees with the balances as shown by the books. If the cash-on-hand is not in agreement with the balance as shown in the books, he should seek explanations from a senior official of the entity. In case any material difference is not satisfactorily explained, the auditor should state this fact appropriately in his audit report. In any case, he should satisfy himself regarding the necessity for such large balances having regard to the normal working requirements of the entity. The entity may also be advised to deposit the whole or the major part of the cash balance in the bank at reasonable intervals.

Where postdated cheques are on hand on the balance sheet date, the auditor should verify that they have not been accounted for as collections during the period under audit.

5.5 Audit of Trading Transactions

5.5.1 General Considerations: In addition to matters which are listed in the audit of cash transactions, certain other principal matters that should be taken into account while vouching trading transactions are:

(i) **Correctness of book-keeping record:** The auditor should also take steps to verify that the amount of profit has not been overstated, *e.g.*, by the inflation of sales or closing inventory, by the understatement of purchase and expenses or by omission to credit account receivables accounts with the value of goods returned by them, etc. The figure of profit can also be inflated by the failure to provide for losses and depreciation or reduction in their value for instance, by not making an adequate provision for bad debts, for discounts payable on the recovery of book debt, for any fall that has taken place in the value of investments or inventory. In such a case, the final accounts would not disclose a 'true and fair' stage of affairs of the business.

(ii) **Observance of accounting principles:** Students are already aware of the implications of all these requirements; nevertheless, there is a necessity for a fresh look into these with a view to knowing how trading results can be upset if any of these are not properly followed. If the distinction between capital and revenue is not kept in mind in recording transactions, the profit or loss would be wrongly stated; as a consequence, there would not be a true statement of assets in the balance sheet. For example, if an amount representing installation cost of a machine, has been wrongly treated as a revenue expense charged off in the year's account, the profit for the year would be understated to the extent of the charge and the value of machine also would be understated. If the benefit of an expense incurred in a given period is not fully realised within that period, it would be proper to carry forward the appropriate proportion of the expense in the books of account without charging that amount wholly to revenue. For example, if annual insurance premium is paid at the end of third quarter of the financial year of the concern, it would be appropriate that only 1/4th of the total premium should be charged in that year's account and the rest carried forward to be charged off in the next year when the benefit from the premium would be exhausted.

Similarly, if commission has been earned by salesmen for effecting sale within the year, the same should be provided in the accounts irrespective of whether a bill for commission has been received or not within the year. It is a common knowledge that the value of fixed assets depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the concern for earning revenue during a given period. Unless this cost is charged to the accounts, the profit or loss would not be correctly ascertained and the values of fixed assets would be shown at higher amounts. Likewise, current assets, if they are stated at more than the realisable value, the year's profit or loss would not be fairly stated. For example, if the figure of sundry account receivables includes some accounts which are not realisable, this is a loss to the concern and it should be provided as soon as it is known. Also, fictitious assets like a worthless patent, trade mark or developmental expense should be written off at the earliest so that the net value of the business can be really known and the infructuous expenses are absorbed by the revenue earned by the business and the true surplus is reflected in the books as profits.

Inventory-in-trade stands on a slightly different footing in as much as no running account in the financial record is generally maintained for inventory. At the year end, the physical quantities of the inventories in hand are noted and values are applied to them to arrive at the value of the closing inventory. Often the inventory records also provide the basis for ascertaining quantities in hand on the closing day. This being an asset, representing a part of the inventory purchased or acquired in the year or earlier needs to be brought into books of account for a fair ascertainment of the profit or loss. Closing inventory is adjusted in "change in inventories" in the Statement of Profit and Loss for giving effect to the adjustment required in the Profit or Loss and for bringing the inventory as an item in the accounts. It is therefore obvious that any mistake, error or fraud in the aforesaid process of bringing inventory into financial books will have considerable impact on the year's trading results and assets position. To obtain a true and fair view of the accounts, the correctness, appropriateness and consistency of the verification and valuation bases and methods are of great significance.

Students, no doubt, are aware that except for any physical losses that the goods may suffer during the manufacturing process or due to some extra-ordinary factors, *e.g.,* fire or pilferage, there should be no difference in the quantities of opening inventory and the quantities purchased being equal to the quantities of goods sold and those held in inventory at the close of the year. It is the duty of the auditor to verify that there has not been any loss or leakage of goods in the process of trading. He should, therefore, reconcile the closing inventory with the opening inventory on taking into account the quantities of goods purchased and sold. If there is a discrepancy, he must locate the cause thereof. Some of the factors which give rise to discrepancy in the inventory are stated below:

(a) Inclusion in the closing inventory of goods that should have been returned to suppliers and non-inclusion of goods returned by account receivables.

(b) Inclusion in the closing inventory of goods received for sale on approval or on a consignment basis and, conversely, non-inclusion in the closing inventory of goods sent out for sale on approval or on consignment basis.

(c) Failure to adjust the quantities of inventories lost by fire or given away as samples.

(d) Failure to adjust any sales, the proceeds whereof have been misappropriated, or purchases, the bills in respect of which had not been received from the suppliers.

(e) Failure to include goods purchased that were in transit at the close of the year and to exclude goods which had been sold but not delivered.

(f) Non-adjustment of the losses in weight of material in the process.

In this connection, it is necessary to mention that since the closing inventory of one period becomes the opening inventory of the next, it is essential that the inventory should be valued consistently from year to year; otherwise a part of profit or loss of one period will be transferred to the next. On this consideration, Students may also refer to AS-2 on Valuation of Inventories for disclosure of accounting policies in this regard. As a matter of general principle, AS-1 "Disclosure of Accounting Policies" also states that consistency is one of the fundamental accounting assumptions. The change in accounting policy, if any, requires appropriate disclosure.

(iii) **Checking of inventory and record:** The inventory accounts are an integral part of the financial accounts. Therefore, any inaccuracy in one affects the other. It is necessary; therefore, that while checking entries of purchases and sales in the financial books, corresponding entries in the inventory accounts also should be checked. In a large concern, this is a stupendous task, on account of the large volume and variety of inventories purchased and sold. In the circumstances, it is practicable for the auditor to only test check the inventory entries. In case no mistakes are found, he can accept the correctness of entries not checked provided there exists an efficient system of internal check. He must, however, reconcile the quantities of goods purchased and sold with the balance at the close of the year.

5.5.2 Internal Control in Respect of Trading Transactions: Trading is a chain of business process of buying, taking delivery of goods bought, making proper arrangements for their storage and issuing them on sale, etc. The function of audit, in this background, is to ensure that there is no leakage of goods or cash; also that the goods that are purchased have been received and are of the type dealt in by the firm, the prices are normal and the goods have been duly accounted for. It is, therefore, the duty of the auditors to see that the trading establishment, the accounts of which he is called upon to audit, has devised a system of internal control as a safeguard against the losses that may arise out of the foregoing. This he performs by reviewing the system. The principal features of such a system are briefly outlined below:

Buying: Buying should be a function independent of receiving, storage and dispatching. There should exist a proper a procedure for buying, as regards who shall authorise a purchase, on what basis purchases are to be made, from whom to buy and in what quantity, etc.

The goods, if possible, should be purchased by a separate Purchase Department. The department should be constantly receiving information as regards prices prevailing in different supply centres and have knowledge as regards the allowance, if any, that should be made, the price of every commodity prevailing in one centre as compared to that in another on consideration of freight, quality and other allied factors. The buying department should maintain an up-to-date list of suppliers and manufacturers of various commodities, dealt in by the concern with a note on their usual terms of trade and past performance. In respect of commodities or brands which are not so well known in the market, it is desirable that the view of the Sales Department should be obtained before an order is placed for purchase of such commodities or brands. It would also be prudent to avoid bulk purchase of such commodities/brands until consumer acceptance is evident. For purchasing such commodities, there should be a system of inviting quotations from a number of suppliers or manufacturers.

When the purchase department decides to place an order for the purchase of commodities or goods, a purchase order, preferably standardized, should be prepared in quadruplicate; it should specify the name of the supplier, the goods ordered with specifications as to quantity, quality, source, etc., the date of supply and the price agreed to. It should also specify the other terms about delivery, freight, insurance, etc. One copy of the Purchase Order should be forwarded to the Accounts Department and another to the Receiving Department. If the order has been placed on the basis of a sample, the sample should also be forwarded to the Receiving Department. The purchase order forms should be pre-numbered and the internal reference number should be given to identify the purchase indent sent by the Inventory

Department. Any purchase which is initiated on indent of any section other than the Inventory Section should be authorised by the concerned departmental head and manager.

Receipt of goods: The responsibility for the receipt of all incoming goods should be centralised in a separate department. The responsibilities of the Receiving Department should be the following-

(a) Verifying all receipts as to the quality and quantity by comparison with the copy of the purchase order issued by the Purchase Department and the forwarding challan of the supplier. The goods should be checked for damage, leakage, etc.

(b) Entering the goods immediately on receipt in the Goods Inward or Goods Received Book.

(c) Drawing up in quadruplicate a Goods Received Note for each consignment.

(d) Transmitting the material in the Inventory Department along with a copy of the G.R. Note as aforementioned and obtaining a receipt for the goods for constituting the record of the department.

Before accepting the goods, the Inventory Department sends a note to the Inspection Department for checking the quality and specification. Only on getting a clearance from this department, the goods are accepted. A copy of the Inspection Note is usually attached to the Goods Received Note.

The original copy of G.R. Note should be retained in the Receiving Department as a permanent record of receipt, preferably bound up in the numerical sequence of receipts. One copy of the note should be handed over to the supplier for being enclosed with the invoice he would be sending for the supply made. The second copy should be forwarded to the Inventory Department along with the goods and the third copy to the Purchase Section to enable it to follow up any non-supply or short supply made by the supplier. It would be a good internal check if the Accounts Section, before passing any invoice for supplies made, compares the suppliers' copy of the note as enclosed with the invoice with that in the Inventory Department because it is from that copy that entries in the inventory records have been made.

Storage:

(*a*) No sooner the quantity of any article in the godown reaches the ordering level specified on the Bin Stock Card then the inventory-keeper should prepare an indent, stating the particulars of goods to be purchased, the quantity required, the date and quantity of goods which was last ordered, the name of the party from whom the goods were obtained and other particulars considered relevant. The indent should be forwarded to the Purchase Department.

(b) The goods should be stored in a manner to ensure that:

  (i) they are easily accessible and at no time are obscured from view;

  (ii) they do not suffer any deterioration during storage;

  (iii) they occupy the minimum amount of space;

  (iv) necessary segregation has been made in the matter of storage of fast moving and relatively slow moving items and easier accessibility has been arranged for the former type.

Also, it should be ensured that the goods are adequately insured against fire, theft, etc. and that conditions of the insurance policy are complied with.

Issues:

(a) All deliveries from the sales-godown under all circumstances should be made on delivery notes signed and authorised by the Sales Department. Where credit is to be allowed to the account receivable, the Sales Department should obtain the prior approval of the Accounts Departments.

(b) The requisition slip should be prepared in quadruplicate. The original copy should be retained by the Sales Department as a permanent record of the sale made. Two copies should be forwarded to the Inventory Department. This department in turn should retain one copy in its record as evidence of goods having been issued, after it has been acknowledged by the Despatch Department and surrender the other to the Despatch Section along with the goods. The fourth copy should go to the Accounts Department. It will the basis on which the Accounts Department shall prepare the bill for the account receivable on receiving a copy of the despatch note from the Despatch Department.

(c) The Inventory Department, on releasing the goods, should make an entry on the Bin/Stock Card.

(d) The goods on release from the sale godown should be sent to the Despatch Department, alongwith both the copies of the requisition slip; one should be obtained back duly signed in acknowledgement of the fact that the goods have been received for despatch. It should be placed on the file in the Inventory Department.

(e) After the goods have been despatched, the Despatch Department should prepare a despatch note in quadruplicate. One copy of the note should be forwarded to the Accounts Department and another to the Sales Department for reporting to it that the goods sold have been despatched; from the third an entry would be made in the Goods Outward Book; and the fourth is to accompany the goods.

(f) The requisition slip forms should be pre-numbered and the control over them should be kept by the Sales Department. All forms that are spoiled should be kept in the file.

(Students may note that the person who has got finished inventory in his custody is described as the inventory-keeper and the department dealing with the goods as the inventory department. Likewise, the person who has in his custody the stores of raw materials, manufacturing stores, etc. is described as the store-keeper and the department is referred to as the stores department.)

The provision of service also constitutes trading, *e.g.,* those rendered by a contractor, estate agent, repairer of motorcars, etc. In those cases, the internal check should provide for the regulation of the charges for the services rendered, either according to an agreement entered into with the parties to whom the services have been provided or on the basis of costs incurred in providing the service a record in respect whereof is maintained. For instance, the charge for a construction job should be regulated according to the agreement entered into with the party; and in case any subsequent modification has been made therein, involving additional work, the charge should be modified accordingly. A motor repairing workshop or an estate agency office should regulate its charges according to the time taken and the expenses incurred in rendering the services. Similarly, a solicitor should charge for the specific item of work handled for the client. A record of work done should be maintained in the time sheets or in diaries which should be posted regularly, to obviate the possibility of the client being undercharged.

It is the duty of the auditor to verify that an appropriate internal check exists in respect of different types of transactions entered into by the client to ensure that all the income receivable has been properly accounted for and adequate precautions have been taken to control expenses.

5.6 Audit of Purchases

The purchases on credit should be verified by reference to the suppliers invoices to which generally copies of delivery notes, disclosing the dates and particulars of goods received and acknowledged by the Receiving Department, are also attached. While vouching entries for purchases with the invoices, the following points should be specially observed:

(a) that the date of invoice falls within the accounting period;

(b) that the invoice is made out in the name of the client;

(c) that the supplier's account has been credited with the full amount of the invoice and that the deduction in the amount of the invoice, if any, has been made on a proper basis;

(d) that the goods purchased are those that are regularly dealt in by the concern or required for the process of manufacture carried on by it and that the price payable has been correctly arrived at;

(e) that the cost of purchases has been debited to an appropriate nominal account or accounts;

(f) that the invoice is signed by the accountant to show that he has verified it as well as the store-keeper to indicate that the delivery of goods have been taken by him. If the invoice relates to the purchase of a technical store or a chemical, the price whereof is dependent on its quality, a copy of the report of a technical person showing that the article purchased is of the specification for which the order has been placed; and

(g) that the manager or some other official, competent to sanction payment, has authorised its payment.

Classification of purchases: For controlling expenditure on purchases it is essential that these should be classified under the following heads-

(i) Purchases of raw material, for each material separately.

(ii) Purchases of finished goods.

(iii) Purchases of consumable stores, fuel etc.

(iv) Purchases of packing materials, etc.

(v) Purchases of articles like stationery for office use.

(vi) Purchases for making additions to assets.

5.6.1 Special Precautions in Verification of Purchase Invoices

(i) When an invoice runs into several pages and the total of each page has been carried forward to the next or where the amount of an invoice has been distributed over several accounts, it should be confirmed that the amounts relating to different parts of the invoice have been adjusted together. When the total amount of the invoice has been adjusted in separate accounts, the entire amount so adjusted should be added together to confirm that there has not been error under adjustment.

(ii) At times, invoices are received in duplicate and even triplicate. In such cases, payment usually is made on the basis of the original invoice. Sometimes, however, the original is kept in record and the price is adjusted on the basis of the duplicate. In such a case, it should be confirmed that the original invoice has also been paid or adjusted separately.

(iii) Often supplies are received on certain special conditions. In such cases, it should be verified that these are the same as were agreed to at the time the order was placed, *e.g.,* payment of freight and insurance charges of goods while in transit, etc. If the amount of an invoice was payable after the lapse of some time, subsequent to the receipt of goods, it should be ascertained that it has not been paid earlier and the benefit of cash discount, if any, has been obtained. Where a trade discount has been deducted from the amount of the invoice, it should be seen that only the net amount has been credited to the supplier.

(iv) Where goods have been purchased for the use of an officer or a subordinate but the invoice is made out in the name of the concern for obtaining the benefit of trade discount, it should be seen that the cost has been charged to the person concerned and not to the Purchases Account.

(v) Purchases of goods from the allied and associated concerns can be made only under an appropriate sanction.

(vi) If the case of an invoice addressed to an individual, particular care should be taken when vouching such an item, since the individual may have attempted to procure goods for his own use while allowing the company to pay for them. The system of internal check for purchases should be such as to preclude such a possibility. Nevertheless, it should be seen whether the goods are of a type which the company usually requires, and whether the invoice has been duly checked by someone other than the individual to whom it was addressed.

The delivery note and the goods inward note should be examined and it should be seen that the goods were inspected on arrival. Further evidence should also be sought to establish whether the goods were actually received into inventory. The original order for goods should have been duly authorised by a responsible official. The firm supplying the goods should be requested not to submit invoices addressed in this way.

(vii) If materials are bought for delivery direct to a account receivable, the exact circumstances of the transaction should be ascertained and the reasons for the goods having been delivered direct to the account receivable. The auditor should make appropriate inquiries in order to establish that the transaction was appropriately authorised by a responsible official. A copy of the delivery note signed by the account receivable on delivery of the goods should be examined, and it should be ascertained whether the account receivable is a regular purchaser of the company's goods and not an employee of the company wishing to take advantage of a weakness in the system. The original order should also be seen to have duly authorised by the appropriate official, and if this practice is a regular feature of the company's mode of transacting business, the system of internal check should be such as to ensure that no fraud may by perpetrated as a result of this practice. The payment for the goods, if it has been received, should be vouched to the cash book and bank statement.

(viii) Though it is not practicable for an auditor to verify that every item of goods purchased has been entered in inventory, he should trace into the inventory record at least purchases of goods during the opening and closing months and accept the correctness of the rest only if he is satisfied that there exists a system of internal control which prevent payment being made for any goods not received in inventory.

5.6.2 Failure to Check Inventory: Some of the frauds which audit may fail to disclose unless inventories are checked are the following-

(i) Suppose there are two cotton mills- Alfa and Beta, and have a common managing director. The mill Alfa closes its accounts on December 31, and mill Beta, on March 31. Further, suppose that when the accounts of Mill Alfa for the year ended December 31, 2014 are prepared in January 2015, the managing director of the mill decides to transfer a part of the profits earned to mill Beta.

To give effect to such a design, mill Alfa enters into an agreement in February 2015, with mill Beta but ante-dates the agreement to November, 2014. It provides that mill Alfa shall purchase 5,000 bales of cotton at ₹ 195, per bale from mill Beta. On the basis of this agreement a book entry showing that 5,000, bales have been purchased in November, 2014, is recorded in the books of the mill Alfa for the year ended 31st December, 2014, and their price is credited to the account of mill Beta, corresponding entries are recorded in the books of account of mill Beta. In pursuance of the entry 5,000 bales of cotton are included in the closing inventory of mill Alfa valued at ₹ 190 per bale, the supposed market price. As a result the profit of mill Alfa is reduced by ₹ 25,000.

Subsequently on 28-2-2015 another contract is entered into by mill Alfa to sell 5,000 bales of cotton to mill Beta ₹ 185 per bale. The corresponding entries are duly recorded in the books of mill Beta. The net effect of both of these entries is that the profits of mill Beta are increased by ₹ 50,000 for the year ended 31-3-2015 and those of mill Alfa, for the year ended 31-12-2014 are reduced by ₹ 25,000 and by the same amount those of the year ended 31-12-2015 also. In fact, neither any bales of cotton are received by the mill Alfa from mill Beta nor they are sold back to Beta. Also neither any price is paid by mill Beta on purchasing neither the bales nor any sale price is received on the bales being sold back.

Students will observe that the foregoing transactions have been represented merely by book entries, as contemplated by clause (b) of Sub-Section (1) of Section 143 of the Companies Act, 2013. Such a fraud may not be discovered, unless the auditor checks entries of purchases and sales of the bales of cotton in the inventory books of the respective mills or carefully takes note of the associated nature of the companies and diligently scrutinizes transactions of the subsequent period.

(ii) A commercial concern dealing in mill stores enters in its accounts several invoices showing that it has purchased mill stores from a number of suppliers. All the purchases have been made for cash and the entries are duly supported by printed invoices showing the names and addresses of the suppliers that are false. All the payments have been duly acknowledged by the parties. The auditor of the concern, not suspecting any *mala fides,* accepts the invoices as correct without tracing the purchases into the inventory book. In fact, no mill stores had been purchased and the transactions entered into merely to reduce profits. The fraud remained undetected due to the failure of the auditor to trace the purchases into the inventories of the concern and preparing a inventory-tally of goods purchased and sold.

(iii) There have been several cases in the past wherein it has been found during liquidation proceedings that the management has overvalued its closing inventory to show a profit larger than what the company has actually earned. In all these cases, fraud would have been detected if the auditor had verified the quantities and value of inventories at the close of the year.

All these cases related to the period before the Companies Act was amended in 1956. Therefore, the auditor escaped liability for professional misconduct. Until then it was possible for the auditor to accept the value of inventory declared by the management. But this is not possible now. Under the present circumstances, a duty is cast on the auditor to verify the closing inventory in the manner stated in Chapter 6.

5.6.3 Gross Profit

(i) **Factors which increase the gross profit:**

(a) Undervaluation of opening inventory; it may be either the effect of non-inclusion of certain items of inventories or that of valuation of the inventory at a rate lower than that warranted by the basis of valuation adopted or miscalculation of the value of one or more items of inventory. In such a case, the increase in the rate of gross profit would be preceded by a fall in the rate of gross profit in the previous year.

(b) Overvaluation of closing inventory, either by the inclusion therein of fictitious items of inventory or over-statement of values of some of them.

(c) Alteration of the basis of valuation of closing inventory, e.g., where the opening inventory was valued at cost or market rate whichever was lower, valuing the closing inventory at the market price which is higher than cost.

(d) Increase in the values of some of the items included in the opening inventory (which were valued at market rate which was lower than cost) above cost, on account of which the unsold inventory of these items at the close of the year is valued at cost.

(e) Under-statement of opening inventory or over-statement of closing inventory, due to adjustment of the amount of sales, when goods sold but not delivered are included in the closing inventory or when goods were delivered and taken out of inventory last year, but sales invoices is raised in the current year.

(f) Inclusion in the closing inventory of goods returned awaiting despatch to supplier, the cost of which has been debited to them or goods returned by account receivables, the cost whereof has not been credited to parties.

(g) Inclusion in the closing inventory of goods received for the sale on approval or on a consignment basis.

(h) Treatment of goods sent out for sale on consignment basis as regular sales.

(i) No provision or under-provision in the expenses accounts included in the Trading Account. For example, purchase may be understated; provision for outstanding wages or carriage inward may not have been made.

(j) Wrong allocations of expenses, *e.g.,* carriage inwards either in whole or in part may be wrongly taken to the Statement of Profit and Loss.

(ii) **Factors which decrease the gross profit:**

(a) Over valuation of the opening inventory or undervaluation of closing inventory either due to mistakes made in taking inventory or in its valuation.

(b) Alteration of the basis of valuation of inventory, e.g., closing inventory having been valued at cost, which is below the market price, when the opening inventory was valued at market price above cost.

(c) Inclusion in the year of the amount of goods purchased in the previous year, that were received and where taken in the same year.

(d) Reversal of the fictitious sale entries recorded in the previous year to boost up profit.

(e) Entry of sales returns twice or failure to account for purchase returns when the goods in question have been sent back.

(f) Excessive provisions have been made for wages or direct expenses.

(g) Failure to include in closing inventory goods sent out for sale on approval or on a consignment basis.

(h) Omission to adjust the value of unused inventory of consumables stores, such as fuel and packing material or inclusion in Trading Account expenses which should have been included in the Profit in the Loss Account.

(i) Failure to take credit for the amount of an insurance claim in respect of a consignment of goods lost in transit or destroyed by fire.

(j) Failure to account for goods sold or destroyed or given away as samples.

From the aforementioned statement of factors affecting gross profit, it would be evident that it is affected by every failure to properly account for values receivable and payable at the time a benefit accrues or is given away. Such a position can arise in a multiplicity of situations, only some of which have been listed above.

The auditor must also take steps to verify that the amount of profit has not been overstated, *e.g.,* by the inflation of sales or closing inventory, by understatement of purchases and expenses or by omission to credit account receivables' accounts with the value of goods returned by them, etc. The figure of profit can also be inflated by the failure to provide for losses and depreciation or reduction in their value, for instance, by not making adequate provisions for bad debts, for discounts payable on the recovery of book debts or for any fall that has taken place in the value of investments or inventory accounts would not disclose a true and fair state of affairs of the business.

Likewise it should be verified that profits have not been understated.

5.6.4 Purchases Returns: If a part or whole of a consignment of goods found to be defective or of a poor quality, the goods sometime are returned to the supplier and his account is debited. The debit is raised in the Purchase Returns Books, on the basis of Debit Note. The supplier, on receiving the Debit Note, issues Credit Note indicating his acceptance of the debit. Thus, on receipt it is attached to Debit Note. All these entries should be verified by reference to the record kept in the Goods Outwards Book or the Stores Record. The original invoices through which the purchases were made also should be referred to for confirming that the nominal account, which was originally debited on the purchases being made, has been subsequently credited on a part or whole of the goods contained in the consignment having been returned. Where the purchase returns are large, either at the beginning or at the close of the year, these might be fictitious, entered to cover bogus purchases recorded earlier. On such a consideration the nature thereof should be ascertained. The rebate in price and allowances granted by the suppliers should be adjusted through the journal on the basis of Credit Notes received from the suppliers. These should be verified by reference to the original invoices.

5.6.5 Schedule III- Disclosure requirement to the Statement of Profit & Loss:

A Company shall disclose separately by way of notes on the face of the Statement of Profit and Loss additional information regarding aggregate expenditure and income as under:-

(a) In the case of manufacturing companies,—

(1) raw materials under broad heads.

(2) goods purchased under broad heads.

(b) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.

(c) In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.

(d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.

(e) In the case of other companies, gross income derived under broad heads.

5.7 Sales

The student should refer to Spicer and Pegler's book for the details in the matter of internal check on sales that should be exercised and the extent to which checking of individual entries in the Sales Day Book can be dispensed with when it is proper and effective. The credit sales should be verified by reference to copies of invoices issued to account receivables and, in the process, attention should be paid to the following matters:

(a) that each item of sales relates to the period of account under audit;

(b) that the goods are those that are normally dealt in by the concern;

(c) that the sale price has been correctly arrived at and the copy of the requisition slip issued by the Sales Department and the copy of the Despatch Note showing the date and mode of despatch of goods are attached with the invoice;

(d) that the amount of the invoice has been adjusted in an appropriate account; and

(e) that the sale has been authorised by a responsible official and in token thereof he has initialed the invoice; also that any alteration in the invoice has been attested by the same person.

It should be generally verified that the sales have been made at a uniform rate, and on identical terms as regards payment of freight, sales-tax, packing, forwarding charges, etc. The additional charges recovered along with the sale price should be credited to separate accounts, appropriately headed, and not to the Sales Account. When a trade discount is allowed, the amount thereof should be deducted from the sale price. Where any special trade discount has been allowed, the reason thereof should be ascertained. The different types of sales should be classified under the following heads:

(1) Sale of raw materials.

(2) Sale of finished goods.

(3) Sale of empties and other packing materials.

(4) Sale of assets.

Small concerns generally do not have well organised Sales and Despatch Departments. In such cases, for verifying sales the auditor should trace a small proportion of sales invoice into the Inventory Book, especially of goods sold at the beginning and at the close of the year. Such a step is essential for verifying that the sales of goods issued in the previous year or years have not been adjusted in the accounts of the year under audit, also that the goods sold during the year have not been erroneously included in the closing inventory. This would also disclose any bogus sales debited to the accounts of fictitious account receivables for which payments have not been received. In the case of sales to directors as well as to associate concerns, it should also be verified that these have been made at market rates. The sale of goods on hire-purchase basis of the goods sent out on sale or return basis or on consignment basis should be separately recorded. When credit sales are not adjusted in the accounts at the time they are made but at the time the sale proceeds are collected, there can be no guarantee that any amount collected in such sales has not been misappropriated. The auditor should, therefore, draw the attention of the management to the risk involved in adopting such practice; also in such a case he should not certify the correctness of any amount outstanding for recovery shown in the Balance Sheet in the absence of confirmation of the balance by the account receivables.

5.7.1 Schedule III- Disclosure requirement to the Statement of Profit & Loss:

A Company shall disclose separately by way of notes on the face of the Statement of Profit and Loss-

(i) In respect of a company other than a finance company:

Item I. Revenue from Operations

Revenue from—

(a) Sale of products;

(b) Sale of services;

(c) Other operating revenues;

Less:

(d) Excise duty.

(ii) In respect of a finance company:

Item I. Revenue from Operations

Revenue from—

(a) Interest; and

(b) Other financial services.

The auditor should see that a separate record in respect of these items has been maintained for purposes of disclosure.

5.7.2 Goods Sent Out on Sale or Return Basis: A record of goods sent out on sale or return basis should preferably be kept in a specially ruled Day Book. In this book first memoranda entries are made; and only after the goods have been sold entries are made debiting the party and crediting the Sales Account. The auditor should refer to 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, also that the goods in respect of which the period of approval has expired at the close of the year either have been received back subsequently or account receivables' accounts have been debited. Further, that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the close of the year, has been included in the closing inventory.

5.7.3 Sales Returns and Allowances: From time to time accounts of account receivables are credited with the value of goods returned and the rebates and allowances sanctioned on one account or another. The entries are passed on the basis of credit notes issued to account receivables. The credit note contains complete particulars of the credit allowed and the basis on which it has been allowed. In each such case the auditor should verify that credits for goods returned have been allowed on the basis of the record maintained in the stores in respect of goods received back in the Goods Returned Book; also that rebates and allowances have been allowed in accordance with the policies and practices of the business. To verify credits in respect of goods returned, the auditor must check entries in the Goods Inward Book kept at the factory gate. He must further verify, on a reference to the memo prepared when the goods were returned, that the goods in fact were defective and the defect was not one which occurred subsequent to the case on which the goods had left the factory premises. If such a memo is not on record, the management should be advised that a responsible official should examine the goods on their return and prepare such a memo.

When there is long time lag between the dates of the sale and that of return of the goods, the reasons for the same as well as the conditions, in which the goods have been received back, should be ascertained. For it could be that the account receivable had returned the goods on its price having fallen, on one or the other pretext with the connivance of the sales staff.

The credit given to allied or associated concerns on account of goods returned by them should be specially examined to verify that the goods have been returned due to some valid reasons and the credit does not represent the reversal of fictitious sales earlier entered in their account. Allowances are granted to account receivables of a number of reasons; goods having been supplied short or goods having suffered damage while they were in transit, some defect in their quality, etc. The auditor should verify that these have been granted under a proper authority and on a due consideration of a claim and of the policies of the business in these matters. If considered necessary, correspondence with the party, the quantities and value of goods supplied and those returned out of them also should be verified.

We have considered earlier how a dishonest book-keeper might misappropriate the amounts received from account receivables by entering false credits in their accounts on account of rebates and allowance on the return of goods. This possibility should be kept in view while verifying the aforementioned credits.

5.7.4 Empties: When the empties or containers in which goods necessarily have to be supplied are costly, the manufacturers normally agree to purchase them back at a reduced price as compared to the one charged for them. In such a case, it is necessary to keep a separate account of the empties "issued and received" and the number of them held by the account receivables, which they may return after the close of the year. The auditor should see that this has been done and also that a provision has been made against the contingency of the containers being returned by account receivables and that for the wear and tear which they would suffer in the process.

5.7.5 Consignment Sale: Where the number of consignments sent out in a year is large, usually a separate consignment Sales Day Book and Ledger are kept. In that case, the entries in the Day Book in respect of price of goods sent out and expenses incurred on their transport and insurance should be verified with copies of proforma invoices and other relevant documents; the sale price of goods sold and expenses incurred by the consignee should be verified from the Account Sales.

The balances in the Consignment Ledger, at the end of the year in such a case, would represent the cost of unsold goods, including a proportion of non-recurring expenses incurred on their transport and insurance. These balances should agree with those shown in the respective account sales received from the consignees.

If the goods sent out for sale on consignment have been charged at the invoice price, the difference between the cost and the invoice price would be credited to the Consignment Stock Adjustment Account. The appropriate part of the amount credited in this account attributable to the inventory remaining unsold at the year end, should be reversed so that credit can be taken for the net amount representing the difference for the part actually sold.

5.8 Cut-Off Arrangement

Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separate from those in the ensuing period so that the results of the working of each period can be correctly ascertained. The arrangement that is made for the purpose is technically known as "Cut-off arrangement". It essentially forms part of the internal check of the organisation. Accounts, other than sales, purchases and inventory are not usually affected by the continuity of the business and, therefore, this arrangement is generally applied only to the aforesaid accounts. The auditor satisfies by examination and test checks that the cut-off procedures adequately ensure that:

(i) goods purchased, property in which has passed to the client, have in fact been included in the inventories and that the liability has been provided for in case of credit purchase; and

(ii) goods sold have been excluded from the inventories and credit has been taken for the sales; if the value of sales is to be received, the concerned party has been debited.

The auditor may examine a sample of documents evidencing the movement of inventories into and out of stores, including documents pertaining to period shortly before and after the cut off date and check whether inventories represented by those documents were included or excluded as appropriate during inventory taking.

5.9 Audit of Ledgers

5.9.1 General Considerations: The audit of ledgers generally involves the under mentioned steps-

(i) Testing the strength and quantity of internal check;

(ii) Tracing the opening balances from the previous year's records;

(iii) Checking the postings from subsidiary books and, if they are kept on the self-balancing system, also tallying the totals of balances in subsidiary ledgers with those in the total of control account;

(iv) Checking the closing balances of individual accounts on the balance schedules afterwards from the schedules on to grouping schedules and then into the final accounts;

(v) Checking the totals of ledger accounts, trial balance, schedules and groupings;

(vi) Verifying the balances in personal accounts, either with the statements of account or confirmation of balances obtained from the parties; verifying the balances in impersonal accounts, *viz*., those of fixed assets, bank balances, etc. with the schedules containing details of assets and liabilities as well as those of nominal accounts (featuring various items of income and expense by reference to the documentary evidence which may exist in a variety of forms to ensure that all the outstanding amounts, both receivable and payable have been properly adjusted);

(vii) Scrutinizing the accounts generally and, in particular, examining the composition of final balances; and

(viii) Ascertaining the extent of clearance of the balances brought forward from the previous year particularly those relating to receivables and payables, sale or disposal of fixed assets and of inventories.

The audit of ledgers is thus an important step in the process of verification of the correctness of Final Accounts. It is an occasion to review the transactions entered during an accounting period, duly classified, in the totality; also that of studying the relationship which exists between different sets of figures. Ledgers, therefore, should be examined carefully and comprehensively. The composition of the balance of each account should be scrutinised and, if a doubt arises, the transaction or the set of transactions, which have given rise to the doubt should be examined in depth.

When a comprehensive and effective system of internal control exists, it is possible to limit the routine checking of ledgers by the application of test checks as stated below:

(i) verifying the postings into the ledgers from the various books of prime entry;

(ii) verifying the totals of the account;

(iii) tracing the balances of the personal and nominal accounts from the ledgers into the schedule of balances;

(iv) comparing schedules totals with the balances in the Control Accounts; and

(v) checking the position of the daily entries into Control Accounts.

The foregoing audit tests are applied to a selected group of entries in the ledgers. Alternatively, steps (i) to (iv) should be applied to accounts for parts of the year determined on a selection. However, the posting of the Control Accounts should be verified for the whole year. In selecting the period or periods of verification of posting and totals, preference should be given to the accounts the composition whereof is not clear or in which items on either side cannot be correlated. Moreover, instead of certain periods being selected for the application of test checks, a few accounts could be selected for being test checked for the whole of the year.

If, however, the system of internal control on application of procedural tests is found to be ineffective, it would be necessary for the auditor to extend the programme of verification of balances of the accounts in the ledgers as aforementioned. In doing so, the auditor should take into account the existence of possibilities of frauds being committed through manipulation of entries in the ledgers, for example, the possibility of the ledger clerk colluding with others for misappropriating amounts collected from the account receivables and subsequently covering up misdeeds by adjusting fictitious credit in the account receivable accounts.

Such a fraud in a ledger would not be disclosed merely on extracting balances from the ledger and agreeing their totals with the balance in the respective Control Accounts, since the balances, despite the fraud, would agree. It would be discovered either on postings being checked in detail, or on obtaining detailed statements of account from account receivables and comparing them with those stated in the books of account.

5.9.2 Ledger Keeper and Frauds: For studying the various avenues which are open to a ledger-keeper to commit a fraud, the auditor should find out whether the ledger-keeper extracts balances of account receivables and account payables from the ledgers and agrees their totals with their balances in the Total Accounts; also whether the balances when they have been extracted, are subsequently checked by some other official; further, whether he has access to the account receivables and account payables; also if he meets them, does he do so on his own or in the presence of responsible official?

Some of the frauds which may be committed by a ledger-keeper are stated below:

(i) **In the Bought Ledger-**

(a) Crediting the account of a supplier on the basis of a fictitious invoice, showing that certain supplies have been received from the firm, whereas in fact no goods have been received or on the basis of duplicate invoice from a supplier, the original amount whereof has already been adjusted to the credit of the supplier in the Bought Ledger, and subsequently misappropriating the payment made against the credit in the supplier's accounts.

(b) Suppressing a credit note issued by a supplier in respect of return or an allowance and misappropriating an amount equivalent thereto out of the payment made to him. For if a credit note issued by a supplier either in respect of goods returned to him or for an allowance granted by him, is not debited to his account, the balance in his account in the Bought Ledger would be larger than the amount actually due to him. The ledger-keeper thus will be able to misappropriate the excess amount standing to the supplier's credit.

(c) Crediting an amount due to a supplier not in his account but under a fictitious name and misappropriating the amount paid against the credit balance.

(ii) **In the Sales Ledger-**

(a) Teeming and lading method. This method has been explained in Chapter 3.

(b) Adjusting an unauthorised credit or fictitious rebate, allowance, discount, etc. in the account with a view to reduce the balance and when payment is received from the account receivable, misappropriating an amount equivalent to the credit.

(c) Writing off the amount receivable from a account receivable's bad debt account and misappropriating the amount received in payment of the debt.

(iii) **In the Nominal Ledger-**

(a) Allocating an item of income or expenditure wrongly, e.g., an item of capital expenditure being charged as revenue and vice versa; and

(b) Understating or overstating the value of inventories, amount of prepaid expenses or liability.

Verification of Posting:

(a) The selection of accounts for checking postings should be made on the same consideration as that accounts, the balances whereof require to be confirmed directly as stated hereinafter. Moreover, either all postings should be checked for only a part of the period covered by the audit or only a few accounts selected for the whole period.

(b) Subsequently, when the closing balances in a ledger are checked, it should be confirmed that postings in the ledger to the extent specified in the Audit Programme have been checked; also that the totals of the balances have been checked. If there is any item in any account in a ledger, the posting whereof has not been checked indicated by absence of the relevant tick against the item, the reason thereof should be ascertained.

(c) Each ledger account should be seen through to confirm that all the entries therein are posted in a chronological order; no entry has been made in between two entries and the figures of an entry have not been altered; also that there is no entry which has been posted directly into the ledger before being recorded in a book of original entry. In each such case, the genuineness of the entry or entries should be verified, for these could be the results of attempts made by the ledger-keeper with an ulterior motive.

Finally, it should be confirmed that all the ledger balances are inked. As a safeguard against the ledger-keeper making an entry in a ledger after the same has been checked, it is usually advisable that until the audit has been completed all the ledgers should remain in the custody of the auditor. The opening balances should be checked, wherever practicable, with the balances shown in the auditor's own copy of trial balance, schedules and groupings of the previous year. Alternatively, these should be checked with the balances shown in the Balance Sheet, as at the end of the year.

While checking the closing balances or the groupings of balances, a memo should be prepared as regards particulars of various balances which need to be disclosed in the Balance Sheet, as well as of matters in respect of which either sanction has to be obtained or adjusting entries have to be passed.

5.9.3 Scrutiny of Ledgers

(i) Bought Ledger: The structure of every account in the Bought Ledger is : opening balance, credits on account of goods purchased and debits raised in respect of returns, allowances and discount receivable, advances paid against goods, payments and transfers. Usually, it is possible to link up each amount on one side of the account, with one or more accounts on the other side; only the amounts which cannot be correlated require a detailed scrutiny. Generally, it should be verified that payments for goods have not been made long before they were due; nevertheless, they have been made within the period of credit, to take advantage of the cash discount allowed by the supplier. The scrutiny of the accounts would show that payments for goods normally have been credited in the order in which their costs have been credited in the accounts. Therefore, if in any case no payment has been made against the opening balances or against any particular item of credit, the reasons thereof should be ascertained. Likewise, credit entries which cannot be correlated with those on the debit side should be enquired into to confirm that they are not fictitious.

It should be further seen whether full payments for purchases have been made at a time or in parts. In the cases where payments have been made in parts, the reasons for such a practice having been followed should be ascertained. Further, when payments to a supplier are usually made by accepting Bills of Exchange but one or more amounts have been paid in cash, the reasons therefore should be ascertained. It would be observed that in respect of goods returned back, as well as allowances allowed by the supplier, either separate payments have been received or the amounts therefore have been deducted out of subsequent payment made for goods purchased. Where this has not been done, the reasons should be ascertained.

The accounts in the Bought Ledger, usually, are in credit. The composition of the balance of each amount should be scrutinised. If it is not clear, reference should be made to the account of the party as shown in the ledger for the previous year or in the one for an earlier year. The composition of each balance will indicate the group in which the balance in the account should be included for statement in the Balance Sheet. When the amount of the opening balance of the account of the cost of goods purchased earlier has not been paid but the goods purchased subsequent thereto have been paid, the reasons for the non-payment of the amount or amounts should be enquired into. It could be that the liability to pay the amount is disputed or is totally denied. The auditor should examine these claims to assess the liability of the client and may then have the balances adjusted and disclosed accordingly. If the liability is totally denied, the amounts should be written back. But when it is partially admitted, these should be reduced to the extent admitted.

If the account of a supplier has been credited at the end of the year with large sums of money, the basis of the credit should be enquired into as it might be a fictitious credit with a view to suppressing profits. If certain goods purchased from a party have been subsequently sold back to him, enquiries should be made to find out if the transactions of the purchase and sale are not mere book entries, hit by Clause (b) of sub-section (1) of section 143 of the Companies Act, 2013. When a balance in an account has been outstanding for payment for an inordinately long time, enquiry should be made to confirm whether the balance in fact is payable.

An account in the Bought Ledger may be in debit. The balance may represent the amount receivable on account of goods returned, rebate allowed by the supplier or advance paid against an order. The auditor should confirm that the advance against the order had been paid in pursuance of a recognised trade practice, also that subsequently goods have been received against the advance or will be received, for such an advance may represent a disguised loan to accommodate a business associate. The book balance also may represent the cost of goods purchased wrongly debited to the account of the supplier, instead of the Purchase Account.

In each such case, it should be ascertained that the book balance is good and recoverable and if it is not considered recoverable, a provision against the same has been made. The book balances should be appropriately classified for purposes of disclosure in the Balance Sheet.

If the debit balance represents a loan to a director or officer of the company, either jointly or severally with another person or it is a debit due by a firm or a private company in which the director is a partner or a member, the same should be separately disclosed in the Balance Sheet in accordance with the provisions contained in Schedule III to the Act. Students may note that in view of section 185 of the Companies Act, 2013 a loan or an advance paid to a director, represented by a book debt which from its inception was in the nature of a loan, is to be regarded as a loan.

(ii) Sales Ledger: The structure of each account in the Sales Ledger is opening balance, debits representing values of goods sold, payments made for goods returned and transfers. The credits represent amounts received for goods sold, advances received against orders, discounts and allowances allowed, value of goods returned back and debts written off. If amounts on either side of each account are checked with the corresponding amounts on the other side, the discrepancy, if any, would be discovered.

It should be seen that the account receivables' balances are being collected promptly, otherwise the capital of the client would be locked up unproductively; also the risk of bad debts and misappropriations would be greater. Therefore, when the examination reveals such a position the auditor should bring this fact to the notice of the management.

If, during the course of examination, it is found that the opening balance in an account or an amount of sales has not been collected, while the amount of sales made subsequent thereto have been duly recovered, it could be that the account receivable is disputing the liability to pay the amount or that the cash collected in payment of the amount has been misappropriated. It may also be found that the debit balance in an account has been collected in parts. It could be the result of misappropriation practiced by the teeming and lading method. All these matters, when noticed, should be fully investigated.

When the payments for sales to a account receivable have been received in parts, it would be beneficial for the client to adjust the amounts received against amounts which have been outstanding the longest. The auditor should confirm that the client is aware of it and has acted accordingly.

Where it is discovered that the returns out of sales, made in the year or years, have been adjusted in the accounts during the year under audit, the justification for such a delayed adjustment should be enquired into, for it could be that the account receivable has been allowed to return the goods, only as a matter of favour. Likewise credit balances resulting from the allowance of discounts and rebates should be scrutinised to confirm that these have been availed of within a reasonable time. If any allowance has been adjusted against an amount recoverable for the goods sold, it should be verified that the allowance is not fictitious, for it could be one which has been adjusted by a dishonest book-keeper with a view to covering up a fraud committed by an employee, by misappropriating the cash collected from the account receivable.

While checking the account receivable's balances, the auditor shall have an opportunity to comprehensively review all the transactions entered into with each of them. If, in the process, he finds that there are any old balances which have not been collected, the possibilities of an amount collected having been misappropriated should be investigated. For the purpose, the auditor should obtain from the account receivable either confirmation of the balances or copy of his statement of account, admitting that the amount is infact payable by him.

If a sale has not been recorded, though the ledger account would not contain an entry in respect thereof, it may contain an entry showing that a credit for the goods returned or an allowance has been adjusted in his account which has been paid to him in cash. This would show that the original sale has not been recorded. Such a discovery may lead to the unearthing of an organised scheme of fraud.

A clever employee who has misappropriated an amount paid by a account receivable might attempt to adjust the debit in the account receivable's account before the close of the year by paying in a bogus cheque. The cheque, no doubt, would be received back unpaid in the beginning of the next year. But the non-payment of the cheque would not be detected until the bank account is reconciled. Therefore, when the bank reconciliation statement shows that the cheque of a party has been received back unpaid, the auditor should find out whether the amount due from him has been or will be recovered.

If the amount paid by a account receivable has been misappropriated, though the balance in the account would be outstanding for payment, it would not be recoverable. It is only on this consideration that there exists an audit practice according to which confirmation of balance is obtained from account receivables and account payables directly at the close of each period.

If the balance in an account has been settled for a smaller sum, the nature of the dispute and the amount which the client has agreed to forego should be ascertained. In case the dispute has been settled by arbitration, the award should be referred to.

All transfers of balances from one account to another should be checked to confirm that these have been made under proper authority in the normal course of the business.

If the scrutiny of the account in the Sales Ledger shows that any of the book debts is not recoverable, the auditor should confirm that an adequate provision has been made against the same.

To verify the adequacy of provision against bad and doubtful debts, usually the client is asked to prepare a list of debts which are irrecoverable either wholly or partially. All the balances in the list afterwards are scrutinised by the auditor to confirm that these are in fact so, also that adequate steps have been taken by the client for their recovery but without success or that they are time-barred for recovery. It is necessary to remember in this connection that debts can be written off only under the authority of a person who is empowered to give up a claim, *e.g.*, board of directors, partners or the proprietor.

When any bad debt is written off, the client should be advised that a record thereof should be kept in the Bad Debts Register in order that if subsequently any recovery is made out of it, may be possible to identify the amount.

Finally, the composition of all balances outstanding of recovery should be examined. Normally, the debit balances in an account should be the total of the amount of sales not collected. In every case, where the composition of a balance is not clear, the copy of the statement of account received from the party should be referred to. If in respect of a particular account receivable, copies of a number of invoices are not in record, his balance should be confirmed by sending out statement of account.

While checking the closing balances which are required to be included under certain specific heads of account, those required to be separately disclosed (*e.g.*, amounts due from Directors, Managers, or concerns in which they are interested) should be listed up separately.

For the tests, which must be applied and the enquiries which should be made for ascertaining which of the account receivable's balances are bad and irrecoverable; students may refer to the next chapter.

Self-balancing and sectional balancing ledgers: When in an organisation a number of ledgers are maintained, it is usual to find the system of self-balancing or sectional balancing of ledgers in operation. Sectional balancing, as any student of accountancy knows, is just the system of maintaining a total account in the general ledger in respect of each sectional ledger like account receivables, account payables, nominal accounts. The self-balancing system is a further improved system which enables the preparation of independent trial balances for each of the separate ledgers by means of contra-adjustment accounts. This, as part and parcel of the system of internal check, is of great assistance to the auditors for localizing errors. It should however be borne in mind that the only reliable verification of balances of various adjustment accounts in the general ledger lies in the thorough verification of the various personal ledger balances. As regards the routine checking aspects, no special technique is involved. The postings to the individual ledgers and to general ledger account maintained for control purpose should be appropriately checked. Also the castings and balancing should be tested.

(iii) General Ledger: The general ledger contains all the balances which are ultimately included in the Statement of Profit and Loss and the Balance sheet. Its examination, therefore, is undertaken last of all. It should be carried out with great deal of care inasmuch as it is the final review of balances which, on inclusion in Final Accounts, cumulatively reflect the financial position of the concern.

Entries in the General Ledger usually are posted in a summary form from the Cash Book, Journal, and from other subsidiary books like Purchases Book, Sales Book, etc. As such before starting its examination, it should be confirmed that all the postings in various accounts have been verified, totals have been checked and the final balances have been linked.

It should also be ascertained that balances in all the income and expense accounts have been adjusted: (i) according to standard accounting practices, and (ii) on a consideration of the legal provisions which are applicable to the concern. Each ledger balance finally should be examined on a consideration of its position in the Final Accounts to see how the financial position of the concern would be affected by the inaccuracy in the balance.

Wherever practicable, the balances in the General Ledger should be traced simultaneously on to the trial balance, the groupings schedules and the Final Accounts. At the same time, by way of a comparison, the corresponding balances in the previous year's Final Accounts also should be referred to.

It should be confirmed that the accounts have been kept according to accepted accounting principles and the Balance Sheet and the Statement of Profit and Loss have been drawn up on the same basis as in the previous year.

Consistency is also one of the fundamental accounting assumptions as stated in AS-1 on "Disclosure of Accounting Policies". Usually, the accounts of a commercial concern are kept on the mercantile basis. It demands that all the liabilities in respect of goods purchased or expenses incurred before the close of the year that were outstanding for payment should be provided for; amounts paid as advances should be included as an asset, the proportion of expense relevant to the period that extends beyond the close of the year should be excluded by the amount being debited to the prepaid Expenses Account. Further, on the same consideration, the income which had accrued before the close of the year, but had not been collected should be taken credit for and correspondingly, income relating to the period, following the close of the year, which has been received in advance should be adjusted as a liability. Thus, unless accounts are adjusted in this manner, neither the Statement of Profit and Loss nor the Balance Sheet would disclose a true and fair state of the business.

The valuation of assets and verification of liabilities are other important steps in the ascertainment of profit earned by the business inasmuch as only under or overvaluation thereof would either depress or boost up profits.

Conventionally, current assets are valued at their cost or net realisable value whichever is lower, fixed assets are valued at cost reduced by the amount of depreciation that they have suffered, calculated on any accepted basis, and followed consistently.

(iv) Main Journal: Both the closing and adjusting entries as well as other entries which cannot be accommodated in any other Journal are recorded in the Main Journal. The evidence in support of entries in this Journal usually exists in a large variety of forms. It may consist of correspondence, contracts, minutes of Board of Directors or the shareholders, statements of account, etc. All the statements attached to support adjusting entries, since these would be prepared by the internal staff, should be verified very carefully, and where possible, some independent evidences in confirmation thereof should be obtained.

The correcting entries will contain references to vouchers which have already been checked by the auditor. He ordinarily, therefore, will have a record thereof in his audit notes. It should be referred to while verifying them. One form of adjusting entries is the one recorded to provide for expenses accrued till the date of the Balance Sheet but not paid, *e.g.*, those in respect of rent, electricity, income-tax, etc. as well as for taking credit for the income accrued but not received, *e.g.,* interest accrued which is not matured for receipt, lease rent accrued which is not due for payment, etc. In all such cases, it is possible that by the time that audit is undertaken, some of the liabilities, a provision for which has been made, may have been paid off; also that the amounts adjusted as not recoverable may have been collected. As a result, in actual practice, it may be found that amount paid or received were larger than those adjusted. But so long as these were estimated on a reasonable basis, it is not necessary for the auditor to reopen accounts to adjust the difference between the amounts of income or expense estimated and those collected or paid.

The opening entries should be verified by reference to the balance sheet or other similar documents for the previous year.

The auditor should specially note that neither any accounting principles nor practices followed in the past have been contravened or altered during the year under audit. If a departure has been made, its effects should be disclosed on the face of the Statement of Profit and Loss. For example, when the basis of valuation of closing inventory or that for providing depreciation on fixed assets has been altered, their effect on profit should be disclosed.

5.10 Outstanding Liabilities

(i) Purchases: In some instances, invoices relating to purchases of goods that have been taken into inventory are received too late to be included in the Purchase Day Book of the closing month. As a result, those will be included in the accounts of the succeeding period. In such a case, a schedule of such invoices should be prepared and their total debited to Purchases Account and carried down as an outstanding liability. If the precise amount of liability on account of such purchases cannot be ascertained, an estimate made by a responsible official might be accepted.

(ii) Wages, Salaries, etc.: the amounts debited to these accounts should represent the amount actually chargeable for the year. Thus, if the amount payable at the close of the year has been paid in the succeeding period, a provision therefore should be made. While doing so, it should also be verified that the corresponding provision made at the end of the previous year has been brought in as a credit, for arriving at the amount chargeable for the year.

(iii) Rent and Taxes: The amount charged towards the rent should be the annual rent as provided for in the lease. If any rent for the year was outstanding at the close of year or has been paid in advance, the amount outstanding or paid in advance should be adjusted as a liability or asset respectively.

Municipal taxes usually are payable in advance. As a result a proportion of last payment is usually carried forward as unexpired to the next period. By scanning the account, it should be ascertained that the charge only for the full has been included in the account.

(iv) Directors' and Managing Director's Fees or Salaries: It should be verified that after making necessary provisions for account outstanding the total amount to be debited to the account agrees with the resolution of the Board of Directors or shareholders under which the payments have been paid at the rates authorised by the articles in respect of meeting attended by the Directors and it should be noted that the working directors of a public company are not expected to receive any such fee pursuant to the guidelines issued by the Company Law Board.

(v) Freight: Carriage and freight account may not be rendered till some time after the period to which they relate. In such a case a provision for the amount outstanding may be made on an estimate and while doing so the amount provided in the earlier year may be taken into account.

(vi) General Expenses: Entries in the various accounts should be carefully examined and analysed to make certain that no item has been debited in this account which should have gone elsewhere. Quite often, donations and subscriptions, bank charges, conveyance and other petty expenses are included under this head. Wherever possible, the use of such omnibus account for these debits should be avoided and, in any event, where the total of items in any individual class of transactions is considerable to warrant a separate account being opened for it, the same should be segregated and recorded in a separate account. When this is not possible, as a precaution an analysis of the account should be prepared at the end of the year and the total under the various headings compared with the corresponding totals in the previous period. Schedule III to Companies Act, 2013, requires that every company must show under distinct heads the expenses that exceed 1% of the revenue from operations of the company or ₹ 1,00,000, whichever is higher. Henceforth, it would be improper to include any such expense under the heading “other expenses”.

5.11 Outstanding Assets

There are two classes of outstanding assets the adjustment whereof has to be examined; first, items accruing but not recorded in books and second, expenditure already incurred, a part or whole of which relates to a period subsequent to the date of the Balance Sheet.

The following are some of the accounts in which adjustment of outstanding assets could be made:

(i) **Rent receivable**: All rents receivable due or accrued to the date of the Balance Sheet should be calculated and brought into account, after a provision has been made for doubtful or irrecoverable arrears of rent, allowance for repairs, etc.

(ii) **Interest and dividend:** Interest receivable on loans accrued to the date of the Balance Sheet should be brought into accounts in all cases where the interest is being regularly received on the dates. If the interest is in arrears, the amount accrued should either be omitted or brought into account and a corresponding provision made against it. Interest on debentures and other securities, receivable on fixed dates accrued and payable before the close of the year should be brought into account and adjustment on account of dividend on shares should be made with reference to the dividend accounting policy followed by the management. This would be in order if the same is accounted for on the basis of declarations during the audit year. It is also possible to account for dividends declared after the close of the year, provided the period in respect of which the same was declared fell within the accounting period of the client. However, accounting of dividend purely on receipt basis would not always be in order for companies. Finally, it should be ensured that the methods in this regard have been consistently followed.

(iii) **Insurance charges paid in advance:** Insurance premiums are always paid in advance; and, in case of a large business, the amount paid, the benefit of which will arise in the succeeding period, may be considerable. The proportion thereof applicable to the period subsequent to the date of the Balance Sheet should be calculated and included as an outstanding asset.

(iv) **Advertisement:** Sometimes payments under advertising contracts are made in advance. In such a case, the proportion thereof relating to any period subsequent to the date of the Balance Sheet should be adjusted as an outstanding asset.

5.12 General Scrutiny of Expense Accounts

The structure of each expense account should be thoroughly scrutinised and the distribution of the total expense over different methods comprised in the period under audit. Where there are significant variations between different months, the cause thereof should be ascertained. At times, it may be found that an expense account has a few credit entries. These may represent recovery of the share of common expenses from one or more participants, refund of rebate obtained from a supplier of an entry made to exclude the expense relating to the succeeding period. All these entries should be verified.

Some entities maintain an Outstanding Book, for keeping a record of expenses which were outstanding at the close of the year that have been paid in the succeeding years. From a reference to the entries therein, it is usually possible to have an explanation for the difference that there is an amount of expenditure paid out in the closing month as compared to that in the earlier months. The book is of much assistance also in the verification of the accuracy of the provision made for expenses which were outstanding at the close of the year.

While verifying the adjustment of liabilities, outstanding at the close of year, it should be observed that the liabilities, a provision for which was made in earlier years, have been paid off during the year, and if any amount has not been paid, reasons thereof should be ascertained, as it may not all be payable.

Where certain common expenses have been divided between two or more activities carried on by the same concern or between two sister concerns, it should be ascertained that the basis adopted for the division is reasonable.

Where there has been a change in the basis of accounting, as compared to that in the previous year, the reasons thereof should be ascertained and if any item is shown in the Statement of Profit and Loss has been affected by any change in the basis of accounting, the amount of the difference should be shown separately by way of a note.

The different elements of cost (material, labour and manufacturing expenses) generally are known as direct expenses. Normally, there exists a direct relationship between the cost of each element and total cost of manufacture of the article. Therefore, where there has been a significant variation in the relationship the reasons thereof should be ascertained. It may be due to some of the expenses having been left out or having been included in excess. This could be ascertained on a verification of the entries relative to adjustments of different types of expenses. The causes of variation in the proportion of direct expenses usually can be readily ascertained but this is not practicable in the case of indirect expenses, for these often are the results of a variety of factors unconnected with manufacturing process.

For instance, the change in indirect expenses may be the effect of the change in the rate of turnover or that in the structure of the management. Quite often office expenses increase with that in the rate of turnover, but they may not do so in proportion thereto. For example, if a business owned by a partnership is taken over by a company or machines are introduced to perform certain routine functions which were previously carried out manually, the cost of administration may increase. Small variations therein may also take place due to substitution of one form of expenditure by another either as a measure of economy or on consideration of good management. For example, a company may decide to raise a part of its working capital by issuing debentures and to pay off its overdraft account on which it was paying a higher rate of interest. The management may otherwise decide that local letters should be delivered by hand even though the cost of peon delivery is greater.

Normally, every increase in an expense is accompanied by that in income, *e.g.,* an increase in selling commission, freight and packing charges is usually the outcome of an increase in sales. At times, however, an item of expense may not immediately result in revenue. For example, the trip of managing director abroad to find a foreign market for the articles manufactured by the company may not start showing results until some time has passed.

The provision for liability that has been incurred, the amount whereof cannot be ascertained accurately, is generally made on the basis of an estimate. But where the existence of the liability is contested, the amount thereof is only disclosed as a contingent liability. Where, in the previous year, provision for an item of expenditure was either not made or was short and the difference in the amount was subsequently paid and the amount of provision is material, the fact should be disclosed by the amount being shown below the line or the amount being shown separately in a bracket against the amount of expenditure of which it forms a part.

5.13 Income Accounts

It is comparatively an easy matter to verify different forms of income earned by the client during the year in totality. In respect of some of the incomes which are collected regularly, *e.g.,* rents on lockers in the case of Safe Deposit Vault, dividends on shares, subscription in case of clubs, advertisement revenue in case of publishers of newspapers, a record of income the basis on which it has been collected and the particulars of the party through whom it has been received are contained in a Demand Register; there is a separate Demand Register for each such form of income. For the verification of such an income, it should be seen that the Demand Register has been checked and the balance that was outstanding for collection at the close of the year has been adjusted as an asset. In cases where the income earned represent charges for services rendered, the particulars of services rendered by the client to different account receivables would generally be recorded in a separate statistical register, *e.g.,* Job Register in case of the printer and Repairs Register in the case of a workshop, Patients Register in case of a doctor, Clients Register in the case of solicitors, etc. By reference thereto it should be verified that the amount receivable in respect of services rendered before the close of the year have either been called or adjusted as an outstanding asset.

The sale proceeds of goods which have been sold at a uniform rate of profit, *e.g.,* boxes of tea, petrol, vanaspati, ghee, etc. can be verified by computing the amount of profit, which the firm should have earned on quantities of goods sold during the year comparing it with the amount actually earned.

In case of a manufacturing concern, the system of invoicing finished goods should be examined to confirm that the system of internal check in operation ensures that goods would be despatched only after they have been either paid for or the account of the purchaser have been debited. Also, the quantities of raw materials consumed during the period should be reconciled with the quantities of finished products manufactured. The rate of wastage, if any, should be compared with that in the earlier period. It should be verified that quantities of goods sold but not delivered in respect of which bills were not prepared before the close of the year, have been adjusted in the books.

For ascertaining the trading profit of a year, it is also necessary that profits from trading transactions which were not completed before the close of the year should be brought into account by allocating the total profits on a reasonable basis over the different accounting periods in which these will be completed. The auditor should therefore see that discounting charges of bills of exchange earned on such sales, profits on contracts not completed, etc., have been distributed over their periods of accrual on a "reasonable basis".

Capital profit *e.g.* profit arising on sale of assets, reissue of forfeited shares, etc., not available for distribution as dividend, are credited to the Capital Reserve. Any transfer to Capital Reserve out of amounts credited to the Statement of Profit and Loss should be separately disclosed. Similarly, income of an extraordinary and non-recurring character should be separately shown in the Statement of Profit and Loss [Part II of Schedule III].

5.14 Asset Accounts

The general make up of fixed asset account is: opening balance, additional adjustment of profit or loss on sale and on account of depreciation.

Every entry which does not conform to this pattern should be inquired into. It should be observed that expenses on current repairs have not been added to the value of the fixed asset but charged to Statement of Profit and Loss and conversely those on additions to or renewal of assets have not been charged to Statement of Profit and Loss. It should also be verified that purchase of assets or addition to them have been duly sanctioned by the concerned sanctioning authority. Where the entire undertaking of a business had been taken over, the value placed by the management on different assets and particularly the amount debited to Goodwill Account or that credited to Capital Reserve Account should be verified by reference to the vendors' agreement. The debit to the Goodwill Account would be necessary only when the amount paid for the business is in excess of the total value of asset taken over reduced by the amount of liabilities taken over. On the other hand, if the last mentioned amount is in excess, it shall be credited to the Capital Reserve Account.

The values of various current assets held at the close of the year and their composition should be compared with those held at the end of the previous year and if there is material change in their amounts or the basis of their valuation, the reasons thereof should be ascertained. If they appear to be unduly large, *e.g.*, when the value of inventory in hand has doubled but the sales have not increased, the fact should be brought to the notice of the management.

It should be also verified that interest at reasonable rate has been charged on loans advanced to directors, managers, and all concerned; also that loans were advanced under appropriate authority either that of directors or shareholders.

The balance in the Suspense Account, if any, should be analysed and the constituent amount included under appropriate heads of the Balance Sheet.

Finally, it should be confirmed that assets have been properly grouped under different heads for purpose of disclosure in the Balance Sheet and the method of valuation of each asset is shown as required by the form in which the Balance Sheet is required to be presented.

5.15 Liabilities

The auditor should obtain a certificate from the client that all the liabilities which had accrued due till the close of the year have been taken into account and contingent liabilities, if any, have been fully disclosed.

It should be verified that the liabilities have been appropriately grouped under different heads for the purpose of disclosure in the Balance Sheet; secured and unsecured liabilities have been segregated; and against the first, nature of security and its amount have been stated.

5.16 Balance Sheet Audit

Until recently, test checks were applied only for confirming balances in a few nominal accounts; those of inventories and stores, amount of sale and other similar records relevant to trading transactions, which were voluminous but of similar nature. Now a days on account of increase in the size of business units, but more so due to mechanization of accounting, the test checks are being applied widely for the verification of income and expense accounts as well as assets and liabilities. This has crystallized into a form of audit known as Balance Sheet audit.

A Balance Sheet audit consists of the verification of all includible Balance Sheet items, together with the examination of expense and income accounts which are so closely related to these items that it cannot be properly verified without such analysis and test. Records, vouchers, books and accounts are examined; capital and revenue accounts are analysed. The concept of Balance Sheet audit has been developed along with the development of formal internal control system.

In outline form, a Balance Sheet audit will include the following:

(i) An examination of partnership agreement, the memorandum and articles of association, minutes of the board of directors, and the system of accounting in force, (depending upon the type of entity).

(ii) The establishment of ownership of all assets included in the Balance Sheet.

(iii) Proof that all owned assets are included.

(iv) The inclusion of the asset in the Balance Sheet is in accordance with the accepted principles of accounting.

(v) Proof that all liabilities are included and at proved amounts.

(vi) The examination of adjusting and closing entries or any other entries necessary to the preparation of the Balance Sheet.

(vii) Evidence that the distinction has been made in recording transactions between capital and revenue; and that capital and revenue have been created on the basis of accepted accounting principles.

(viii) Proof that the share capital issues have been made in compliance with the requirements of law and they are correctly recorded in the financial books.

(ix) An analysis of the charges and credit to the revenue accounts and the inclusion of the resultant balance in the Balance Sheet.

Given below are some of the overall tests which may be applied for verification of balance in the Statement of Profit and Loss.

Expenses Accounts:

(i) Check direct expense such as customs duty, excise duty with the value of purchases and quantity of goods for sales; verify adjustment of regular expenses *e.g.* rent, managerial salaries, insurance charges, postage, stationery, etc.

(ii) Compare the total of each expense account comprised in the Statement of Profit and Loss with the corresponding amount in the same account for the previous year and if there is any material variation in any one of them, find out the reason therefore.

(iii) Determine whether increases or decreases in wages, material consumed and variable expenses appear to be proportionate to the increase or decrease in the turnover.

(iv) Investigate the causes of any material change in the rate of gross profit.

(v) Enquire into extraordinary expenses, e.g., donations paid to charities or item of a non-recurring nature, like expenses of foreign tours, those on an advertisement campaign and others which have resulted in changes of material amount on the revenue of the period.

(vi) Ascertain whether there have been any changes in the basis of accounting which have resulted in significant increase or decrease in the amount of expenses included in the Statement of Profit and Loss e.g. due to non-provisions of closing inventory of stationery or advertisement material, non-provisions of bonus or gratuity payment to staff, etc.

(vii) Compare schedules of outstanding expenses and provision with those for the previous period and ascertain causes of any material changes therein; check in detail the provisions for depreciation and taxation.

Income Account:

(i) Verify different types of income in respect of which separate Demand Registers are maintained, by reference to them and confirm that amounts outstanding have been properly adjusted.

(ii) Examine the system of invoicing goods to ensure that goods cannot be issued without the sale price thereof being received or the amount being debited to the account receivable's account.

(iii) Reconcile the quantity of raw material consumed with quantities of finished products manufactured and compare the rate of wastage with that in the earlier period.

(iv) Compare the total of each income account comprised in the Statement of Profit and Loss with the corresponding amount in the same account in the previous year and, if there is any material variation, find out reasons therefore.

Account Payables:

(i) The account payables' ledger trial balance should be extracted by the client and agreed with the Control Account, if any, before the balances for confirmation are selected.

(ii) The outstanding liability in respect of goods received, within the last week of the close of the year, should be verified by comparing entries in the Goods Inward Register with those in the Purchase Journal. In verifying this, due attention should be paid to the cut-off arrangement made by the client.

(iii) A certificate should be obtained from the client that all the liabilities which had accrued upto the date of the Balance Sheet have been taken into account.

Account Receivables:

(i) The trial balance of the account receivables' ledger should be extracted by the client and agreed with the Control Account, if any, before the balances for confirmation are selected.

(ii) The amount of sales made during the week before the close of the year should be verified on comparing the entries in the Goods Outward Register with those in the Sales Journal. Here also, due attention should be paid to the cut-off arrangement.

(iii) A certificate should be obtained from the client that all the book debts are good and recoverable and that a provision has been made against those considered bad or doubtful.

5.17 Analytical Procedures

Nature and Purpose: 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. These collectively are known as overall tests. As stated earlier, 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. "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.

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.

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.

Various methods may be used in performing the above procedures. These range from simple comparisons to complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, financial statements of components (such as subsidiaries, divisions or segments) and individual elements of financial information. The auditor's choice of procedures, methods and level of application is a matter of professional judgement.

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 years 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. For example if on comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio, it would be necessary for the auditor to make further enquiries. These may reveal that this was the result of pilferage of inventories, misappropriation of a part of the sale proceeds or a change in the cost of sales without a corresponding increase in the sales price.

Likewise, on verifying the balances of sundry account receivables and account payables 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 a 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 a 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.

Similarly, by taking 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.

Similarly, 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 a inter-firm and intra-firm comparison of trading results. For 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 sugarmill 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.

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.

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.

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.
- 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.

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 (Revised) establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

Analytical Procedures that Assist When Forming an Overall Conclusion: 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.

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 accordingly.

The analytical procedures performed in accordance with paragraph 6 of "SA 520 Analytical Procedure" may be similar to those that would be used as risk assessment procedures.

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; and

(ii) Performing other audit procedures as necessary in the circumstances.

5.18 Direct Confirmation of Balances

If the trial balance of the General Ledger agrees to the inclusion of the balance in the total accounts governing the Bought Ledger and the Sales Ledger (instead of individual balances of accounts contained therein), it would not necessarily prove that the balances in the account of the Bought and Sales Ledgers are correct. For example there could still be compensating errors in the ledgers which would not affect the agreement of the trial balance. Therefore, it is essential that the individual balances of account receivables and account payables should be verified on obtaining either confirmation of balance from them or detailed statements of account.

SA505, "External Confirmations", lays down standards for external confirmation of balances. As per the Standard, External Confirmation means 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 objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.

SA 500 (Revised) 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 obtained. That SA also includes the following generalisations applicable to audit evidence:

- 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. SA 505 is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements. In deciding to what extent to use external confirmations, the auditor considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.

External Confirmation Procedures: When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including-

(i) Determining the information to be confirmed or requested;

(ii) Selecting the appropriate confirming party;

(iii) 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

(iv) Sending the requests, including follow-up requests when applicable, to the confirming party. Selecting the items for which confirmations are needed.

External confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so, the relevant details thereof. Other examples of situations where external confirmations may be used include the following:

- Bank balances and other information from bankers.
- Accounts receivable balances.
- Inventories held by third parties.
- Property title deeds held by third parties.
- Investments purchased but delivery not taken.
- Loans from lenders.
- Accounts payable balances.
- Long outstanding share application money.

The reliability of the evidence obtained by external confirmations depends, among other factors, upon the application of appropriate procedures by the auditor in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures. Factors affecting the reliability of confirmations include the control which the auditor exercises over confirmation requests and responses, the characteristics of the respondents, and any restrictions included in the response or imposed by management.

The following procedures should be followed for confirmation of the balances of account receivables and account payables at the close of the year:

(i) Confirmatory letters, in respect of the balance, either as at the date of the Balance Sheet or as at another selected date before the close of the year, should be sent out within a period of 15 to 21 days after the end of the year even when the audit is taken up much later.

(ii) If the number of accounts is large, letters may be issued only in respect of balances in the accounts of principal account receivables and account payables, selected according to some system, which would ensure that the accounts selected would constitute a representative sample of all accounts of account receivables and account payables. After the size and the contents of the sample have been determined, the client should be requested to prepare confirmatory letters requesting the parties to confirm the balances in their accounts as on a specified date.

(iii) The balances shown in the confirmatory letters should be compared by auditors with the book balances of the account receivables and account payables before the letters are despatched. He should also take control of the copies of these balances to prevent these being erased subsequently. The letters should be posted by the auditor. In case these are being posted by the client, there should be adequate check by the auditor that all the letters prepared have been duly posted.

(iv) Each confirmatory letter should show the balance in the account of the account receivable or account payable and the address of the auditors at which the confirmation under the signature of the party is to be sent. It should be signed by the client or the auditor, as has been mutually agreed upon. Also a stamped envelope containing the auditor's name and address should be enclosed. The envelope containing the letter of confirmation should have the address of the auditor as the sender.

(v) The account receivables or account payables who fail to reply within a reasonable time should be reminded. Also, letters received back undelivered should be sent again at the correct address.

(vi) On the confirmations being received, the auditor should verify that in each case either the balance has been confirmed or it can be satisfactorily reconciled. In case the balance in the account differs from that confirmed by the party, the client should be requested to prepare a reconciliation statement.

(vii) In every case, where a reconciliation statement has been prepared, it should be verified that the difference in the amount confirmed and that shown by the books of account is not the result of an omission to credit any amount received from the party or failure to debit him with any amount of sales or to credit him with the value of goods received with a view to suppressing or inflating profits.

(viii) If the difference is the result of some dispute or claim for an allowance or return, etc. not granted to the party, it should be confirmed that a provision equal to the difference which ultimately have to be credited to the party has duly been made.

Selection of accounts for direct verification: A few suggestions as regards selection of accounts for obtaining direct confirmation from parties are given below-

(i) Credit Balances**:** Balance in the accounts of suppliers, depositors, employees, securities deposited by account payables.

(ii) Sundry account receivable balances: Balances of advances to suppliers, balances recoverable for goods sold, securities deposited, etc. especially when the balances are in round figures have been continually increasing. It is usually not possible to obtain confirmation of amounts outstanding against Government Departments. These, thus, should be left out.

(iii) (a) A certain percentage of total number of accounts should be selected: some on the basis of largeness of their balances and others according to numerical or alphabetical order. For example, all accounts having balances above ₹ 10,000 may be included in the list of balances prepared for obtaining confirmations. Also accounts of parties with names beginning with, say "B" and "M" may be included in the list.

(b) A few amount with no unpaid items, as well as those the balance whereof have been written off during the period under review should be specially included. Furthermore, accounts wherein payments or other credits have been adjusted subsequent to the confirmation date should not be omitted.

(c) Accounts of parties, any cheque whereof has been received back unselected and accounts which are 'dead', *i.e.,* wherein there has been no operation during the year should also be included.

The group of accounts selected in the foregoing manner for obtaining confirmation of the account receivables and account payables balances would be representative sample of all the accounts of account receivables and account payables.

Unless there is evidence that the difference in the amounts confirmed and those shown by the respective accounts in the books is the result of some omission of fictitious entries, the position as revealed by direct verification of a sample of accounts could be accepted.

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6

Verification of Assets and Liabilities

Learning Objectives

After studying this chapter, you will be able to –

- Make a clear distinction between revenue and capital expenditure.
- Understand provision for providing depreciation and reserves has been dealt in detail.
- Verify various kinds of assets and liabilities.
- Identify events occurring after the balance sheet date.

The act of examining/establishing the existence and valuation of Assets and Liabilities may be referred to as Verification. While verifying the assets and liabilities of an entity, an auditor is required to have knowledge of applicable Accounting Standards, for e.g., AS 6 on Depreciation, AS 10 on Fixed Assets, AS 26 on Intangible Assets, etc. The auditor is further required to check the presentation of various items in the Balance Sheet and Statement of Profit and Loss, for e.g., as per Schedule III to the Companies Act, 2013 in the case of a company.

6.1 Capital and Revenue Expenditure

Capital Expenditure: A capital expenditure is that which is incurred for the under mentioned purposes-

(a) Acquiring fixed assets, i.e., assets of a permanent or a semi-permanent nature, which are held not for resale but for use with a view to earning profits.

(b) Making additions to the existing fixed assets.

(c) Increasing earning capacity of the business.

(d) Reducing the cost of production.

(e) Acquiring a benefit of enduring nature of a valuable right.

The different forms that capital expenditure takes are: (i) land; (ii) building; (iii) plant and machinery; (iv) electric installations; (v) premium paid for the lease of a building; (vi) development expenditure on land; and (vii) goodwill; etc.

Expenses which are essentially of a revenue nature, if incurred for creating an asset or adding to its value for achieving higher productivity, are also regarded as expenditure of a capital nature. Examples of capital expenditure are-

(i) Material and wages- capital expenditure when expended on the construction of a building or erection of machinery.

(ii) Legal expenses- capital expenditure when incurred in connection with the purchase of land or building.

(iii) Freight- capital expenditure when incurred in respect of purchase of plant and machinery.

(iv) Repair- Major repairs of a fixed asset that increases its productivity.

(v) Wages- Wages paid on installation costs incurred in Plant & machinery.

(vi) Interest- Interest paid for the qualification period as per AS-16 i.e. before the asset is constructed.

Whenever, therefore, a part of the expenditure, ostensibly of a revenue nature, is capitalised it is the duty of the auditor not only to examine the precise particulars of the expenditure but also the considerations on which it has been capitalised.

Revenue Expenditure: An expenditure, the benefits of which is immediately say within one year expended or exhausted in the process of earning revenue, for example on purchase of goods for sale, on their movement from one place to another, on maintaining assets, on keeping a business organization going, etc. Examples of revenue expenditure are-

(i) Cost of raw material and stores consumed in the process of manufacture.

(ii) Salaries and wages of employees engaged directly or in-directly in production.

(iii) Repairs and renewals of fixed assets.

(iv) Advertisements.

(v) Postage.

(vi) Printing and Stationery.

(vii) Rent, rates and taxes.

(viii) Insurance.

(ix) Interest on borrowings.

6.2 Depreciation

6.2.1 Definition of Depreciation: Accounting Standard 6 issued by the Institute of Chartered Accountants of India on "Depreciation Accounting" defines depreciation as follows-

"Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time, obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose usefulness is predetermined".

The term “depreciable amount” of a depreciable asset as per the standard is its historical cost, or other amount substituted for historical cost in the financial statements less the estimated residual value.

The accounting standard recommends that the depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

6.2.2 Purposes of Providing Depreciation

(i) **To keep capital intact:** It will be evident that one of the effects of providing for depreciation on an asset is to retain in the business out of the profits in each year, an amount equal to the proportion of the cost of the asset employed in the business that has run off, estimated on the basis of the period of its working life and its scrap value. Thus, the original capital of the entity, assuming that all profits have been withdrawn and losses, if any, made good will remain intact. If, on the contrary, depreciation had not been charged, the net income would have been overstated over the years of the life of the asset, and if the same was withdrawn or distributed as dividends, the business would have no funds for the replacement of the asset.

(ii) **To ascertain cost accurately:** Unless a proper charge on account of depreciation is included in the Statement of Profit and Loss, the true cost of manufacture of different products will not be ascertained. This is because depreciation is as much a charge against revenue as any other expenditure and must be included in accounts irrespective of the fact whether the final result of a working is profit or loss.

(iii) **To charge initial costs against earnings:** The cost of a machine less its scrap value can, in effect, be regarded as the price for use of the machine paid in advance for the period it will be rendering service. According to this view unless an appropriate part of this price is charged to the profits of the business each year, the profit earned on its working will not be correctly ascertained.

The object of depreciation accounting thus is to determine on a scientific basis, the proportion of the cost of a machine which must be charged in the accounts of each year during which the machine will be used. Depreciation is an expense incurred for earning profit, which is similar to the hire of an asset, the only difference being that in one case the amount is paid to an outsider while, in the other, it is kept in the entity itself. Therefore, each accounting period must be charged a fair proportion of the cost of fixed assets as the price for their use, and the charge should not be contingent on profits being earned. Accordingly, depreciation is a charge against profits and not an appropriation out of profits.

(iv) **To prepare true and fair statements:** Unless depreciation is provided, the assets will be shown at an amount higher than their true value and the profit shown will be more than the real profit. In other words, the Balance Sheet and the Statement of Profit and Loss will not be true and fair.

Depreciation should not be confused with any fluctuation in the value of fixed assets. The market price of an asset at the end of a year may be either more or less than its book value. It would be the result of a rise or a fall in the price level, a factor over which the business has no control. Such fluctuation in the value of assets may or may not be taken into account, for fixing the sale price of the articles manufactured, but these must be totally ignored for computing the amount of depreciation chargeable to the Statement of Profit and Loss.

6.2.3 Depreciation on Wasting Assets: In terms of the decision in the case *Lee* v. *Neuchatel Asphalte Co. Ltd. (1889)*, there does not appear any necessity to provide depreciation on wasting assets like mines, quarries, etc. In the present-day context, however, it is highly doubtful whether the principle propounded in the above case would hold good. Wasting assets exhaust by working and necessarily that involves depletion of the capital employed on such assets. It is, therefore, necessary with a view to maintain the capital employed, a charge for such depletion for ascertaining a true and fair view of the accounts. By this process, the cost inherent in depletion would be accounted for and the fair value of the asset would be disclosed in the Balance Sheet. The term depletion stands for depreciation in case of a wasting asset, because here depreciation is really represented by the quantum of diminution of the deposits of materials in the wasting asset.

The legal position governing depreciation in case of a company is contained in the Companies Act, 2013. However, it is enough to know at this stage that in the opinion of the Company Law Board (Now National Company Law Tribunal), depreciation on wasting assets is a necessary charge for arriving at the true and fair picture of the Statement of Profit and Loss and Balance Sheet.

6.2.4 Methods of Depreciation: As per AS 6, there are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straight line method and the reducing balance method.

Under the Straight Line Method, an equal amount is written off each year during the life of the asset.

Under the Reducing Balance Method, the annual charge for depreciation decreases from year to year with the result that earlier years suffer to the benefit of later years. Also under this method, the value of an asset can never be completely written off.

The rate of depreciation to be applied in the case of the Reducing Balance Method is substantially higher than that which must be applied under the Straight Line Method if an asset is to be written off within a certain period. For example, if an asset to the written off to 5% of its original cost over 13 years, under the Straight Line Method the rate of depreciation will be 7.3% but the equivalent rate under Reducing Balance Method will be 20%.

The main advantage of the Reducing Balance Method is that during the first few years, when the charge on account of depreciation is heavier, the cost of repairs is usually small and thus, the total charge for each asset is distributed almost equal annually throughout its life, taking cost of repairs also into account. What is claimed as an advantage for the Reducing Balance Method is a drawback in the case of the Straight Line Method. This can be overcome by building up a reserve for repairs and renewals. This is done by an equal amount determined on estimating the average cost of repairs and renewals being annually charged to the Statement of Profit and Loss and credited to the provision for repairs account. Against this provision for the expenditure on repairs and renewals is charged as and when incurred, with the result that the annual charge for depreciation and repairs is equalised.

The various important factors which the management should take into account while selecting a particular method are:

(i) type of asset;

(ii) the nature of the use of the asset;

(iii) circumstances prevailing in the business; and

(iv) state of the economy-whether stable or inflationary.

For example, in a stable economic condition, a going concern with steady operations may select the straight line method. Further certain assets like patents and trade marks should also be depreciated on a straight line basis because of their nature conditioned by a legally prescribed life. A company with uneven asset acquisition over the years may go for written down value method.

The method of depreciation is applied consistently to provide comparability of the results of the operation of the enterprises from period to period. A change from one method of providing depreciation to another is made only if adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statement of the enterprise. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the assets coming into use. The deficiency or surplus arising from recomputation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of the past years, the deficiency is charged in the Statement of Profit and Loss. In case the change in method results in surplus, the surplus is credited to the Statement of Profit and Loss in the year in which such change is made. Such a change in method is a change in the accounting policy and its effect is quantified and disclosed.

6.2.5 Determining the Amount of Depreciation: The assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:

(i) historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;

(ii) expected useful life of the depreciable asset; and

(iii) estimated residual value of the depreciable asset.

The useful life of a depreciable asset is shorter than its physical life and is:

(i) pre-determined by legal or contractual limits, such as the expiry dates of related leases;

(ii) directly governed by extraction or consumption;

(iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise, etc.; and

(iv) reduced by obsolescence arising from such factors as:

  (a) technological changes;

  (b) improvement in production methods;

  (c) change in market demand for the product or service output of the asset; or

  (d) legal or other restrictions.

Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis.

Determination of residual value of an asset is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the contrary, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of subsequent revaluation of the asset. One of the bases for determining the residual value would be the realisable value of similar assets which have reached the end of their useful lives and have operated under conditions similar to those in which the asset will be used.

The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

The useful lives of major depreciable assets or class of depreciable assets may be reviewed periodically. Where there is revision of estimated useful life of an asset, the unamortised depreciation amount should be charged over the remaining useful life too.

An entity may adopt different types of methods of depreciation for different types of assets provided the same are adopted on a consistent basis. Even a company having plants at different locations may adopt different method of depreciation in the same accounting year. Further, it may be noted that the depreciation would be charged on pro-rata basis in respect of assets acquired during the financial year.

6.2.6 Disclosure in the Statement of Profit and Loss and Balance Sheet of a Company: Section 123 of the Companies Act, 2013 provides that the dividend shall be declared or paid by a company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of Schedule II "Useful lives to compute Depreciation", to the Companies Act, 2013. Schedule II to the Act provides that useful life of an asset shall not ordinarily be different from the useful life specified in Part 'C' to the said Schedule and the residual value of an asset shall not be more than 5% of the original cost of the asset. If a company does not use the useful life or residual value of the asset as provided in the Schedule II, then justification for the difference shall be disclosed in its financial statement.

Where during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such asset shall be calculated on a pro rata basis from the date of such addition, or as the case may be, upto the date on which such asset has been sold, discarded, demolished or destroyed.

If an asset is used for any time during the year for double shift, the depreciation will increase by 50% for that period and in case of the triple shift the depreciation shall be calculated on the basis of 100% for that period.

The useful life or residual value of any specific asset as notified for accounting purpose by a Regulatory Authority constituted under an Act of Parliament or by the Central Government shall be applied in calculating the depreciation to be provided for such asset irrespective of the requirements of Schedule II.

The Schedule II to the Companies Act, 2013 needs disclosure in the financial statements about the depreciation method used and the useful lives of the assets for computing depreciation, if they are different from the life specified in the Schedule II.

Schedule III "General Considerations for preparation of Balance Sheet and Statement of Profit and Loss of a Company", to the Companies Act, 2013, requires separate disclosure of depreciation charged and impairment losses/reversals along with a reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments.

Accounting Standard 6 requires following information to be disclosed in the financial statements;

(i) the historical cost or other amount substituted for historical cost of each class of depreciable assets;

(ii) total depreciation for the period for each class of assets; and

(iii) the related accumulated depreciation.

It also requires following disclosure of information in the financial statements alongwith the disclosure of other accounting policies;

(i) depreciation method used; and

(ii) the useful lives of the assets for computing depreciation, if they are different from the life specified in the Schedule.

6.2.7 Legal Necessity of Provision for Depreciation: On account of the provision under Section 123 that, no dividend shall be declared except out of profits arrived at after providing for depreciation in accordance with the provisions of the Act, it has become obligatory for every company distributing dividend to make a provision for depreciation. However, it may be noted that Schedule II to the Companies Act, 2013 provides the useful lives to compute depreciation on the asset as well.

6.2.8 Provision of Depreciation for Past Years: Section 123(1) of the Companies Act, 2013 prescribes that if a company has not provided for depreciation for any previous financial year it shall, before declaring, or paying dividend, provide for such depreciation:

(a) either out of the profits of that financial year, or

(b) out of the profits of any other previous financial year or years.

The implication of this provision is that if, for example, the profits of a company for the year ending 31st March, 2015 are proposed to be distributed, and it is found that due to inadequacy of profits no provision for depreciation had been made for the year ended 31st March, 2014 it would be necessary to make provisions in respect of the depreciation, for the year ended 31st March, 2014 as well as 2015 and only the balance of the profits for the year 31st March, 2015 would be available for distribution as a dividend.

Ascertainment of depreciation for computing net profits for the purpose of managerial remuneration: Under Section 197(1) of the Companies Act, 2013 depreciation calculated in the manner specified in Section 198 of the Companies Act, 2013 must be deducted for arriving at the amount of net profits, on which remuneration payable to managerial personnel is to be calculated.

6.2.9 Auditor's Duty as Regards Depreciation: Apart from fixed assets in respect of which depreciation must be provided in the manner aforementioned, it also has to be provided on semi-permanent assets, *e.g.*, patents, trademarks, blocks and dies, etc. Since the auditor is not in a position to estimate the working life of a majority of them, for this he has to rely on the opinion of persons who have a technical knowledge of the assets. He must, however satisfy himself that an honest attempt has been made to estimate the working life of each asset, that the total provision for depreciation is adequate and that the method adopted for determining that amount to be written off appears to be fair and reasonable. If he is of the opinion that the provision for depreciation is not adequate, he should report to the appropriate authority. He must also see that depreciation written off is properly disclosed in the Statement of Profit and Loss and the Balance Sheet.

6.2.10 Revaluation of Fixed Assets: In recent years, due to an abnormal rise in the price level, it has been suggested in many quarters that accountants should modify the practice that so far prevailed of calculating the provision for depreciation on historical cost (*i.e.*, original cost of fixed assets) and may, for the purpose adopt the replacement cost basis. In support of such a view, it has been argued that, as a result of the rise in the price level, replacement costs of assets have gone up to such an extent that the depreciation provision, based on the original costs, does not leave in the business sufficient funds enabling it to replace its fixed assets. Thus when financial statements are prepared on a basis other than historical cost basis, it is necessary that depreciation should also be computed accordingly on the revised book value of the assets. The revalued amounts of fixed assets are presented in financial statements either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued amount or by restating the net book value by adding therein the net increase on account of revaluation. An upward revaluation does not provide a basis for crediting to the Statement of Profit and Loss the accumulated depreciation existing at the date of revaluation. Further an increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. A decrease in net book value arising on revaluation of fixed assets is charged to Statement of Profit and Loss except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve, it is sometimes charged against that earlier increase. It sometimes happens that an increase to be recorded is a reversal of a previous decrease arising on revaluation which has been charged to Statement of Profit and Loss in which case the increase is credited to Statement of Profit and Loss to the extent that it offsets the previously recorded decrease. On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the Statement of Profit and Loss except that, to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it is charged directly to that account. The amount standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve. AS-6 on "Depreciation Accounting requires where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets.

6.2.11 Impairment of Assets: Besides charging annual depreciation on assets by the reason of normal wear and tear, effluxion of time and obsolescence to re-instate the correct value of the assets considering the future cash flows that the asset can generate, impairment loss needs to be provided. The difference between the carrying amount of an asset and recoverable amount is termed as Impairment Loss. The treatment of impairment loss is similar to depreciation except the fact that impairment loss can be re-instated in future if the recoverable amount of the asset exceeds the carrying amount. Various external and internal sources of information can be taken as the basis of determining the impairment for Assets.

The auditor must ensure that provisions of AS 28, "Impairment of Assets" issued by the Institute are followed.

6.3 Reserves

6.3.1 Reserves vs. Provision: Reserves are amounts appropriated out of profits which are not intended to meet any liability, contingency, commitment or diminution in the value of assets known to exist at the date of the Balance Sheet. In contradistinction, provisions are amounts charged against revenue to provide for:

(i) depreciation, renewal or diminution in the value of assets; or

(ii) a known liability, the amount whereof cannot be determined with substantial accuracy; or

(iii) a claim which is disputed.

Amounts contributed or transferred from profits to make good the diminution in assets values due to the fact that some of them have been lost or destroyed, as a result of some natural calamity or debts have proved to be irrecoverable are also described as provisions. Provisions are normally charged to the Statement of Profit and Loss before arriving at the amount of profit. Reserves are appropriations out of profits.

The difference between the two is that provisions are amounts set apart to meet specific liabilities of diminution in assets value. These must be provided for regardless of the fact whether or not any profit has been earned by the concern. If a provision is in excess of the amount considered necessary, the same must be written back or credited to a Reserve Account.

Reserves are made up of amounts appropriated out of profits, held for equalising the dividends of the company from one period to another or for financing the expansion of the company or for generally strengthening the company financially.

If we examine the Balance Sheet of a company, at a given time, and deduct the total liabilities to outside trade payables from the value of assets shown therein, the difference between the two figures will represent the net worth of the company based on the book values of assets as on that date. It will consist of the capital contributed by the shareholders as well as total undistributed profit held either to the credit of the Statement of Profit and Loss or to reserves; the reserves again will be segregated as revenue or capital reserves. It may be noted that the amount of a reserve is affected by the values placed on assets. If these are excessive, the real reserve might not exist at all or be smaller than the figure at which it is shown in the balance sheet.

Revenue reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose, e.g., 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.

A capital reserve on the other hand represents surplus or profit earned in respect of certain types of transactions; for example, on sale of fixed assets at a price in excess of cost, realisation of profits on issue of forfeited shares or balances which because of their origin or the purposes for which these are held, are not regarded by the directors as free for distribution as a dividend through the Statement of Profit and Loss. However, students may note that as per AS-5, profit or losses arising out of sale of fixed assets should be routed through Statement of Profit and Loss though they may be shown separately.

Capital Reserve is a reserve which does not include any amount regarded as free for distribution through the Statement of Profit and Loss. In its narrowest sense, therefore the description would include only share premium, capital redemption reserve, development rebate reserve and profit on reissue of forfeited shares. It may further 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 also would be 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 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.

Students may further note that according to the format prescribed for the Balance Sheet in Schedule III to the Companies Act, 2013, the amount of capital and revenue reserves must be shown separately. Also capital redemption reserve and securities premium account must be segregated. Further, if there are more than one kind of revenue reserves, their nature and amounts must be disclosed; also the balance of the Statement of Profit and Loss, if in debit, should be shown as a negative figure under the head “Surplus” and therefore would be adjusted under the head “reserve and Surplus”.

Schedule III further provides that the aggregate of amount are set aside or proposed to be set aside to reserves, if material, should be disclosed in the Statement of Profit and Loss. Similarly aggregate of amounts, if material, withdrawn from reserves should be disclosed.

Reserves either may be retained in the business as a part of the working capital or invested outside the business in marketable securities. To the extent additional capital can be usefully and profitably employed in the business, undistributed profits should be left in the business. For these when so employed, would earn a higher return than what they would if they were invested outside in the shares or debentures of another company. So much of the profits as cannot be usefully employed in the business as well as the part of the profits earned which necessarily must be invested outside the business, under some legal obligation *i.e.*, for the redemption of debentures, reserves should be invested in such securities which are easily realisable and the prices whereof are not liable to wide fluctuations. The term ‘Reserves Fund’ should be employed to describe a reserve only when the amount of reserve is invested outside the business and it is represented by the readily realised assets.

Reserves which are not disclosed in the Balance Sheet are known as secret or hidden reserves. Secret reserves can be created in the following ways:

(i) By writing down fixed asset more than what is necessary.

(ii) By writing off capital expenditure as though it were revenue.

(iii) Under-valuation of inventory.

(iv) By making an excessive provision for bad debts.

(v) By making an excessive provision for contingencies or by continuing to carry forward provision even when they are not required.

Before the Companies Act, 1956 came into force, there were no restrictions on the creation of secret reserves except that whenever secret reserves were brought back into accounts, it was necessary to disclose the amount adjusted out of such reserves.

Note: Students may read the decision in the case *Rex vs. Kylsant and Moreland* to acquaint themselves with the circumstances which led to the introduction of restrictions on the creation of secret reserves.

6.3.2 Specific Reserves: A specific reserve is created for some definite purpose out of the profits of the company. The purpose may be anything connected with the business which the Article of Association or the directors want to be provided for, such as replacement of fixed assets, expansion of the organisation, income-tax liability of the future, etc.

There may be slight confusion since some of the objects for which specified reserves are created, may also appear to be covered by a charge against revenue, for example, provision for bad and doubtful debts as well as reserve for bad and doubtful debts or a provision for repairs and renewals running along with a reserve for an identical purpose. The only distinction between the two is based on whether it is a charge against revenue or an appropriation of profits. To create any specific reserve existence of profit is essential. Any amount which the directors desire to retain or the Articles require the company to retain over and above provision, necessary for a true and fair disclosure of profit, is specific reserve unless the same is retained for a general purpose, when it would become a general reserve.

Normally, specific reserves are created to comply with the terms of the Articles of Association or in accordance with a decision of the Board to meet a particular situation which may arise in the future. Also some of the specific reserves may be required under contractual obligations or legal compulsion. An example of the former would be the fund for redemption of debentures; that of the latter would be the development rebate reserve which is compulsory if the advantage of the development rebate is to be enjoyed in respect of income-tax. Such specific reserves take on the character of capital reserves.

Note 6(B) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Reserves and Surplus" in notes to accounts as follows:

(B) Reserve and Surplus

- (i) Reserves and Surplus shall be classified as:
  - (a) Capital Reserves;
  - (b) Capital Redemption Reserve;
  - (c) Securities Premium Reserve;

(d) Debenture Redemption Reserve;

(e) Revaluation Reserve;

(f) Share Options Outstanding Account;

(g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);

(h) Surplus i.e. balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

(Additions and deductions since last balance sheet to be shown under each of the specified heads)

6.4 Verification of Assets

6.4.1 General Principles: Verification of assets is an important audit process: by convention its scope has been limited to inspection of assets, where it is practicable, and collection of information about them on an examination of documentary and other evidence so as to confirm:

(a) that the assets were in existence on the date of the balance sheet;

(b) that the assets had been acquired for the purpose of the business and under a proper authority;

(c) that the right of ownership of the assets vested in or belonged to the undertaking;

(d) that they were free from any lien or charge not disclosed in the balance sheet;

(e) that they had been correctly valued having regard to their physical condition; and

(f) that their values are correctly disclosed in the balance sheet.

Verification of assets is primarily the responsibility of the management since the proprietor or the officials of the entity are expected to have a much greater intimate knowledge of the assets of the business as regards location, condition, etc. than that which an outsider might be able to acquire on their inspection. They alone thus are competent to determine the values at which these should be included in the Balance Sheet. The auditor's function in the circumstances is limited only to an appraisal of the evidence, their inspection and reporting on matters affecting their valuation, existence and title, observed in the course of such an examination. Principally, the auditor is required to verify the original cost of assets and to confirm, as far as practicable, that such a valuation is fair and reasonable. As regards the manner in which the original cost should be ascertained, there are well defined modes of valuation which he is expected to follow.

Assets are valued either on a 'going concern' or a 'break-up value' basis. The first mentioned basis considered appropriate when the concern is working and the second, when it has closed down and is being wound-up. AS - 1 mentions that "Going Concern" is one of the fundamental accounting assumptions to be followed in preparation and presentation of financial statements. In case of non-observance, the fact that "Going Concern" assumption has not been followed is to be specified. If considered necessary, the auditor can also obtain the assistance of expert valuer. He must further ensure that the Balance Sheet discloses the basis on which different assets have been valued.

6.4.2 Valuation of Assets: Fixed assets are acquired for purpose of business with the object of earning revenue in the ordinary course of business; these are intended to be used and not sold, *e.g.,* land, building, machinery, etc. Almost all fixed assets (except land and goodwill) suffer depletion or exhaustion due to efflux of time and their use or exploitation. In addition, almost all assets are subject to impairment taking into consideration its recoverable value in future. Mines and quarries are notable examples of the class of assets that are described as wasting assets, denoting that their value diminishes on exploitation, in contradistinction to the loss of value through use or obsolescence that takes place in the case of other assets. Floating assets are acquired for resale with a view to earning profits or are those that come into existence during the processes of trade or manufacture. All those, in the normal course of business, are quickly convertible into cash, *e.g.,* inventory, trade receivable, bills receivable, etc.

Fixed Assets: Fixed assets are included in the Balance Sheet at their cost less depreciation and impairment loss. Cost includes all expenditure necessary to bring the assets into existence and to put them in working condition. It would be incorrect to value them at their sale price since these are not intended to be sold. For the very same reason, the fluctuations in the market values are ignored even when these are permanent. If these were taken into account, it would result in either under or over allocation of their cost. In case any government grant is received in relation to specific fixed assets then either the grant can be shown as deduction from cost of the asset or grant can be treated as deferred income which is recognised in Statement of Profit and Loss.

Wasting Assets: More as a result of custom than financial expediency, no specific provision to reduce the value of wasting assets exists in the Companies Act, 2013. For the first time, this matter was considered by the Court in the case *Lee* v. *Neuchatel Asphalt Company Limited* and it was held that it was not necessary for a company to provide depreciation on wasting assets to arrive at the amount of profits which it could distribute. It cannot, however, be contended that the value of wasting assets remains unaltered despite their exploitation year after year. On a consideration of this position, the Institute of Chartered Accountants in England and Wales, as early as 1944, recommended that provision for depreciation or depletion should be made in respect of every wasting asset, such as mine, on the basis of the estimated physical exhaustion that takes place. The amount that must be provided can be determined on ascertaining the proportion that the quantity of the output during the year bears to the total quantity that the mine is expected to yield during its normal working life. The unit for such a computation should be the unit of the refined produce and not that of the raw one. Schedule II to the Companies Act, 2013 covers cases in respect of which provisions of the accounting standards as applicable shall apply. On the very same consideration, if a mine has been acquired on a lease, the total amount paid for the lease should preferably be amortised over the period of the lease in proportion to the output in each year. This may sometimes appear impracticable; under such a situation, amortisation on a time basis may be considered.

Floating Assets: In the case of these assets the attempt is to include them in the Balance-sheet at their realisable value. These, therefore, are valued either at cost or market value whichever is less. The term 'cost' refers to purchase price including duties and taxes, freight inwards and other expenditure directly attributable to acquisition less trade discount, rebates, duties drawbacks and subsidies, in the year in which they are accounted, whether immediate or deferred in respect of such purchase. The term 'market value' may either refer to "Net realisable value" or "the replacement cost".

(i) **Net Realisable value-** Net Realisable value is the estimated selling price in the ordinary course of business less estimated costs of completion and the estimated costs necessarily to be incurred in order to make the sale.

(ii) **Replacement Cost-** It refers to the price which would have to be paid for acquiring the same assets at the current market rate on the date of the Balance-sheet. The replacement cost is determined by taking into account the price that would have to be paid for purchasing the assets from normal sources of supply. In case free market for the assets does not exist it may not be possible to determine the replacement cost.

It may be noted here that in case of valuation of inventories, only net realisable value as a variant of market value has to be considered. This is in accordance with the Accounting Standard 2 on 'Valuation of Inventories'.

Inventory: It is a current asset held for sale in the ordinary course of business or in the process of production for such sale or for consumption in the production of goods or service for sale. The normally accepted accounting principle of valuation of inventory is at cost or net realisable value whichever is lower. This principle is in accordance with the AS 2 on 'Valuation of Inventories'. This general principle applies to valuation of all inventories except inventories of the following to which special considerations apply.

(a) Work-in-progress arising under construction contracts, including directly related service contracts (see Accounting Standard (AS) 7, "Construction Contracts");

(b) Work-in-progress arising in the ordinary course of business of service providers;

(c) Shares, debentures and other financial instruments held as inventory; and

(d) Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

The inventories referred to in (d) above are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assured under a forward contract or a Government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this statement.

For instance, in the case of inventory of tea, coffee and rubber, held by the plantations which have produced them, with a view to showing in their annual accounts the true profits in respect of each crop, it is valued at the date of the Balance Sheet at the price at which it has been sold subsequently, reduced either by actual or estimated selling expenses pertaining thereto. And where inventories are held for maturing (*e.g.,* rice, timber and wine), though their value increases substantially with the passage of time, these are usually valued at an amount which is equal to their cost plus storage charges. Where during storage the weight shrinks, an allowance for this factor is also made. In no case, however, the price applied is allowed to exceed the current market (selling) price of similar goods less costs necessarily to be incurred in order to make the sale.

Following the fundamental accounting assumption of consistency, whatever basis of valuation is adopted; it should be consistent from one period to another to prevent distortion of trading results disclosed by the annual accounts. Therefore, any change in the accounting policy relating to inventories (including the basis of comparison of historical cost with net realisable value and the cost formulae used) which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policy which has a material effect in the current period the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

Different connotations of 'Cost': The significance of this term varies in different circumstances on account of the nature of goods and the methods by which cost has been computed. Essentially, it refers to an appropriate combination of the cost of purchase, cost of conversion and other costs incurred in the normal course of business in bringing the inventories up to the present location and condition.

In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

(a) abnormal amounts of wasted materials, labour, or other production costs;

(b) storage costs, unless those costs are necessary in the production process prior to a further production stage;

(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d) selling and distribution costs.

The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.

The cost of inventories, other than those dealt with in paragraph 14 of AS-2, should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

Valuation of inventories below historical cost: The historical cost of inventories may at times not be realised, *e.g.,* if their selling prices have significantly declined, or if they become wholly or partially obsolete, or if the quantity of inventories is so large that it is unlikely to be sold/utilised within the normal turnover period and there exists a genuine risk of physical deterioration, obsolescence or loss on disposal. In such circumstances, it becomes necessary to write down the inventory to 'net realisable value,' in accordance with the principle of conservatism which requires that current assets should not be carried in the financial statements in excess of amounts expected to be realised in the ordinarily course of business. Materials and other supplies held for use in the production of inventories are not written down below cost, if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value.

Disclosure: The financial statements should disclose-

(a) the accounting policies adopted in measuring inventories, including the cost formula used; and

(b) the total carrying amount of inventories and its classification appropriate to the enterprise.

Investments: The Companies Act has introduced a concept of trade investments. These are investments made by a company in the shares and in debentures of another, not sufficiently large as to make the other a subsidiary. Such investments are always valued at cost since the basic consideration in making the investment associates in trade.

The market value of shares or debentures of a company which are not quoted on the Stock Exchanges is ascertained on a consideration of the financial position of the company as disclosed by its last Balance Sheet and Statement of Profit and Loss. For this purpose, the dividend policy and the price at which shares have changed hands in the previous months also are taken into account.

Where shares or debentures have been acquired by a concern *in lieu* of services rendered in the promotion of a company (*e.g.,* in pursuance of an underwriting contract) or in the part payment of purchase consideration, these are included in the Balance Sheet at cost, determined on a reference to the relative agreement in pursuance whereof the allotment has been made. For example, where shares have been allotted in consideration of subscription obtained to loans or debentures, these are valued at the amount paid for them, reduced by the amount of underwriting commission earned; the shares allotted in pursuance to a vendor's agreement are valued at the price specified in the agreement. As per AS-13, the cost of an investment should include acquisition charges such as brokerage, fees and duties. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident.

When an investment is sold for determining the amount of profit or loss resulting on its sales, it is necessary to first ascertain its cost. While doing so, a distinction is made between capital and revenue expenses and receipts. For instance the amount of brokerage paid on purchasing investment (Government Securities or debentures) is added to their cost. Costs such as transfer fees, stamp duty, etc. should be capitalised. But the amount, if any, paid on account of interest which had accrued due till the date of transaction is not taken into account for it is recoverable. Likewise, the value of bonus shares allotted subsequent to the purchase of the shares is not added to their cost. Then the cost of the original requisition would represent the cost for the total holding including bonus shares. However, the amount received on sale of 'right' in respect of new shares offered by the company may be deducted from the value of shares held, it being a capital receipt. On the very same consideration, any dividend received on shares for a period which had closed before the date of acquisition is treated as a capital receipt. As per AS-13, interest, dividend and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income. For example, when unpaid interest has accrued before the acquisition of an interest-bearing investment and is therefore included in the price paid for the investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion is deducted from cost. When dividends on equity are declared from pre-acquisition profits, a similar treatment may apply. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

As per AS-13 "Accounting for Investments", "an enterprise should disclose current investments and long term investments distinctly in its financial statements". Regarding valuation, it states as under:

"Investments classified as current investments should be carried in the financial statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

Any reduction in the carrying amount and any reversals of such reductions should be charged or credited to the Statement of Profit and Loss.

On disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to the Statement of Profit and Loss."

6.4.3 General Principles Regarding Verification of Assets

(i) Where a company or a partnership has taken over the assets of a going concern, the agreement of sale should be inspected and that amount paid for them ascertained. It should be further verified that the allocation of the total cost among the various assets is fair and reasonable.

(ii) The cost of assets acquired piecemeal should be verified with their invoices, purchase agreements or ownership rights and the receipt of the sellers in respect of the price paid. It should be verified that expenditure on assets newly acquired and that on the renewal and replacement of old assets has been correctly recorded, consistent with the method that has been generally followed in the past.

(iii) When an asset is sold, its sale-proceeds should be vouched by reference to the agreement, containing the terms and conditions of sale, counterfoil of the receipt issued to the purchaser or any other evidence which may be available. If the sale of a fixed asset has resulted in capital profit, it should be transferred to capital reserve. However, the profit limited to the original cost or a loss should be transferred to the Statement of Profit and Loss.

(iv) It is obligatory for a company to provide for depreciation out of the profits in accordance with the provisions under sub-section (1) of section 123, before any profits can be distributed as dividend. The law requires that depreciation should be provided in the manner as specified in Schedule II to the Companies Act, 2013.

(v) The existence of fixed assets, where practicable, should be verified by a physical inspection and, or by comparing the particulars of assets as are entered in the Schedule attached to the Balance Sheet, with the Plant or Property Register and reconciling their total value with the General Ledger balances.

(vi) Wherever possible, all the securities and documents of title, cash, negotiable instruments, etc. representing the assets, should be inspected at the close of the last day of the accounting period. If this be not practicable and the examination is undertaken at the later date, a careful scrutiny of transactions subsequent to the date of the balance sheet must be made to ensure that the changes in their balance that have subsequently taken place are *bonafide* and are supported by adequate evidence.

(vii) It should be ascertained that no unauthorised charge has been created against an asset and all the charges are duly registered and disclosed. Where shares or securities are lodged with a bank to secure a loan or an overdraft, a certificate should be obtained from the bank showing the nature of the charge, if any.

(viii) Where assets, *e.g.,* government securities, share scrips and debenture bonds are in the custody of a third party other than a bank, these must be inspected.

(ix) Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.

Note 6(I) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Tangible Assets" in notes to accounts as follows:

(I) Tangible Assets

(i) Classification shall be given as:

- Land
- Buildings
- Plant and Equipment
- Furniture and Fixtures
- Vehicles
- Office Equipment
- Others (specifying nature)

It is the duty of the management to ensure that the fixed assets of the company are in existence and for this purpose, it is important that physical examination of plant and machinery and other fixed assets should be carried out periodically depending upon the size of the company. The auditor is also required to report on the physical verification of the fixed assets by the management, and the treatment of the discrepancies, if any.

6.4.4 Audit of Fixed Assets: The Guidance Note on Audit of Property, Plant and Equipment issued by the ICAI recommends that verification of PPE (referred as fixed assets) consists of examination of related records and physical verification. The auditor should, normally, verify the records with reference to the documentary evidence and by evaluation of internal controls. Physical verification of PPE is primarily the responsibility of the management. The auditor must also consider the appropriateness of the accounting policies, including policies for determining which costs are capitalised, whether a cost or valuation model is followed and depreciation (including assessment of residual values) appropriately calculated.

As per the relevant Revised AS, the auditor should ensure that the entity has capitalised the assets as per the component approach, whereby a component or part of an asset which is significant in value compared to the total value of the asset or the useful life of which is different from that of the asset, has to be capitalised separately.

The verification of records would include verifying the opening balances of the existing PPE from records such as the Schedule of fixed assets, ledger or register balances to acquisition of new fixed assets should be verified with reference to supporting documents such as orders, invoices, receiving reports and title deeds. The auditor must verify records to ensure that the assets under construction or pending Self-constructed fixed assets and capital work-in-progress should be verified with reference to the supporting documents such as contractors' bills, work orders and independent confirmation of the work performed from other parties. When fixed assets have been written off or fully depreciated in the year of acquisition, the auditor should examine whether these were recorded in the fixed assets register before being written off or depreciated. In respect of retirement of fixed assets, the auditor should examine whether retirements were properly authorised, whether depreciation accounts have been properly adjusted, whether the sale proceeds, if any, have been accounted for and the resulting gains or losses, if material, have been properly adjusted and disclosed in the Statement of Profit and Loss. In case the asset is impaired the auditor must ensure that the asset has met the criteria as specified in AS 28, "Impairment of Assets". Further, if conditions so warrants, the reversal norms of impairment loss are duly complied with.

The ownership of assets like land and buildings should be verified by examining title deeds. In case the title deeds are held by other persons such as bankers or solicitors, independent confirmation should be obtained directly by the auditor through a request signed by the client.

Physical verification of fixed assets is primarily a responsibility of the management. The management is required to carry out physical verification of fixed assets at appropriate intervals in order to ensure that they are in existence. However, the auditor should satisfy himself that such verification was done by the management wherever possible and by examining the relevant working papers. The auditor should also examine whether the method of verification was reasonable in the circumstances relating to each asset. The reasonableness of the frequency of verification should also be examined by the auditor in the circumstances of each case. The auditor should test check the book records of fixed assets with the physical verification reports. He should examine whether discrepancies noticed on physical verification have been properly dealt with.

The auditor should see that the fixed assets have been valued and disclosed as per the requirements of law and generally accepted accounting principles. The auditor should test check the calculations of depreciation and the total depreciation arrived at should be compared with that of the preceding years to identify reasons for variations. He should particularly examine whether the depreciation charge is adequate keeping in view the generally accepted basis of accounting for depreciation. The Institute has also recommended that the company should provide depreciation so as to write off the asset over its normal working life. The company may provide depreciation with different useful life and residual value than as prescribed under Schedule II to the Companies Act, 2013, after disclosing the justification for the same.

Revaluation of fixed assets implies re-statement of their book values on the basis of systematic scientific appraisal which would include ascertainment of working condition of each unit of fixed assets. It would also include making technical estimates of future working life and the possibility of obsolescence. Such an appraisal is usually made by independent and qualified persons such as engineers, architects, etc. To the extent possible, the auditor should examine these appraisals. As long as the appraisal appears reasonable and based on adequate facts, he is entitled to accept the revaluation made by the experts.

6.4.5 Fixed Assets and requirement of Companies (Auditor's Report) Order, 2015 [CARO, 2015]:

(A) Clause (i)(a) to Paragraph 3 of the CARO, 2015 requires the auditor to comment whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets.

What constitutes proper records is a matter of professional judgment made by the auditor after considering the facts and circumstances of each case. It is necessary that the aggregate original cost, depreciation or amortisation to date, and impairment loss, if any, as per these records under individual heads should tally with the figures shown in the books of account. It is not possible to specify any single form in which the records should be maintained. This would depend upon the mode of account keeping (manual or computerized), the number of operating locations, the systems of control, etc. It may be noted that with the advent of the information technology, many companies are maintaining electronic records. The auditor may, therefore, accept electronic fixed assets register if the following two conditions are satisfied:

(1) The controls and security measures in the company are such that once finalised, the fixed assets register cannot be altered without proper authorization and audit trail.

(2) The fixed assets register is in such a form that it can be retrieved in a legible form. In other words, the emphasis is on whether it can be read on the screen or a hard copy can be taken. If this is so, one can contend that it is capable of being retrieved in a legible form.

In case the above two conditions or either of the two conditions are not satisfied, the auditor should obtain a duly authenticated print-out of the fixed assets register. In case the auditor decides to rely on electronically maintained fixed assets register, he should maintain adequate documentation evidencing the evaluation of controls that seek to ensure the completeness, accuracy and security of the register.

The auditor should examine whether the company has an appropriate mechanism in place to ensure compliance with this provision of Schedule II.

The purpose of showing the situation of the assets is to make verification possible. There may, however, be certain classes of fixed assets whose situation keeps changing, for example, construction equipment which has to be moved to sites. In such circumstances, it should be sufficient if record of movement/custody of the equipment is maintained.

(B) Clause (i)(b) to Paragraph 3 of the CARO, 2015 requires the auditor to comment whether the fixed assets of the company have been physically verified by the management at reasonable intervals. The clause further requires the auditor to comment 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.

Physical verification of the assets has to be made by the management and not by the auditor. It is, however, necessary that the auditor satisfies himself that such verification was done and that there is adequate evidence on the basis of which he can arrive at such a conclusion. The auditor may prefer to observe the verification, particularly when verification of all assets can be made by the management on a single day or within a relatively short period of time. If, however, verification is a continuous process or if the auditor is not present when verification is made, then he should examine the instructions issued to the staff (which should, therefore, be in writing) by the management and should examine the working papers of the staff to substantiate the fact that verification was done and to determine the name and competence of the person who did the verification. In making this examination, it is necessary to ensure that the person making the verification had the necessary technical knowledge where such knowledge is required. It is not necessary that only the company's staff should make verification. It is also possible for verification to be made by outside expert agencies engaged by the management for the purpose.

The auditor should examine whether the method of verification was reasonable in the circumstances relating to each asset. For example, in the case of certain process industries, verification by direct physical check may not be possible in the case of assets which are in continuous use or which are concealed within larger units. It would not be realistic to expect the management to suspend manufacturing operations merely to conduct a physical verification of the fixed assets, unless there are compelling reasons which would justify such an extreme procedure. In such cases, indirect evidence of the existence of the assets may suffice. For example, the very fact that an oil refinery is producing at normal levels of efficiency may be sufficient to indicate the existence of the various process units even where each such unit cannot be verified by physical or visual inspection. It may not be necessary to verify assets like building by measurement except where there is evidence of alteration/demolition. At the same time, in view of the possibility of encroachment, adverse possession, etc., it may be necessary for a survey to be made periodically of open land.

The Order requires the auditor to report whether the management "at reasonable intervals" has verified the fixed assets. What constitutes "reasonable intervals" depends upon the circumstances of each case. The factors to be taken into consideration in this regard include the number of assets, the nature of assets, the relative value of assets, difficulty in verification, situation and spread of the assets, etc. The management may decide about the periodicity of physical verification of fixed assets considering the above factors. While an annual verification may be reasonable, it may be impracticable to carry out the same in some cases. Even in such cases, the verification programme should be such that all assets are verified at least once in every three years. Where verification of all assets is not made during the year, it will be necessary for the auditor to report that fact, but if he is satisfied regarding the frequency of verification he should also make a suitable comment to that effect.

The auditor is required to state whether any material discrepancies were noticed on

verification and, if so, whether the same have been properly dealt with in the books of account. The latter part of the statement is required to be made only if the discrepancies are material. The auditor has, therefore, to use his judgement to determine whether a discrepancy is material or not. In making this judgement, the auditor should consider not merely the cost of the asset and its relationship to the total cost of all assets but also the nature of the asset, its situation and other relevant factors. If a material discrepancy has been properly dealt with in the books of account (which may or may not imply a separate disclosure in the accounts depending on the circumstances of the case), it is not necessary for the auditor to give details of the discrepancy or of its treatment in the accounts but he is required to make a statement that a material discrepancy was noticed on the verification of fixed assets and that the same has been properly dealt with in the books of account.

6.5 Verification of Specific Assets

6.5.1 Land and Buildings: Sometimes the two assets are shown together in the Balance Sheet. Nevertheless, their ledger accounts should always be separated particularly in view of the fact that buildings are subject to depreciation while land in general is not.

The land holdings should be verified by an inspection of the original title deed to ensure that the land described therein covers all the lands the cost of which is debited in the books of the concern. The auditor however, not being competent to verify the regularity of the title of the concern to the land, is not responsible for doing so. Therefore, generally, a certificate should be obtained from the legal adviser of the client confirming the validity of his title to the land. The auditor should, however, verify that the conveyance deed has been duly registered as required by section 17(1) of the Registration Act, 1908 also that particulars required to be endorsed thereon according to section 58 of the same Act have been duly made and verified. He should, in addition, generally ascertain that *prima facie* the title of the client does not appear to be defective.

If the property is mortgaged, the title deed would be in the possession of the mortgagee or his solicitors. A certificate to this effect should be obtained from them. It should also be ascertained whether there is any second or subsequent mortgage. If ground rents, outstanding for recovery, are included in the Balance Sheet as an asset, the auditor must examine the counter parts of leases granted and also verify that the ground rents which were outstanding for recovery on the date of the Balance Sheet have since been recovered. If there has been any sale of land or building, it should be verified that the amount of profit or loss resulting on sale has been correctly adjusted in the accounts.

The cost of buildings, as is entered in the books, should be depreciated considering appropriate useful lives, depending upon the quality of their structure and the use which is being made of them. The cost of fittings and fixtures to the building should be adjusted separately in the account from the cost of buildings, since these suffer higher rate of wear and tear than the brick and mortar structure and therefore, have to be depreciated considering lesser useful lives.

If the values of land and buildings are not separately recorded in the books of account, the same should be separated for purposes of calculating the amount of deprecation. This should be done with the assistance of a valuer, unless the same can be achieved on the basis of some documentary evidence available in the record.

Since buildings are continually repaired and there is only a thin margin of differentiation between the expenditure of their improvement and that on repairs, it is necessary for the auditor to scrutinise closely the expenditure on repairs so as to exclude from its expenditure that could legitimately be considered to have added either to the life or the utility of the asset. Such expenditure should be added to their cost while the amount incurred on current repairs is written off.

It is not customary to write up the book values of land and buildings even though their market values have increased but, where this has been done it will be necessary for the auditor to verify that the appreciation adjusted has been disclosed as required by the law. On the same consideration, no notice need be taken of any fall in the market value of such an asset until the same has crystallized by the asset being sold.

The land holding in the case of real estate dealer will be a current asset and not a fixed asset. The same should, therefore, be valued at cost or market value whichever is less. The amount of profit or loss arising on sale of plots of land by such a dealer should be verified as follows:

(i) Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realised for it.

(ii) This basis of distribution of the common charges between different plots of land developed during the period, and basis for allocation of cost to individual properties comprised in a particular piece of land should be scrutinised.

(iii) If land price lists are available, these should be compared with actual selling prices obtained. And it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.

(iv) Where part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.

(v) The prices obtained for various plots of land sold should be checked with the plan map of the entire tract and any discrepancy or unreasonable price variations should be inquired into. The sale price of different plots of land should be verified on a reference to certified copies of sale deeds executed.

(vi) Out of the sale proceeds, provision should be made for the expenditure incurred on improvement of land, which so far has been accounted for.

6.5.2 Leasehold Property: Various steps involved in the verification of leasehold rights are stated below-

(i) Inspect the lease or assignment thereof to ascertain the amount of premium, if any, for securing the lease, and its terms and conditions; and that the lease has been duly registered. A lease exceeding one year is not valid unless it has been granted by a registered instrument (section 107 of the Transfer of Property Act, 1882).

(ii) Ascertain that all the conditions, the failure to comply with which might result in the forfeiture or cancellation of the lease, e.g., payment of ground rent on the due dates, insurance of property, its maintenance in a satisfactory state of repairs, etc. prescribed by the lease, are being duly complied with.

(iii) Examine the counterpart of the tenants' agreements, if part of the leasehold property has been sublet.

(iv) Make certain that due provisions for any claim that might arise under the dilapidation clause on the expiry of the lease has been made, and, if no such provision has been made, draw the client's attention to the matter.

(v) Ensure that the outlay as well as any legal expenses incurred to acquire the lease which are shown as an asset in the Balance Sheet is being written off at a rate which could completely wipe off the asset over the unexpired term of the lease.

A leasehold property, even where no premium has been paid for its acquisition, may sometime come to have a considerable value. In such a case, it may not be advisable to continue to show the asset as if it has no value. Nevertheless, where the leasehold rights have been revalued that fact should be clearly shown on the Balance Sheet till the account has been completely written off.

6.5.3 Building: If the building has been built or is in the course of construction, under a contract the auditor should verify the debit balance of the account by reference to the architect's certificate, as well as the contractor's receipts for amounts paid.

If the building has been constructed by the client's own organisation, it will be necessary for the auditor to verify that the basis upon which cost of materials, wages and the supervision charged have been allocated to the account, is reasonable. The expenses charged should include all the expenditure necessary to bring the building into existence and to make it habitable. As a safeguard against any mistake arising in the expenses chargeable to the asset, the auditor should obtain a certificate from a responsible official in respect of total expenditure incurred on the construction of the building up to the date of the Balance Sheet. The amount of expenditure, where possible, should also be compared with the estimated cost of construction which may have been prepared by an architect or received with the tenders, if any, invited for construction. If there is a material discrepancy in the amount of actual and estimated expenditure, causes thereof should be reviewed.

6.5.4 Intangible Assets: 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 expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources 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 is internally generated. If an item covered does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in an amalgamation in the nature of purchase, it forms part of the goodwill recognised at the date of the amalgamation.

Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a license or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. In determining whether such an asset should be treated under AS 10, Accounting for Fixed Assets, or as an intangible asset under this Statement, judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

As per AS-26, 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.

Note 6(J) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Intangible Assets" in notes to accounts as follows:

(J) Intangible Assets

- (i) Classification shall be given as:
  - (a) Goodwill.
  - (b) Brands /trademarks.
  - (c) Computer software.
  - (d) Mastheads and publishing titles.
  - (e) Mining rights.

(f) Copyrights, and patents and other intellectual property rights, services and operating rights.

(g) Recipes, formulae, models, designs and prototypes.

(h) Licenses and franchise.

(i) Others (specify nature).

6.5.5 Plant and Machinery: In the absence of a Plant, the Register containing detailed particulars of various articles of machinery and equipment, showing separately original cost, addition to and sales from it from time to time. It is not normally practicable for the auditor to verify the existence of such assets. The auditors should therefore insist on a Plant Register being maintained where the value and variety of machinery and plant are substantial in comparison with the total assets of the business.

Where such a register is kept, it is customary to prepare at the end of each year a statement from the Plant Register showing opening balance, sale and addition thereto during the year in respect of various items of machinery and plant. Its total is then reconciled with the balance in the General Ledger.

The cost of addition, if any, is verified with the invoice of machinery supplied together with evidence in respect of other incidental expenses chargeable to the account, including installation expenses. If any of the addition represents the cost of machinery manufactured by the concern with its own material and by its own labour, the basis on which the expenditure has been allocated should be verified. In addition, a certificate is obtained from the engineer responsible for the manufacture of the plant confirming the total cost of manufacture.

In case any item or machinery has been scrapped, destroyed or sold the auditor should ascertain that the profit or loss arising thereon has been correctly determined which has either been disclosed in the Statement of Profit and Loss or credited to the Capital Reserve. In appropriate circumstances, a certificate should be obtained from a senior official that this has been done.

Though it is the duty of the management to ensure that fixed assets are in existence, the auditor also should, periodically, physically examine various items of plant and machinery and other fixed assets, say, once in every three or five years, depending upon the size of the concern.

Certain companies, for convenience of inspection attach to each unit of plant and machinery a metallic disc bearing the number at which it is shown in the Plant Register.

When an asset has been revalued, depreciation should be provided on the revised value and not on the historical value.

6.5.6 Patterns, Dies, Loose Tools, etc.: Several entities have large investments in such assets which have a relatively short useful life and low unit cost. Evidently, it is a difficult matter, under the circumstances, to prepare a separate account for each such asset although a careful control over such property is necessary.

On these considerations, some entities charge off small tools and other similar items to Production Account as and when they are purchased and do not place any value on the unused inventory on the Balance Sheet. Nevertheless, a record of issues and receipts of tools to workmen is kept, as a check on the same being pilfered and a memorandum inventory account of dies and patterns is also maintained. In other concerns, the cost of tools, dies, etc. purchased is debited to appropriate assets account, and an inventory of the unused items at the end of the year is prepared and valued; the sum total of opening balance and purchase reduced by the value of closing inventory, as disclosed by the inventory, is charged off to Production Account in respect of such assets. On the other hand, some concerns carry such assets at their book values at the end of the first year and charge off the cost of all the purchases in the subsequent year to the Production Account on the plea that they represent cost of replacement.

The most satisfactory method, however, is that of preparing an inventory of serviceable articles, at the close of each year, and revaluing the assets on this basis, the various articles included in the inventory being valued at cost. Care, however, should be taken to see that the inventory does not include any worn out or defective articles the life of which has already run out.

6.5.7 Furniture, Fittings and Fixtures: The cost of these assets should be verified by reference to the invoices of suppliers. The entire expenditure incidental to their purchase also should be debited to the appropriate asset account. Further, the auditor should carefully scrutinise the details of the cost of additions debited to these accounts so as to ascertain that only the cost of genuine additions has been debited to such accounts. In the case of assets in regard to which there is a danger of loss through pilferage, there should be a satisfactory system of inventory control over them. It requires that each article of furniture is entered in a Inventory Register before its price is paid and the inventory number under which it is entered is painted over it also that at the end of each period, an inventory is prepared and reconciled with the Inventory Register and cost of all the articles which becomes unserviceable or have been lost is written off under proper authority.

6.5.8 Motor Lorries, Vans, etc.: The cost of these assets should be verified by reference to the invoices of suppliers and their ownership confirmed from permit and Registration Books. The auditor should also verify that the vehicles are covered by a comprehensive policy of insurance and adequate depreciation has been provided in respect of each of them. In case the number of vehicles is large, there should be a Vehicle Register similar to the Plant Register.

6.5.9 Livestock: A schedule of livestock at the close of the year should be obtained and entries in the same should be verified with the Register of Animals if it has been maintained. The entire stock of animals should be revalued on a uniform basis, from year to year, the cost of animals which have either been sold or have died during the year being excluded, and that of newly born or purchased during the year being added. There should be adjustment in the value of dry cattle on appropriate basis.

6.5.10 Ships: The cost of ships, if purchased outright, should be verified on a reference to the Bill of Sale and, if built to order, from the agreements with the shipbuilders. The ownership of the title should be verified from the certified copy of the entry in the port of registration unless the same is endorsed on the back of the Bill of Sale. Any mortgage or charge created on the ship is disclosed in the copy of 'entry' in case any exists, the same should be disclosed. In addition, it should be ascertained that the vessel is fully insured against all risks.

6.5.11 Investments: AS 13 on "Accounting for Investments" defines Investments as assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise.

An investment constitutes a significant portion of the total assets. An investment may be represented by Government securities, shares, debentures etc.

The following procedure should be adopted for verifying the investments-

(i) Obtain schedule of securities and share in hand at the beginning of the audit period containing description, date of purchase, face value, book value (also the amount paid up if it differs from the book value), market value, rate of interest, date of payment of interest, date around which dividend is normally declared etc. In separate columns enter the amounts of interest and dividend received during the period, interest or dividend accrued or outstanding at the close of the period, tax deducted out of the first mentioned amount and deductible out of the second.

(ii) Add to the above list, securities and shares purchased and sold during the year, giving the same description in regard to both.

(iii) Balance this schedule and compare the closing balance with the control account in the General Ledger.

(iv) The auditor should ascertain whether the investments made by entity are within its authority.

(v) The auditor himself should also be satisfied that the transactions for the purchase/sale of investments are supported by due authority and documentation.

(vi) The acquisition/disposal of investments should be verified with reference to the brokers' contract note, bill of costs, etc. special attention should be paid to investments purchased or sold cum-dividend, ex-dividend, cum-interest/ex-interest, cum rights/ex-rights or cum bonus/ex-bonus.

(vii) Where the amount of purchases or sales of investments are substantial, the auditor should check the prices paid/received with reference to stock exchange quotations.

(viii) The auditor should also physically inspect investments. The investments should be physically verified at the last date of the accounting year. In case investments are not held by the entity in its own custody - then certificate should be obtained from the relevant authority to the effect of holding of investments.

(ix) In case investments are held otherwise than in the name of the entity, e.g. in the name of nominees/trustees, the auditor should ascertain the reasons for the same and examine relevant documentary evidence.

(x) The auditor should also examine the relevant provisions of section 143(1) of the Companies Act, 2013 and see that a company other than an investment or banking company, whether so much of the assets of the company as represented by shares and debentures have been sold at a price less than that at which they were purchased by the company.

(xi) The auditor should see title deeds of immovable properties and see that same have been properly classified.

(xii) The auditor should satisfy that the investments have been valued and disclosed in the financial statements in accordance with the recognised accounting policies and practices and relevant statutory requirements. Reference to principles laid down in AS-13 on "Accounting for Investments" relating to valuation of investments will be necessary.

(xiii) The auditor should examine whether in computing the cost of investments, the expenditure incurred on account of transfer fees, stamp duty etc. is included in the cost of investments.

(xiv) The auditor may also see that any money raised through share issue to the extent remains unutilised has been shown under the head "Investments" and the manner in which the same has been invested should also be indicated.

Note: About accounting of dividend income by companies, the Company Law Board has prescribed a procedure. In terms of the procedure, dividend declared during the accounting year even though not received should be accounted for in the same year. If dividend is declared after the year is over, but before the annual accounts are finalised and if the dividend relates to the accounting year, the same also should be accounted for in the year itself.

Section 187 of the Companies Act, 2013 requires that all investments made by a company on its own behalf shall be made and held by it in its own name except in cases which are specifically exempt.

Investment in the shares or debentures of a subsidiary: The auditor should obtain a complete schedule of all such investments held, showing particulars as regards the name of the subsidiary company, class of shares or debenture, date of purchase, number of units and denoting numbers, book value, dividend received etc. All the particulars entered in the schedule should be verified with the relevant account in the General Ledger. He should, at the same time, examine all the investments by inspection of the securities, share scrips or certificates, debenture bonds, etc. If any of the securities are held by bankers, he should verify them with their certificate which should disclose the charge, if they are subject to any such charge.

The provisions contained in Part I of Schedule III to the Companies Act, 2013 require that shares held in a subsidiary should be shown separately. The shares or debentures of a subsidiary are valued at cost. If the subsidiary has suffered a loss, then a provision for the proportionate part of the loss should be made in the accounts of the holding company.

6.5.12 Investment in the Capital of a Partnership Firm: This has now got to be disclosed separately. To establish the authenticity of this item the auditor should go through the partnership deed, noting the capital contributed by the company, and the latest Balance Sheet and the Statement of Profit and Loss, duly audited. The amount of the loss, if any, falling to the share of the company should be debited to the Statement of Profit and Loss; the share of profit should be similarly credited to the Statement of Profit and Loss. The auditor should see whether the firm has been duly registered and he will do well to note the particulars sent for registration.

Note 6(K) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Non-Current Investments" in notes to accounts as follows:

(K) Non-current Investments

(i) Non-current investments shall be classified as trade investments and other investments and further classified as:

(a) Investment property;

(b) Investments in Equity Instruments;

(c) Investments in preference shares;

(d) Investments in Government or trust securities;

(e) Investments in debentures or bonds;

(f) Investments in Mutual Funds;

(g) Investments in partnership firms;

(h) Other non-current investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.

(iii) The following shall also be disclosed:

(a) Aggregate amount of quoted investments and market value thereof;

(b) Aggregate amount of unquoted investments;

(c) Aggregate provision for diminution in value of investments.

Note 6(N) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Current Investments" in notes to accounts as follows:

(N) Current Investments

(i) Current investments shall be classified as:

(a) Investments in Equity Instruments;

(b) Investment in Preference Shares

(c) Investments in government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firms

(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) The following shall also be disclosed:

(a) The basis of valuation of individual investments;

(b) Aggregate amount of quoted investments and market value thereof;

(c) Aggregate amount of unquoted investments;

(d) Aggregate provision made for diminution in value of investments.

6.5.13 Patent Rights: The ownership of a patent is verified by inspection of the certificate issued in respect of grant of the patent. If it has been purchased; the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are 'alive' and legally enforceable and renewal fees have been paid on due dates by being charged to revenue and to the Patent Account. The last renewal receipt should be examined to ascertain that the patent has not lapsed. If a number of patents are held, a schedule thereof should be obtained. The auditor should ensure that patents are being shown at cost less amortisation charges. The cost of a patent includes it purchase price and the registration cost if brought outright. If the patent has been developed by the client in-house, all development expenses, legal charges, including registration fees and other direct costs incurred in creating it, should be capitalized. The cost of patent should be written off over the legal term of its validity or over its useful commercial life, whichever is shorter. AS-26 has suggested ten years as useful life until and unless there is clear evidence that useful life is longer than ten years. As stated earlier, student may refer to AS-26 as well.

6.5.14 Trademarks and Copyright: The existence of a trademark is verified by an inspection of the certificate as regards grant of the trademark. Where it has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are alive and legally enforceable. Copyrights are also acquired by surrender of rights and they also should be verified similarly. The auditor should obtain a schedule of trademarks and copyrights and verify that renewal fees have been paid and charged to revenue. The last renewal receipt should, in each case, be examined to ascertain that the trade mark has not lapsed. Copyrights and trademarks are generally revalued at cost less amortisation charges till date. The copyright and trademarks are generally revalued at cost less amortisation charges till date. If copyright and trademarks were purchased, the cost includes purchase price and registration charges. If it has been developed by the client, the cost should include cost of developing outlays, design costs and other associated direct cost. The cost of trademarks and copyright should be amortized over the period of legal validity or useful commercial life, whichever is shorter. Where auditor finds that any publication has ceased to command sale, he should have the amount of its copyright written off to revenue. AS-26 has suggested for every intangible assets useful life of ten years unless and until there is clear evidence that useful life is longer than ten years.

6.5.15 Assets Abroad: Where documents of title relating to assets held abroad are not available for inspection, a certificate should be obtained from the agent or any other party holding the document. Such a certificate must disclose unequivocally that they are free from any charge or encumbrance. The auditor should state in his report whatever evidence has been produced for his verification.

6.5.16 Development of Property: Expenses when incurred for the development of any property and which cannot be conveniently added to the value of such property should be capitalized under this head and written off over the period during which the benefit from such development will accrue to the business. Examples may be expenses incurred in grading and preparing the soil for plantations, overhead removal cost for collieries and mines, etc. These expenses should be verified with reference to the budgets, sanction of the appropriate authority, technical report, if any, and the bills for actual expenditure incurred. It should also be ensured that appropriate write off has been made against these assets, keeping in view the period of benefit or the exploitation, as the case may be.

6.5.17 Railway Siding: For verification of this item it would be essential to refer to agreement with Railway for availing of the facility. All expenses connected with the laying of the rails and making individual agreements, the amount paid to the Railway, if any should make up the cost. The cost of the railway siding should also be appropriately depreciated keeping in view the terms of agreement with the Railway, the permit or lease, if any, for the land used in providing the siding, etc.

6.5.18 Endowment policies : Endowment policies taken out for the redemption of leases, or sinking fund policies for the redemption of debentures and policies for other similar purposes, being in the nature of quasi-fixed assets, should be verified by inspection of the policies and the auditor should ascertain that the last premium on them has been duly paid.

6.6 Current Assets

6.6.1 Inventory: The valuation of inventory is frequently the main factor in determining the result shown by the accounts. Apart from the effect on the Balance Sheet, incorrect treatment of inventory would affect the profits of the year that has closed as well as that of the next following. The valuation of the closing inventory, therefore, is an important step essential for the determination of the profits of the year and also for truly disclosing the financial position of the concern at the close of the year. An auditor being intimately concerned with these aspects of financial statements, it is his duty to verify the existence of the inventory possessed by the concern at the end of the year and to ascertain that the same has been valued correctly on a consistent basis.

The precise duties in regard to verification of inventory are nowhere defined. Under the circumstances, these have to be deduced from an interpretation of the general responsibility of auditors in regard to the statements of accounts verified by them, especially in regard to inventory. These have been considered in a few English decisions.

Justice Lindsay, while delivering the famous judgement in the case of *Kingston Cotton Mills Co. Ltd*. (1896) observed: It is no part of the auditor's duty to take inventory. No one contends that it is so; he must rely on other people for details of the inventory in hand. In the case of a cotton mill, he must rely on some skilled person for the material necessary to enable him to enter the inventory as its proper value in the Balance Sheet.

In the same case, Justice Lopes observed as follows: "An auditor is not bound to be a detective, or as was said to approach his work with a foregone conclusion that there is something wrong. He is watchdog, but not a blood hound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest to rely upon their representations, provided he takes reasonable care."

In the case of the *Westminster Road Construction & Engineering Co. Ltd*. (1932), it was held that an auditor must make the fullest use of all materials available to him and although he is neither an inventory-taker and nor a valuer of work-in-progress, he will be guilty of negligence if he fails to take notice of all available evidence from which it could be reasonably deducted that the work-in-progress was overvalued.

The decision thus appear to have settled the following three principles for the general guidance of the auditor:

(i) That it is no part of auditor's duty to take inventory.

(ii) That for the purpose he can rely upon statements and reports made available to him in regard to the valuation of inventories so long as there is no circumstance which may arouse his suspicion and he is satisfied that the procedures in the matter of inventory taking and management are such as would enable it to give such a certificate and that these have been followed.

(iii) That an auditor would be failing in his duty if he does not take reasonable care in verifying the statements of inventory which are put up to him according to the information in his possession and the expert knowledge expected of him in regard to methods of verification and inventory control.

The above view was almost accepted universally by accountants until as a result of the disclosures in the case of *McKesson and Robbins*, the auditors in the U.S.A decided to make physical contact with the inventories presented to them.

In United Kingdom, the situation also underwent a change in 1967 since the decision of the famous case in *Thomas Gerrard & Sons Limited*. The liquidator of Thomas Gerrard & Sons Limited succeeded in an action against the company's auditors. The Managing Director of the company manipulated cut-off procedures and included non-existent inventories in the accounts in order to pay huge dividends, which in fact were paid out of the capital. The auditors relied on the Kingston Cotton Mill unsuccessfully; because the learned judge pointed out that this decision also made reference to the absence of suspicious circumstances. In the instant case such circumstances were in plenty as many sales and purchase invoices at the yearend had been deliberately altered. The Judge further observed that in these circumstances the auditors should reasonably have attended the inventory taking.

Following this in 1968, the Institute of Chartered Accountants in England & Wales issued Auditing Statement U-9 advising positively that auditors should attend at inventory taking for the purpose of observing the client's procedures and ensuring that they were likely to result in a reliable count. In this context it is also necessary to consider that during the last fifty years, there has been a great advancement in the techniques and methods of inventory control. With the aid of modern methods of costing, accounting ratios and budgetary control, it is now possible to obtain more accurate information in regard to quantities and value of inventory. Besides, now-a-days greater attention is being paid by businessmen to inventory control and, as a result, the inventory records maintained are more amenable to tests and checks.

The provisions in the Companies Act, 2013 have also considerably advanced the responsibilities of auditors in this regard. Section 128 of the Act requires a company to maintain proper books of account. Such books of account must, it is believed, include books kept to record transactions in inventory. The Act empowers the Central Government to require companies engaged in production of such goods or providing such services as may be prescribed to maintain books as would furnish particulars in relation to utilisation of material or labour or other items of cost as may be prescribed. Furthermore, by section 338(2)* of the Companies Act, 2013 'proper books of account' have been defined to include statements of annual inventory taking and (except in case of goods sold by way of ordinary retail trade) of all goods sold and purchased.

6.6.2 Verification of Inventories: The responsibility for properly determining the quantity and value of inventories rests with the management of the entity.

It is therefore the responsibility of the management of the entity to ensure that the inventories included in the financial information are physically in existence and represent all inventories owned by the entity. The management satisfies this responsibility by carrying out appropriate procedures which will include verification of all items of inventory at least once in every financial year. This responsibility is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence. Verification of inventories may be carried out by employing the following procedures:

(a) examination of records;

(b) attendance at inventory-taking;

(c) obtaining confirmations from third parties;

(d) examination of valuation and disclosure; and

(e) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgment of the auditor.

Examination of Records: The entities usually maintain detailed inventory records in the form of stores/inventory ledgers showing in respect of each major item the receipts, issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents (*e.g.,* goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case.

6.6.3 Attendance at Inventory-taking: Physical verification of inventories is the responsibility of the management of the entity. However, where the inventories are material and the auditor is placing reliance upon the physical count by the management, it may be appropriate for the auditor to attend the inventory-taking. The extent of auditor's attendance at inventory-taking would depend upon his assessment of the efficacy of relevant internal control procedures, and the results of his examination of the inventory records maintained by the entity and of the analytical review procedures.

The procedures concerning the auditor's attendance at inventory-taking depend upon the method of inventory-taking followed by the entity. There are two principal methods of inventory-taking: periodic inventory-taking and continuous inventory-taking. Under the first method, physical verification of inventories is carried out at a single point of time, usually at

* Section 338 of the Companies Act, 2013 not yet enforced.

the year-end. Under the second method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous inventory-taking method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous inventory-taking methods for certain inventories and carry out a full count of other inventories at a selected date. The auditor is expected to examine the adequacy of the methods and procedures of physical verification followed by the entity. Before commencement of verification, the management should issue appropriate instructions to inventory-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the auditor. The auditor should examine these instructions to assess their efficacy. Where the auditor is present at the time of inventory-taking, he should observe the procedure of physical verification adopted by the inventory-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those inventories which have a high value either individually or as a category of inventories. Proper attention should also be paid to the physical condition of inventories. Ideally, there should be no movement of inventories when the physical verification is being carried out. On occasions, however, it may be necessary for the entity to continue the production, receiving, or despatch operations during physical verification. In such circumstances, it is essential that the entity has the procedures to identify and record such movement. The auditor should review the procedures adopted by the entity to account for the movement of inventories from one location to another within the entity during inventory-taking (*e.g.* issues from stores to production departments). The auditor should also examine whether the entity has instituted appropriate 'cut-off procedures' to ensure that -

(i) goods purchased but not received have been included in the inventories and the liability has been provided for;

(ii) goods sold but not despatched have been excluded from the inventories and credit has been taken for the sales.

The auditor may examine a sample of documents evidencing the movement of inventories into and out of stores, including documents pertaining to period shortly before and shortly after the cut-off date, and check whether the inventories represented by those documents were included or excluded, as appropriate, during the inventory-taking. The auditor should review the original physical verification sheets and trace selected items - including the more valuable ones - into the final inventories. He should also compare the final inventories with inventory records and other corroborative evidence, *e.g.*, inventory statements submitted to banks. The auditor should examine whether the discrepancies noticed on physical verification have been investigated and properly accounted for. Where continuous inventory-taking methods are being used by the entity, the auditor should pay greater attention to ascertaining whether the management:

(i) maintains adequate inventory records that are kept up-to-date;

(ii) has satisfactory procedures for physical verifications of inventories, so that in the normal circumstances the programme of physical verification will cover all material items of inventories at least once during the year; and

(iii) investigates and corrects all material differences between the book records and the physical counts.

The auditor should determine whether the procedures for identifying defective, damaged, obsolete, excess and slow-moving items of inventory are well-designed and operate properly.

6.6.4 Confirmations from Third Parties: Where significant inventories of the entity are held by third parties, the auditor should examine that the third parties are not such with whom it is not proper that the inventories of the entity are held. The auditor should also directly obtain from the third parties written confirmation of the inventories held. Arrangements should be made with the entity for sending requests for confirmation to such third parties. Auditor should also consider SA 505, "External Confirmation" when he has obtained confirmation from third parties.

6.6.5 Examination of Valuation and Disclosure: The auditor's objective concerning valuation is to obtain evidence that the amount at which inventories have been valued is computed on an appropriate basis. The auditor should satisfy himself that the valuation of inventories is in accordance with the normally accepted accounting principles and is on the same basis as in the preceding year. The generally accepted accounting principles involved in the valuation of most types of inventories are dealt with in Accounting Standard (AS) 2, of 'Valuation of Inventories' issued by the Council of the Institute of Chartered Accountants of India. The auditor should examine the methods of applying the basis of inventory valuation. Thus, with regard to determination of cost, the auditor should examine, *inter alia*, the inventory sheets, records of physical verification, invoices, costing records and other relevant documents and also examine and test the treatment of overhead expenses as a part of cost of inventories. Wherever feasible, and particularly where only a single or a few major products are produced, the auditor may call for a reconciliation of the total cost of production for the year as determined by the cost records with the total expenses as per the financial books and review this reconciliation. Where standard costs are used or where overheads are charged at standard rates or percentages, he may ensure that appropriate adjustment is made to the inventories. The auditor should examine the evidence supporting the assessment of net realisable value. In this regard, the auditor should particularly examine whether appropriate allowance has been made for defective, damaged and obsolete and slow-moving inventories in determining the net realisable value. The auditor should satisfy himself that the inventories have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

6.6.6 Analytical Review Procedures: In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to inventories-

(i) reconciliation of quantities of opening inventories, purchases, production, sales and closing inventories;

(ii) comparison of closing inventory quantities and amounts with those of the previous year;

(iii) comparison of the relationship of current year inventory quantities and amounts with the current year sales and purchases, with the corresponding figures for the previous year;

(iv) comparison of the composition of the closing inventory (for example raw materials as a percentage of total inventories, work-in-process as a percentage of total inventories) with the corresponding figures for the previous year;

(v) comparison of current year gross profit ratio for the previous year;

(vi) comparison of actual inventory, purchase and sales figures with the corresponding budgeted figures, if available;

(vii) comparison of yield with the corresponding figure for the previous year;

(viii) comparison of significant ratios relating to inventories with the similar ratios for other firms in the same industry, if available;

(ix) comparison of significant ratios relating to inventories with the industry norms if available. It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out audit of inventories. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgment of the auditor.

6.6.7 Work-in-progress: The auditor may involve a technical expert in verification of work-in-progress if necessary. He may advise his client that where possible the work-in-progress should be reduced to the minimum before the closing date, particularly of items the production of which have been abandoned and for items the manufacture of which is not being actively undertaken provided cost sheets are available in respect of individual items or lots of jobs or work orders, which cannot be identified with physical work, these should be verified as follows:

(i) Ascertain that the cost sheets are duly attested by the Works Engineer and Works Manager.

(ii) Test the correctness of the cost as disclosed by the cost records by verification of quantities and cost of materials, wages and other charges included in the cost-sheets by reference to the records maintained in respect of issues of materials, payment of wages and its classification and original evidence in respect of all expenditure included in the cost-sheets.

(iii) Compare the unit cost or job cost as shown by the cost sheet with the standard cost or the estimate of cost expected to be maintained under actual operating conditions during a limited future period (wherever these have been developed).

(iv) Ensure that the allocation of overhead expenses has been made on reasonable basis and that total of the overhead expenses does not include any amount in respect of selling distribution and office expenses.

(v) Compare the cost-sheet in detail with that of the previous year both in regard to the composition of cost and the value placed on various components. If they vary materially, investigate the causes thereof.

6.6.8 Inventory and requirement of Companies (Auditor's Report) Order, 2015 [CARO, 2015]:

(A) Clause (ii)(a) to Paragraph 3 of the CARO, 2015 requires the auditor to comment whether the management has conducted physical verification of inventory at reasonable intervals. According to Accounting Standard (AS) 2, "Valuation of Inventories":

"Inventories are assets-

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services."

Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, stores and spares, consumables and loose tools awaiting use in the production process. It may be noted that packing materials are also included in inventories. Inventories do not include machinery spares covered by Accounting Standard (AS) 10, "Accounting for Fixed Assets", which can be used only in connection with an item of fixed asset and the use of which is expected to be irregular.

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. It is, however, necessary that the auditor satisfies himself that the physical verification of inventories has been conducted at reasonable intervals by the management and that there is adequate evidence on the basis of which the auditor can arrive at such a conclusion. For example, the auditor may examine the documents relating to physical verification conducted by the management during the year as also at the end of the financial year covered by the auditor's report.

What constitutes "reasonable intervals" depends on circumstances of each case. The periodicity of the physical verification of inventories depends upon the nature of inventories, their location and the feasibility of conducting a physical verification. The management of a company normally determines the periodicity of the physical verification of inventories considering these factors. Normally, wherever practicable, all

the items of inventories should be verified by the management of the company at least once in a year. It may be useful for the company to determine the frequency of verification by 'A-B-C' classification of inventories, 'A' category items being verified more frequently than 'B' category and the latter more frequently than 'C' category items.

(B) Clause (ii)(b) to Paragraph 3 of the CARO, 2015 requires the auditor to comment on the reasonableness and adequacy of the inventory verification procedures followed by the management of the company. In case the procedures of physical verification of inventories, in the opinion of the auditor, are not reasonable and adequate in relation to the size of the company and the nature of its business, the auditor has to report the same.

An auditor should obtain reasonable assurance about existence and condition of inventories. Observation of physical verification/examination of records of verification of inventory is the primary source of evidence for the purpose of reporting under this clause. While the physical verification of inventories is primarily the duty of the management, the auditor is expected to examine the methods and procedures of such verification. The auditor may, if considered appropriate by him, be also present at the time of stock-taking. The duties and responsibilities of the auditor while attending a stock taking by the management are governed by the principles laid down in the Standard on Auditing SA 501, Audit Evidence – Additional Considerations for Specific Items, issued by the Institute of Chartered Accountants of India. The auditor should establish the reasonableness and adequacy of procedures adopted for physical verification of inventories having regard to the nature of inventories, their locations, quantities and feasibility of conducting the physical verification. This would require the auditor to make use of his professional judgement.

There are two principal methods of physical verification of inventories: periodic and continuous. Under the periodic physical verification method, physical verification of inventories is carried out at a single point of time, usually at the year-end or at a selected date just prior to or shortly after the year-end. Under the continuous physical verification method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous physical verification method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous physical verification methods for certain stocks and carry out a full count of other stocks at a selected date.

Normally, before commencement of verification, the management should issue appropriate instructions to stock-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the auditor. The auditor should examine these instructions to assess their efficacy. The auditor has to use his *professional judgement regarding the nature, timing and extent of the procedures to be applied in forming his opinion for commenting on this clause. The auditor can rely upon the work of an internal auditor provided the auditor complies with the requirements of Standards on Auditing (SA) 610, "Using the Work of an Internal Auditor", issued by the Institute of Chartered Accountants of India.*

The auditor should ascertain whether the management has instituted adequate cut-off procedures. For example, he may examine a sample of documents evidencing the movement of inventories into and out of stores, including documents pertaining to periods shortly before and shortly after the cut-off date, and check whether the inventories represented by those documents were included or excluded, as appropriate, during the stock-taking.

The auditor should review the original physical verification sheets and trace selected items - including the more valuable ones - into the final inventories. He should also compare the final inventories with stock records and other corroborative evidence, e.g., inventory statements submitted to banks.

Where continuous stock-taking methods are being used by the entity, the auditor should, in addition to performing the audit procedures discussed above, pay greater attention to ascertaining whether the management:

(i) maintains adequate stock records that are kept up-to-date;

(ii) has established adequate procedures for physical verification of inventories, so that in the normal circumstances, the programme of physical verification will cover all material items of inventory at least once during the year; and

(iii) investigates and corrects all material differences between the book records and the physical counts.

The auditor should determine whether the procedures for identifying damaged and obsolete items of inventory operate properly.

The auditor may determine the reasonableness and adequacy of the procedures of physical verification of inventories by examining the related records and documents. These records and documents would also include the policy of the company regarding physical verification. The following are the documents which can be examined by the auditor in this regard:

(i) written instructions given by the management to the concerned staff engaged in the verification process;

(ii) physical verification inventory sheets duly authenticated by the field staff and responsible officials of the company;

(iii) summary sheets/consolidation sheets duly authenticated by the responsible officials;

(iv) internal memos etc., with respect to the issues arising out of physical verification of inventory;

(v) any other relevant documents evidencing physical verification of inventory.

In case where the inventories are material and the auditor is placing reliance on the records, documents, information and explanations provided by the management, it would be desirable that the auditor, in order to substantiate the fact that the physical verification is carried out in accordance with the procedure explained by the management, attends the physical verification. Where the auditor is present at the time of stock-taking, he should observe the procedure of physical verification adopted by the stock-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those inventories which have a high value either individually or as a category of inventories.

While commenting on this clause, the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable or adequate.

(C) Clause (ii)(c) to Paragraph 3 of the CARO, 2015 requires the auditor to comment whether the company is maintaining proper records of inventory. The clause also requires the auditor to comment whether any material discrepancies were noticed on physical verification of inventory and if so, whether those material discrepancies have been properly dealt with in the books of account.

What constitutes "proper records" has not been defined. However, in general, records relating to inventories should contain, inter alia, the following:

(i) particulars of the item like nomenclature, nature, etc.

(ii) identification code of the item;

(iii) details regarding quantity of the receipts, issues, balances and dates of transactions in a chronological manner;

(iv) relevant document number and department identification, if any;

(v) location.

If priced stores ledger is maintained, the records of the inventory should also disclose the prices at which the recording of the issues and receipts is made. The records should contain the particulars in respect of all items of inventories. The auditor should also satisfy himself that the stock registers are updated as and when the transactions occur. The auditor should also verify that the transactions entered in stock registers are duly supported by relevant documents. The purpose of showing the location of the inventory is to make verification possible. The record of movement/custody of the inventory should be maintained.

It is not possible to specify any single form in which the records should be maintained. This would depend upon the mode of account-keeping (manual or computerized), the number of operating locations, the systems of control, etc. The Order further requires the auditor to examine whether material discrepancies have been noticed on verification of inventories when compared with book records. Such an examination is possible when quantitative records are maintained for inventories but in many cases circumstances may warrant that records of individual issues (particularly for stores items) are not separately maintained and the closing inventory is established only on the basis of a year-end physical verification. Where such day-to-day records are not maintained, the auditor will not be able to arrive at book inventories except on the basis of an annual reconciliation of opening inventory, purchases and consumption. This reconciliation is possible when consumption in units can be co-related to the production, or can be established with reasonable accuracy. Where such reconciliation is not possible, the auditor would be unable to determine the discrepancies. If the item for which the discrepancy cannot be established is not material, the discrepancy, if any, will also not be material. For example, an item categorised as 'C' in ABC analysis might not be material and therefore, the discrepancy, if any, in regard to such an item would not be material. In other cases, however, the auditor will have to report that he is unable to determine the discrepancy, if any, on physical verification for the item or class of items to be specified.

6.6.9 Goods on Consignment: Where a separate account in respect of each consignment is not being maintained and only memoranda accounts in respect of goods sent on consignment are kept, the auditor should make sure that inventories sent out on consignment but unsold have been included in the closing inventory; when a separate account in respect of each consignment is being maintained, the auditor should verify that the debit balance in each Consignment Account represents only the cost of unsold goods *plus* proportionate expenses incurred on their transport and transit insurance; also that a provision has been made or any damage or loss suffered by the inventory or for a fall in sale price.

6.6.10 Goods on Approval: The auditor should ensure that any goods sent to customers on approval which were unsold at the close of the year have not been treated as sold and are shown in the account as Inventory on Approval and are valued at lower of the cost or market value. In case they are reported to have suffered any damage, a provision for the same should be made.

6.6.11 Goods in Bond: Where some of the goods are in bond, it is usual to have separate inventory sheets for them. The particulars of inventory entered on them should be examined by reference to bond warrants. If the same are pledged with some bank, a certificate should be obtained from the bank. The bonded goods should be valued at cost or market value, whichever is less. The value placed on such inventory should be counter-checked by reference to relevant invoices from foreign suppliers.

6.6.12 Contracts in Course of Completion: In the field of building construction, a contract may sometime extend over two or more years. When that happens, it is necessary to value the work-in-progress at the end of each year. In such a case, it would obviously be incorrect to value the work-in-progress at cost and postpone determination of profit to the year when the construction is finally completed and possession thereof made over, for it will lead to no profit being shown till the final year. Such a procedure will not be acceptable either to the shareholders or to the taxing authorities. One of the methods by which a part of profits can be included in the account of each year is the total profit anticipated in terms of percentage of total construction, computed in physical terms, completed each year. Such a procedure, however, may not yield a satisfactory result where the total income cannot be estimated accurately. In such an event, it is advisable to prepare cost statements and on that basis to compute value of work-in-progress at cost *plus* the part of the profit attributable thereto. As a general principle, it is imprudent to take credit for any anticipatory profit unless it is possible, reasonably and accurately, to estimate the amount. Even where this is practicable, the amount of profit should be estimated only in respect of instalments of contract price which has accrued or had been collected before the close of the year. In the case of contracts the construction of which is undertaken on the basis of 'cost *plus* percentage on cost' it would not be incorrect to take credit for the percentage of profit on cost actually incurred. For instance, if a factory is being built at 'cost *plus* 10% of cost basis' the process of incurring cost itself will establish a claim against the customer for the amount of such cost *plus* 10%. In such a case, it would not be incorrect to take credit for the whole of the profit which has actually accrued.

In the case of goods produced against a forward contract which are ready for delivery, the same should be valued at the price at which they will be delivered less expenses which will be incurred on their delivery. However, such a basis of valuation should not be adopted where there is any uncertainty regarding the terms of final settlement. For instance, where the buyer has to inspect the goods and he has the right to reject goods considered unsatisfactory, the contract price should not be applied until the goods have been inspected and approved.

Note 6(O) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Inventories" in notes to accounts as follows:

(O) Inventories

- (i) Inventories shall be classified as:
  - (a) Raw materials;
  - (b) Work-in-progress;
  - (c) Finished goods;
  - (d) Stock-in-trade (in respect of goods acquired for trading);
  - (e) Stores and spares;
  - (f) Loose tools;
  - (g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

6.7 Trade Receivables

The term 'trade receivable' suggests particularly amounts recoverable from customers, but in practice it is applied to a wide range of claims which a business may carry as an asset in its books. Advances or loans cannot, however, be included under this head.

Verification of trade receivables may be carried out by employing the following procedures:

(a) Examination of records;

(b) Direct confirmation procedure (also known as 'circularization procedure')

(c) Analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgement of the auditor. The general procedure is as under:

6.7.1 Examination of Records

(i) The auditor should carry out an examination of the relevant records himself about the validity, accuracy and recoverability of the trade receivables balances. The extent of such examination would depend on the auditor's evaluation of the efficacy of internal controls.

(ii) The auditor should check the agreement of balances as shown in the schedules of trade receivable with those in the ledger accounts. He should also check the agreement of the total of trade receivable balances with related control account. Any differences in this regard should be examined.

(iii) Verification of subsequent realizations is a widely used procedure, even in cases where direct confirmation procedure is followed. In the case of significant trade receivables, the auditor should also examine the correspondence or other documentary evidence to satisfy himself about their validity and accuracy.

(iv) While examining the schedules of trade receivables with reference to the trade receivables' ledger accounts, the auditor should pay special attention to the following aspects:

   (a) Where the schedules show the age of the debts, the auditor should examine whether the age of the debts has been properly determined.

   (b) Where the amounts outstanding are made up of items which are not overdue, having regard to the credit terms of the entity.

   (c) Whether transfers from one account to another are properly evidenced.

   (d) Whether provisions for allowances, discounts and doubtful debts should recognise that even though a trade receivable may have confirmed the balance due by him, he may still not pay the same.

(v) The following are some of the indications of doubtful and uncollectible debts, loans and advances:

   (a) The terms of credit have been repeatedly ignored.

   (b) There is stagnation, or lack of healthy turnover, in the account.

   (c) Payments are being received but the balance is continuously increasing.

   (d) Payments, though being received regularly are quite small in relation to the total outstanding balance.

   (e) An old bill has been partly paid (or not paid), while later bills have been fully settled.

   (f) The cheques received from the trade receivables have been repeatedly dishonoured.

   (g) The debt is under litigation, arbitration, or dispute.

   (h) The auditor becomes aware of unwillingness or inability of the trade receivable to pay the dues, e.g., a trade receivable has either become insolvent, or has closed down his business, or is not traceable.

   (i) Amounts due from employees, which have not been repaid on termination of employment.

   (j) Collection is barred by statute of limitation.

(vi) Bad debts written off or excessive discounts or unusual allowances should be verified with the relevant correspondence. Proper authorization should be inspected.

(vii) In the case of claims made against insurance companies, shipping companies, railways, etc., the auditor should examine the correspondence or other available evidence to ascertain whether the claims have been acknowledged as debts and there is a reasonable possibility of their being realized. If it appears that they are not collectible, they should be shown as doubtful. Similar considerations apply in respect of claims for export incentives, claims for price escalation in case of construction contracts, claims for interest on delayed payments, etc.

(viii) The auditor should examine whether contingent liability, if any, in respect of bills accepted by customers and discounted with the banks is properly disclosed. He should also examine whether adequate provision on this account has been made, where required.

6.7.2 Direct Confirmation Procedure

(i) The verification of balances by direct communication with trade receivables is theoretically the best method of ascertaining whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak. The utility of this procedure depends to a large extent on receiving adequate response to confirmation requests. Therefore, in situations where the auditor has reasons to believe, based on his past experience or other factors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.

(ii) 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.

(iii) The confirmation date, the method of requesting confirmations, and the particular trade receivables from whom confirmation of balances is to be obtained are to be determined by the auditor.

(iv) 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 settled by the auditor in consultation with the entity.

(v) The form of requesting confirmation from the trade receivables may be either (a) the 'positive' form of request, wherein the trade receivable is requested to respond whether or not he is in agreement with the balance shown, or (b) the 'negative' from of request wherein the trade receivable is requested to respond only if he disagrees with the balance shown.

(vi) The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reasons to believe that there may be a substantial number of accounts in dispute or inaccuracies or irregularities.

(vii) The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the trade receivables are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same degree of assurance with respect to the trade receivable balances.

(viii) In many situations, it may be appropriate to use the positive form for trade receivables with large balances and the negative form for trade receivables with small balances.

(ix) Where the number of trade receivables is small, all of them may be circularized, but if the trade receivables are numerous, this may be done on a sample basis. The sample list of trade receivables to be circularized, in order to be meaningful, should be based on a complete list of all trade receivable accounts. While selecting the trade receivables to be circularized, special attention should be paid to accounts with large balances, accounts with old outstanding balances, and customer accounts with credit balances. In addition, the auditor should consider accounts in respect of which provisions have been made or balances have been written off during the period under audit of earlier years and request confirmation of the balance without considering the provision or write-off. The auditor may also consider including in his sample some of the accounts with *nil* balances. The nature of the entity's business (*e.g.*, the type of sales made or services rendered) and the type of third parties with whom the entity deals, should also be considered in selecting the sample, so that the auditor can reach appropriate conclusions about the trade receivables as a whole.

(x) In appropriate cases, the trade receivable may send a copy of his complete ledger account for a specific period as shown in the entity's books.

(xi) The method of selection of the trade receivables to be circularised should not be revealed to the entity 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 requests for confirmation which should be properly addressed and duly stamped. The auditor should maintain strict control to ensure the correctness and proper despatch 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 receivables 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.

(xii) 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 receivables taken as a whole.

(**Note:** Students may note that SA 505, "External Confirmation" also provide guidelines for Direct Confirmation Procedure.)

6.7.3 Analytical Review Procedures: In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to trade receivables, loans and advances-

(i) comparison of closing balances of trade receivables, loans and advances with the corresponding figures for the previous year;

(ii) comparison of the relationship between current year trade receivable balances and the current year sales with the corresponding budgeted figures, if available;

(iii) comparison of actual closing balances of trade receivables, loans and advances with the corresponding budgeted figures, if available;

(iv) comparison of current year's ageing schedule with the corresponding figures for the previous year;

(v) comparison of significant ratios relating to trade receivables, loans and advances with similar ratios for other firms in the same industry, if available;

(vi) comparison of significant ratios relating to trade receivables, loans and advances with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of trade receivables, loans and advances. The exact nature of analytical review procedures to be applied in specific situation is a matter of professional judgement of the auditor.

6.7.4 Disclosure: The auditor should satisfy himself that trade receivables, loans and advances have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

Note 6(P) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Trade Receivables" in notes to accounts as follows:

(P) Trade Receivables

- (i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the Date they are due for payment should be separately stated.
- (ii) Trade receivables shall be sub-classified as:
    - (a) Secured, considered good;
    - (b) Unsecured considered good;
    - (c) Doubtful.
- (iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
- (iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

6.7.5 Debts Requiring Special Consideration

(i) **Debts due in foreign currency:** In the case of debts in a foreign currency, the auditor should find out by converting the amount into home currency whether it is more or less than the amount shown as recoverable. If there is any deficiency or appreciation, it should be appropriately adjusted in the Statement of Profit and Loss.

(ii) **Hire Purchase debts:** Strictly, these are not debts since the hirer has the option of returning the goods, the auditor should, therefore, confirm that the instalments of hire money which had accrued have been realised in case there are any arrears and the article which is the subject of hire purchase is still in the possession of the hirer, it should be necessary to set up a provision for the loss anticipated on sale of the asset or on account of non-recovery of the outstanding balance.

(iii) **Package and empties:** If packages are returnable but the customer has not deposited any security against their return, it is possible that he may fail to return them. Against such a contingency, the auditor should ask the client to make a suitable provision.

6.7.6 Debt Due from Subsidiary Companies: Because of the close relationship existing between a holding and subsidiary company, it is necessary for an auditor to find out that the debts shown as outstanding from the subsidiary are genuine and have resulted from transactions entered into in the normal course of business. Therefore, the balance outstanding should not only be confirmed with the statements of account received from the subsidiary but its basis should also be inquired into. If the debt is covered by an agreement, the same should also be referred to. If any security is deposited against due repayment of advances the same should be inspected. Debts due from a subsidiary company should be disclosed duly classified in the same way as accounts receivables.

6.7.7 Bills Receivable: If possible, the auditor should attend on the last day of the accounting period to inspect the bills in hand and agree their total with the balance in the Bills Receivable Account. If verification is postponed till some time, after the existence of the bills which had matured in between the two dates should be verified with the entries in respect of cash collected for them. If some bills were discounted after the date of the Balance Sheet, the collection of their proceeds should be verified. If any bills were dishonored after the date of the Balance Sheet, the auditor should ascertain what portion, if any, of the amount will not be recovered and ensure that provision for the same has been made. Where a new bill is reported to have been taken in lieu of a bill which has matured, the auditor should inspect the bill. Where a number of bills are found to have been discounted before the close of the year the auditor should see that the amount of the bills so discounted is shown as a contingent liability on the Balance Sheet. If some of the bills are with bankers for collection, the auditor should obtain a certificate from them.

Generally, it will be the duty of the auditor to ensure that the bills were properly drawn and stamped and that they were not dishonoured. Where some of the bills were dishonoured, the auditor should ensure that they have been noted and protested.

6.7.8 Advances: These include amounts recoverable either in cash or in kind for value to be received, *e.g.,* rates, taxes and insurance. The auditor should obtain a list of all advances and compare them with balances in the ledger. He should ascertain that advances were made under proper authority and were being recovered regularly by agreed instalments. Where there is an agreement the same should be inspected. In the case of old balances, the auditor should ensure that provision has been made in respect of irrecoverable advances. Particulars mentioned above in respect of trade receivables must also be given for advances.

6.7.9 Loans: In general the procedure outlined in regard to trade receivables is also applicable in the case of loans (and advances). Apart from verification of the balances of loans, the auditor should inspect loan agreements and acknowledgements of parties in respect of outstanding loans. A loan or an advance, if material, can be granted only if authorised by the Memorandum and Articles of Association in the case of company. In addition, he 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. It should be verified that the loan has been acknowledged by the trade receivable and, in addition, he has executed a Pronote or a bill of exchange. If any security is deposited against due repayment of the loan, the same should be inspected. The loan should be classified for purposes of Balance Sheet in the same way as other debts. In addition, advances and loans to partnership firms in which the company or any of its subsidiaries is a partner should be disclosed.

Section 143(1) specifically requires an auditor to inquire among other things whether:

(i) 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; and

(ii) Loans and advances made by the company have been shown as deposits.

The Research Committee of the Institute of Chartered Accountants of India has given guidance for making inquiry as regards the above two matters. The guidance is on the following lines. The matter under clause (i) applies to loans and advances made by the company during the financial year under audit, whether they are outstanding on the date of the Balance Sheet or not. The inquiry should be made in the light of conditions prevailing when the loan or advance was made.

Loans and advances have not been defined anywhere in the Act. However, having regard to the requirement of clause (ii) above a distinction is obviously intended to be made between 'loans and advances' and 'deposits'. A deposit may be defined as the placing of money or money's worth with a third party, either for safe keeping or by way of security for the performance, of the depositor's obligations, or for the purpose of earning interest; in the last case the depositing with a party who customarily accepts deposits.

Items required to be disclosed under the head 'Loans and Advances' in Part I of Schedule III to the Companies Act, 2013, to the Act which do not fall within the above definition of a 'deposit' should be construed for the purpose of the clause (i) as "loans and advances."

Clause (i) applies to all loans and advances made 'on the basis of security' for this purpose would include any movable or immovable property, whether belonging to the borrower or not, of which either physical possession or over which a legally effective charge is given to the lender. In order to ascertain that loans and advances are "properly secured," auditors should make inquiries to ascertain that *prima facie*:

(a) the company holds a legally enforceable security, and

(b) the value of the security fully covers the amount of the loan or advance and is reasonably ascertained.

In order to comply with the requirements of paragraph (*a*) above, it will be necessary for the auditor to make appropriate inquiries depending upon the type of security. A few instances are given below.

	Types of Security	Documents etc. to be seen
(a)	Shares and debentures	The scrip and the endorsement thereon of the name of the transferee, in the case of transfer.
(b)	Government securities, and other securities, documents of title which are transferable by endorsement and delivery, *e.g.,* Bills of Lading and Railway Receipts.	The scrips or other documents duly endorsed in favour of the lenders.
(c)	Legal mortgage of immovable property.	Duly registered mortgage deed.
(d)	Equitable mortgage of immovable properties	Title deeds deposited.
(e)	Life Insurance Policy.	Assignment of policy in favour of the lender, duly registered with the insurer
(f)	Pledge of goods.	Appropriate record of goods held at the Balance Sheet date.
(g)	Hypothecation of goods.	Deed of Hypothecation or other document creating the charge, together with a statement of inventories held at the Balance Sheet date.

The valuation of securities which are quoted on a Stock Exchange would not normally present any problem. For securities which are not so quoted, the auditor should call for the last accounts of the company whose shares or debentures are deposited as securities and satisfy himself that *prima facie* the valuation placed on the securities or immovable property by the management is reasonable.

In the case of life insurance policies, the auditor shall call for evidence of the surrender value of the policy. In the case of inventories and other goods held on pledge or hypothecation, the auditor should ascertain that *prima facie* the valuation placed upon the goods is in order.

The loan agreement or correspondence in regard to the terms of the loan or advance should be seen. Where the loan or advance is made to a company, any charge on the assets of such a company should have been registered under section 77 of the Act in order to constitute an effective security.

Loans and advances on the basis of security would include loans or advances which are only partly secured from the commencement, or loans or advances which become partly secured owing to any reason, such as a fall in the value of the security. In the case of partly secured loans or advances, it would be advisable to show separately in the Balance Sheet as “Partly secured” including the extent to which they are secured.

The terms on which the loan or advance is made would primarily include the security, the interest charged and the terms of payment. It would be difficult to lay down any general principles regarding the rate of interest which may be charged on loans and advances. Various considerations such as the position and standing of the borrower, type of security, purpose of the loan, prevailing market rate of interest, etc. would be taken into account. If the loan has been given for business considerations, *e.g.,* loans to staff for purchase of cars, house, etc. loans to suppliers of raw materials or other goods there may be justification for interest being charged at a rate lower than the market rate or even, in appropriate circumstances, no interest being charged at all. However, when a loan is given only with a view to earning interest, the interest charged should be at the commercial rate. Particular attention should be paid to loans or advances to concerns in which the directors of the company are interested.

The question whether the terms on which a loan or advance has been given are "prejudicial to the interests of the company or its members" is a difficult one. Obviously, the auditor is not to inquire as to how such transactions of the company affect the interest of individual members (in their personal capacities). The reference to "members" should, therefore, be construed as a reference to the members of the company as a class, in their capacity as members. The members of company would be primarily interested in the reasonable return of their investment and the safety of their capital. The question whether a loan is prejudicial to the interest of the members should, therefore, be considered from this angle.

It should be noted that an inquiry has to be made as to whether loans and advances have been shown as deposits and not *vice versa*. It should be noted that a company cannot grant loans to directors unless the ordinary business of the company is that of making loans and advances.

Note 6(L) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Long Term Loans and Advances" in notes to accounts as follows:

(L) Long-term Loans and Advances

- (i) Long-term loans and advances shall be classified as:
  - (a) Capital Advances;
  - (b) Security Deposits;
  - (c) Loans and advances to related parties (giving details thereof);
  - (d) Other loans and advances (specify nature).
- (ii) The above shall also be separately sub-classified as:
  - (a) Secured, considered good;
  - (b) Unsecured, considered good;
  - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Note 6(R) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Short Term Loans and Advances" in notes to accounts as follows:

(R) Short-term Loans and Advances

(i) Short-term loans and advances shall be classified as:

(a) Loans and advances to related parties (giving details thereof);

(b) Others (specify nature).

(ii) The above shall also be sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

6.8 Bank Balances

These should be verified by reference to bank reconciliation statement, and the balance certificates received from banks. If a Bank Reconciliation statement includes a large number of uncleared items as on the date of the Balance Sheet, the auditor should verify that the items were subsequently collected. On the other hand, where a cheque issued for more than three months before the close of the year is shown in the bank reconciliation statement, the entry has to be reversed.

If audit is undertaken long after the close of the year, the auditor should reconcile the bank balances right up to the date on which he undertakes the audit.

Note 6(Q) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Cash and cash equivalents" in notes to accounts as follows:

(Q) Cash and Cash Equivalents

(i) Cash and Cash Equivalents shall be classified as:

(a) Balances with Bank;

(b) Cheques, Drafts on hand;

(c) Cash on hand;

(d) Others (specifying nature).

(ii) Earmarked balances with banks shall be separately stated.

(iii) Balances with bank 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.

The auditor should satisfy himself that cash and bank balances have been valued and disclosed in the financial statements in accordance with recognized accounting policies and practices and relevant statutory requirements, if any. In this regard, the auditor should examine that following items are not included in cash and bank balances.

(a) Temporary advances.

(b) Stale or dishonoured of cheques.

Postage and revenue stamps, if material in amount, may be shown separately instead of being included under cash and bank balances.

6.9 Cash In Hand

In a Balance Sheet all the under mentioned cash balances are included under the above head (also refer para 6.8):

(a) cash balance in hand;

(b) petty cash balance in hand;

(c) balances of stamps in hand;

(d) cash in transit;

(e) cash at branches; and

(f) cash with agents;

The first three of the above mentioned items are verified by actual count. The cash in transit and that with branches and agents is verified from documentary evidence available in regard thereto and the advice in respect of their subsequent remittance in whole or a part.

Special care is necessary in regard to verification of cash balances for 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 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 client 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. Such an attempt is known to have been made in the past.

If the auditor is unable to check the cash balance on the date of the Balance Sheet, he should arrange with his client for all the cash balance to be banked and where this cannot conveniently be done on the evening of the close of the financial year, it should be deposited the following morning. The practice should also be adopted in the case of balance at the factory, depot or branch where cash cannot be checked at the close of the year. In case this is not possible, the auditor should verify the receipts and payments of cash upto the date he counts the cash. This should be done soon after the cash balances have been counted. The Cash Book of the day on which the balance is verified should be signed by the auditor to indicate the stage at which the cash balance was checked. If any cheques or drafts are included in cash balance, the total thereof should be disclosed.

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 have them initialed by a responsible official and debited to Appropriate Accounts.

6.10 Miscellaneous Expenditure

This refers to expenditure essentially of a revenue nature which, instead of being charged off as and when it is incurred, is accumulated in an account appropriately headed to indicate its nature and the balance in the account is written off over a period of years during which its benefit is expected to accrue to the business. Examples of expenses are: prepaid expenses, discount allowed on subscription to debentures. As long as the expense is not written off, it continues to appear as an asset on the right hand side of the Balance Sheet. Such expenses are described as Deferred Revenue Expenditure so as to indicate clearly the fact that though the expense is essentially of a revenue nature, its writing off has been deferred for adequate reasons.

For verification of such expenditure, it is necessary for the auditor to examine the evidence showing that the expense has actually been incurred as well as the proposed basis of its apportionment over a period of years. Wherever it is possible he must find out that the benefit of the expenditure which is being carried forward as an asset has not exhausted and, if so, the amount should be written off. If during the year any amount has been added thereto, the justification for the same should be examined.

Capitalisation of expenditure: Where a part of the expenditure, in respect of a period before the business had reached the revenue earning state, has been capitalized, the auditor should carefully examine that the amount so capitalized only represents expenditure which could be considered to have directly or indirectly contributed to bring into existence assets. In this connection, he should examine the resolution of the Board of Directors by which the capitalisation has been authorised and the amount capitalized should be disclosed in the Balance Sheet.

Students may note that with the issuance of AS-26 on Intangible Assets, the concept of miscellaneous expenditure would undergo a change. Para 55 of AS 26, "Intangible Assets" which deals with recognition of an expense requires that an expenditure on an intangible item should be recognised as an expense when it is incurred unless:

(a) it forms part of the cost of an intangible asset that meets the recognition criteria, viz., future economic benefit, cost measured reliability, etc.

(b) the item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. In this case, this expenditure should form part of the amount attributed to goodwill (Capital Reserve) at the date of acquisition.

The examples as prescribed in AS 26 of expenditure that are recognised as expenses are as under:

(a) expenditure on start up activities, unless this expenditure is included in the cost of an item of fixed asset under AS 10.

(b) expenditure on training activities.

(c) expenditure on advertisement and promotional activities.

(d) expenditure on relocating or re-organising part or all of an enterprise.

It should be further noted that, discount or premium relating to borrowing and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares can be treated as deferred revenue expenditure. Since, AS 26 does not apply to such item due to its specific nature.

6.11 Verification of Liabilities

6.11.1 General Considerations: Liabilities are the financial obligations of an enterprise other than owners' funds. Liabilities include loans and borrowings, trade payables and other current liabilities, deferred payment credits, instalments payable under hire purchase agreements, and provisions. Besides liabilities, this Guidance Note also deals with contingent liabilities, i.e., obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable. An important feature of liabilities which has a significant effect on the related audit procedure is that these are represented only by documentary evidence which originates mostly from third parties in their dealings with the entity.

Verification of liabilities is as important as that of assets, for, if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the concern. For example, if the liability for certain expenses if found to have been omitted or understated, it would signify that against the revenue for the relative period, the full amount of expenses have not been charged. As a result, the figure of profit as disclosed by the Statement of Profit and Loss would be larger by the amount of the liability which has been omitted. Moreover, since the liability would not be included in the balance sheet, it would also be incorrect. Conversely, where a fictitious liability for expenses is adjusted in the accounts or when a liability is overstated, the result will be that the revenue would bear an increased charge which would have the effect of artificially reducing the profits. This will falsify the figure of profit or loss disclosed by the Statement of Profit and Loss. Besides, on account of the inclusion of the liability, the Balance Sheet also will be false, since it would include an undisclosed 'secret reserve'. The auditor must, therefore, apart from vouching the entries in regard to the adjustment of liabilities, verify at the close of the year that the liabilities stated in the Balance Sheet are in fact payable and all its liabilities that could be traced by the exercise of the diligence and care on the part of the auditor have been accounted for. He must also obtain a certificate from a responsible official stating that to the best of his knowledge and belief, all liabilities, whether for purchases (supplies) or expenses or any other account existing at the date of the Balance Sheet have been included in the books of account; also that all the contingent liabilities have been disclosed in footnote to the Balance Sheet have been provided for.

It has been held, *inter alia,* in the case of the *Westminster Road Construction Engineering Co. Ltd.* (1932) that the auditor must take care to satisfy himself that all the expenses and liabilities which the company could be expected to have incurred have been brought into accounts. In the course of his judgment in this case, the learned judges observed:

"If the auditor found that a company in the course of its business was incurring liabilities of a particular kind and that the trade payables sent in their invoices after an interval and that liabilities of the kind in question must have been incurred during the accountancy period under audit when he was making his audit, sufficient time has not elapsed for the invoices relating to such liabilities to have been received and recorded in the company's books, it becomes his duty to make specific inquiries as to the existence of such liabilities and also before he signed a certificate as to the accuracy of the Balance Sheet to go through the invoice files of the company in order to see that no invoice relating to liabilities has been omitted. The evidence has established to my satisfaction that no experienced auditor would have failed to ascertain the existence of the liabilities omitted from this Balance Sheet.

6.11.2Loans and Borrowings: Verification of liabilities may be carried out by employing the following procedures-

(i) examination of records;

(ii) direct confirmation procedure;

(iii) examination of disclosure;

(iv) analytical review procedures,

(v) obtaining management representations.

The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgement of the auditor which is based, inter alia, on the auditor's evaluation of the effectiveness of the related internal controls.

Loans and Borrowings: The auditor should satisfy himself that the loans obtained are within the borrowing powers of the entity.

The auditor should carry out an examination of the relevant records to judge the validity and accuracy of the loans.

In respect of loans and advances from banks, financial institutions and others, the auditor should examine that the book balances agree with the statements of the lenders. He should also examine the reconciliation statements, if any, prepared by the entity in this regard.

The auditor should examine the important terms in the loan agreements and the documents, if any, evidencing charge in respect of such loans and advances. He should particularly examine whether the requirements of the applicable statute regarding creation and registration of charges have been complied with.

Where the entity has accepted deposits, the auditor should examine whether the directives issued by the Reserve Bank of India or other appropriate authority are complied with.

In case the value of the security falls below the amount of the loan outstanding, the auditor should examine whether the loan is classified as secured only to the extent of the market value of the security.

Where short-term secured loans have been disclosed separately from other secured loans, the auditor should verify the correctness of the amount of such short-term loans.

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), the auditor should verify the correctness of the amount of such instalments.

The auditor should 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. Future instalments under hire purchase agreements for the purchase of assets may be shown as secured loans.

The deferred payment credits should be verified with reference to the important terms in the agreement, including due dates of payments and guarantees furnished by banks. The auditor should also verify the copies of hundies/bills accepted separately.

Trade Payables and Other Current Liabilities: The auditor should check the adequacy of cut-off procedures adopted by the entity in relation to transactions affecting the trade payable accounts. For example, the auditor may examine the documents relating to receipt of goods from suppliers during a few days immediately before the year-end and verify that the related invoices have been recorded as purchases of the current year.

The auditor should check that the total of the trade payables' balances agrees with the related control account, if any; the difference, if any, should be examined.

The auditor should examine the correspondence and other relevant documentary evidence to satisfy himself about the validity, accuracy and completeness of trade payables/acceptances.

The auditor should verify that in cases where income is collected in advance for services to be rendered in future, the unearned portion, not applicable to the period under audit, is not recognised as income of the period under audit but is shown in the balance sheet as a part of current liabilities.

While examining schedule of trade payables and other schedules such as those relating to advance payments, unclaimed dividends and other liabilities, the auditor should pay special attention to the following aspects:

(a) long outstanding items;

(b) unadjusted claims for short supplies, poor quality, discount, commission, etc.;

(c) liabilities not correlated/adjusted against related advances;

(d) authorisation and correctness of transfers from one account to another.

Based on his examination as aforesaid, the auditor should determine whether any adjustments in accounts are required.

In case there are any unusual payments around the year-end, the auditor should examine them thoroughly. In particular, the auditor should examine if the entries relating to any such payments have been reversed in the subsequent period.

The auditor should review subsequent transactions to identify/confirm material liabilities outstanding at the balance sheet date.

Disclosure Requirements as per Schedule III to the Companies Act, 2013 in respect of Trade Payables and Other Current Liabilities are:

Current liabilities
- Trade Payables
- Other current liabilities

Note 6(G) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Other Current Liabilities" in notes to accounts as follows:

(G) Other Current Liabilities

The amount shall be classified as:

(a) Current maturities of long-term debt;

(b) Current maturities of finance lease obligations;

(c) Interest accrued but not due on borrowings;

(d) Interest accrued and due on borrowings;

(e) Income received in advance;

(f) Unpaid dividends;

(g) Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under 'Other current liabilities';

(h) Unpaid matured deposits and interest accrued thereon;

(i) Unpaid matured debentures and interest accrued thereon;

(j) Other payables (specify nature).

6.11.3 Provisions: The term 'provision' means amounts retained by way of providing for depreciation or diminution in value of assets or retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy. Provisions include those in respect of depreciation or diminution in the value of assets, product warranties, service contracts and guarantees, taxes and levies, gratuity, proposed dividend etc. This Guidance Note, however, does not deal with provisions for depreciation or diminution in the value of assets.

The audit of provisions primarily involves examining the reasonableness and adequacy of the amounts provided for. The auditor should also examine that the provisions made are not in excess of what is reasonably required.

Provisions for Taxes and Duties: The adequacy of the provision for taxation for the year should be examined. The position regarding the overall outstanding liability of the entity as at the date of balance sheet should be reviewed. In respect of assessments completed, revised or rectified during the year, the auditor should examine whether suitable adjustments have been made in respect of additional demands or refunds, as the case may be. Similarly, he should examine whether excess provisions or refunds have been properly adjusted. The relevant orders received up to the time of audit should be considered and, on this basis, it should be examined whether any short provisions have been made good. If there is a material tax liability for which no provision is made in the accounts, the auditor should qualify his report in this respect even if the reserves are adequate to cover the liability.

If the entity disputes its liability in regard to demands raised, the auditor should examine whether there is a positive evidence or action on the part of the entity to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal under section 246 of the Income-tax Act, 1961. Where an application for rectification of mistake (e.g., under section 154 of the Income tax Act, 1961) has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure (see Accounting Standard (AS) 4, Contingencies and Events Occurring after the Balance Sheet Date issued by the Institute of Chartered Accountants of India). In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

In case the entity has made the provision for taxation on the basis of the tax-effect accounting method, the auditor should examine whether the method has been applied properly.

Provision for Gratuity: The auditor should examine whether the entity is required to pay gratuity to its employees by virtue of the provisions of the Payment of Gratuity Act, 1972 and/or· in terms of agreement with employees and, if so, whether provision for accruing gratuity liability has been made by the entity. The auditor should examine the adequacy of the gratuity provision with reference to the actuarial certificate obtained by the entity. In case the entity has not obtained such an actuarial certificate, the auditor should examine whether the method followed by it for calculating the accruing liability for gratuity is rational.

Provision for Bonus: In the case of provision for bonus, the auditor should examine whether the liability is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or award of competent authority. Where the bonus actually paid is in excess of the amount required to be paid as per the provisions of the applicable law/agreement/award, the auditor should specifically examine the authority for the same (e.g., resolution of the board of directors in the case of a company).

Provision for Dividends: The auditor should examine that dividends are provided for as per applicable provisions of the relevant laws and rules framed thereunder, relevant agreements and resolutions.

Other Provisions: Where provisions are made for liabilities that may arise on account of product warranties, service contracts, performance warranties etc., the auditor should examine whether the provisions made are in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, issued by the Institute of Chartered Accountants of India. The auditor should also examine the reasonableness of the basis adopted for quantifying the provision with reference to the relevant agreements.

6.11.4 Examination of Disclosure: The auditor should satisfy himself that the liabilities have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

In some cases loans are guaranteed by third parties in whose favour the assets of the entity are charged. The auditor should examine whether the disclosures concerning such loans are appropriate, e.g., they may be classified as secured with disclosure of the fact that the assets of the entity have been charged in favour of third parties which, in turn, have given guarantees to parties from whom loans have been obtained.

The auditor should recommend to the entity to disclose, in parentheses or in footnotes, the installments of term loans, if any, falling due for repayment within the next twelve months.

The auditor should examine that the following have been disclosed in respect of contingent liabilities:

(a) nature of each contingent liability;

(b) the uncertainties which may affect the future outcome;

(c) an estimate of the financial effect or a statement that such estimate cannot be made.

6.11.5 Analytical Review Procedures: In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions-

(i) comparison of closing balances of loans and borrowings, trade payables, etc., with the corresponding figures for the previous year;

(ii) comparison of the relationship between current year trade payable balances and the current year purchases with the corresponding figures for the previous year;

(iii) comparison of actual closing balances of loans and borrowings, trade payables, etc., with the corresponding budgeted figures, if available;

(iv) comparison of current year's ageing schedule of trade payables with the corresponding figures for the previous year;

(v) comparison of significant ratios relating to loans and borrowings, trade payables, etc., with the similar ratios for other firms in the same industry, if available;

(vi) comparison of significant ratios relating to loans and borrowings, trade payables, etc. with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of liabilities. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor

6.11.6 Special Considerations in the Case of a Company: In addition to the procedures described above, the auditor· should also employ the following procedures in the case of audit of a company-

(i) In determining whether the loans obtained by the company are within its powers, the auditor should scrutinise its memorandum and articles of association and also examine whether the provisions of sections 179 and 180(1)(c) of the Companies Act, 2013 are complied with.

(ii) The auditor should examine the register of charges to ensure that charges created have been duly registered for the compliance of Section 77 of the Companies Act, 2013. He should also ensure that the description of such charges disclosed in the balance sheet agrees in substance with that stated in the documents creating the charges.

(iii) The auditor should examine all loans taken from bodies corporate under the same management or from a company, firm or other party in which any director is interested and determine whether, in his opinion, the rate of interest and other terms and conditions of the loans are prime facie prejudicial to the interest of the company.

(iv) Where the company has accepted deposits, the auditor should examine compliance with the relevant legal provisions, e.g., section 73 of the Companies Act, 2013 and the rules framed thereunder/directions issued by the Reserve Bank of India.

(v) In respect of unclaimed dividends, the auditor should examine whether the company has complied with the relevant provisions of the Companies Act and the rules framed thereunder regarding transfer of unpaid or unclaimed dividends to Investor Education and Protection Fund.

(vi) In case of declaration of dividend out of reserve, the auditor should verify that the conditions laid down in Companies (Declaration and Payment of Dividend) Rules, 2014 have been fulfilled before the declaration namely:

   (a) The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year.

   It is provided that this shall not apply to a company, which has not declared any dividend in each of the three preceding financial year.

   (b) The total amount to be drawn from such accumulated profits shall not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

   (c) The amount so drawn shall first be utilised to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.

   (d) The balance of reserves after such withdrawal shall not fall below fifteen per cent of its paid up share capital as appearing in the latest audited financial statement.

   (e) No company shall declare dividend unless carried over previous losses and depreciation not provided in previous year(s) are set off against profit of the company of the current year.

(vii) The auditor should examine whether any undisputed amounts payable in respect of income-tax, wealth tax. sales tax, customs duty and excise duty are outstanding as at the balance sheet date for a period of more than six months from the date they became payable. If so, the auditor should report the amounts of such outstanding dues.

(viii) The verification procedure to be adopted by the auditor for audit of debentures would vary from year to year, depending upon whether fresh debentures are issued and/or they are redeemed or converted into shares during the year. In case of fresh issue of debentures, the auditor should examine the memorandum and articles of association of the company and resolutions authorising the issue. He should also examine compliance with the requirements of the terms of issue and any variations thereof and necessary approvals/clearances for· the issue from authorities concerned such as SEBI, RBI etc. The auditor should also examine that proper accounts are maintained with regard to amounts received towards application, allotment and calls and that the payments by way of refunds/interest and all other relevant accounts are duly reconciled. Where debentures are issued at a premium/discount, the auditor should ensure that such sums are accounted for distinctly. In case of buy-back, conversion, re-issue or redemption of debentures, the auditor should examine that these are in accordance with the terms of the issue. The auditor should examine that the requirements relating to creation of debenture redemption reserve and, where applicable, sinking fund and its Investment; and other related requirements are complied with.

6.11.7 Loan and requirement of Companies (Auditor's Report) Order, 2015 [CARO, 2015]:

(A) Clause (iii)(a) to Paragraph 3 of the CARO, 2015 requires the auditor to comment 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, 2013. If so, whether receipt of the principal amount and interest are also regular.

The clause covers not only the loan granted during the year but covers all loans including opening balances. Further, there is no stipulation regarding the loan being given in cash or in kind. In the absence of such stipulation, the auditor is required to disclose the requisite information in his report in respect of all kind of loans whether given in cash or in kind to the parties covered in the register maintained under section 189 of the Act.

Under section 189 of the Act, every company is required to maintain one or more registers which contain the particulars of all contracts or arrangements to which section 184(2) or section 188 of the Act applies. The auditor should obtain a list of companies, firms or other parties covered in the register maintained under section 189 of the Act from the management. The auditor should examine all loans (secured or unsecured) granted by the company to identify those loans granted to companies, firms or other parties covered in the register maintained under section 189 of the Act. It may so happen that a party listed in the register maintained under section 189 of the Act might take a loan from the company and repays it to the company during the financial year concerned. Therefore, while examining the loans, the auditor should also take into consideration the loan transactions that have been squared-up during the year and

report such transactions under the clause.

The clause mainly requires the auditor to report upon the regularity of receipt of principal amount of loans and interest thereon. The scope of auditor's inquiry under this clause shall be restricted in respect of companies, firms or other parties covered in the register maintained under section 189 of the Act.

The auditor has to examine whether the receipt of principal amount and interest is regular. The word 'regular' should be taken to mean that the principal and interest should normally be received whenever they fall due, respectively. If a due date for receipt of interest is not specified, it would be reasonable to assume that it falls due annually. A loan repayable on demand falls due as and when the lender calls back the loan. The auditor can make an assessment of the regularity only if the loan is demanded by the company since the question of regularity would be judged by consequent action of the company (payment or non-payment). If the lending company has not called back the loan, the auditor cannot comment under this sub-clause.

The following are some of the procedures that the auditor may apply to report on the clause:

(i) the auditor, while obtaining an understanding of the terms and conditions, should also take note of repayment schedule;

(ii) if loan agreements are not executed, any other equivalent documents may be referred to arrive at the terms of receipt of interest, for example, letters of understanding, acknowledgement by the party of the terms and conditions communicated by the company, etc.;

(iii) the dates of receipt of principal amount and payment of interest needs to be verified with reference to the books of accounts of the company to come to the conclusion whether such receipts are regular; and

(iv) if the results of the procedures mentioned above indicate any irregularity in receipt of principal and/or interest, the auditor should mention the fact in his report.

(B) <u>Clause (iii)(b)</u> to Paragraph 3 of the CARO, 2015 requires the auditor to comment, in the case of loans granted to the companies, firms or other parties covered in the register maintained under section 189 of the Companies Act, 2013, if overdue amount is more than ₹ 1 lakh, whether reasonable steps have been taken by the company for recovery of the principal and interest.

This clause requires the auditor to state whether reasonable steps have been taken by the company for recovery of the principal and interest, wherever the overdue amount is more than ₹ 1 lakh. A loan is considered to be overdue when the payment has not been received on the due date as per the lending arrangements. In such cases, the auditor has to examine the steps, if any, taken for recovery of this amount. It may, however, be noted that the scope of the auditor's inquiry under this clause is restricted to loans

given by the company to parties covered in the register maintained under section 189 of the Act. In making this examination, the auditor would have to consider the facts and circumstances of each case, including the amounts involved. It is not necessary that steps to be taken must necessarily be legal steps. Depending upon the circumstances, the degree of delay in recovery and other similar factors, issue of reminders or the sending of an advocate's or solicitor's notice, may amount to "reasonable steps" even though no legal action is taken. The auditor is not, therefore, required to comment adversely on the mere absence of legal steps if he is otherwise satisfied that reasonable steps have been taken by the company. The auditor should ask the management to give in writing, the steps which have been taken. The auditor should arrive at his opinion only after consideration of the management's representations. The auditor should obtain sufficient appropriate audit evidence to support the fact that reasonable steps have been taken for recovery of the principal and interest of loans granted by the company.

6.11.8 Debentures: Directors of a company in exercise of the powers vested in them may raise a loan by issue of debentures with or without creating a charge on the assets of the company. Debenture holders do not carry any voting right. When a charge is created over some of the assets, debentures are described as mortgage debentures. The terms and conditions on which the loan is raised, together with particulars of property charged as security for their repayment are printed on the debenture bonds along with a certificate showing that the charges have been registered with the Registrar. It is also customary to create a trusteeship in favour of one or more persons whenever some property belonging to the company is charged as security for repayment of the debentures. The trustees have all the powers of a mortgagee of the property and can act in whatever way they think expedient to safeguard the interest of the debenture holders. By the inclusion of section 71 in the Companies Act, 2013, the trustees of debenture holders now are expected to show the same degree of care and diligence in the administration of the debenture trusts as is required of other trusts. They cannot avoid such liability which they could do before. Both, the members and debenture holders, if they so desire, can obtain a copy of the trust-deed from the company. Section 71 of the said Act has also made compulsory for the appointment of trustees and creation of reserve for redemption of debentures.

The debenture bonds are issued to various debenture holders and entries in respect thereof are made in the books of account in exactly the same way as in the case of shares. Therefore, the amount received on issue of debentures should be vouched in the same way as the amount received on issue of capital. Apart from this, various steps involved in the verification of debentures are stated below:

(a) Prepare a schedule of debenture holders with reference to the Register of debenture holders and tally the total amount received from debenture holders in respect of different classes of debentures that are outstanding for payment with the total of debentures as shown in the General Ledger.

(b) Study the Memorandum and Articles of the company to ascertain the borrowing powers of the company; also whether any limitation has been placed thereon.

(c) Inspect a copy of the debenture bonds that have been issued in acknowledgement of amounts received to ascertain the terms of repayment and particulars of the assets charged as security for the repayment of the amount; and verify that all the requirements of the Act relating to their issue have been fully complied with.

(d) See in the case of mortgaged debentures, that the obligations undertaken by the company under the debentures trust deed to the debenture holders were being strictly honoured.

(e) Confirm that the under mentioned information, required by law, has been duly communicated to the Registrar of Companies:

  (i) Particulars of charges which have been created over the assets of the company as per the requirement of section 77 of the Act.

  (ii) Information in regard to satisfaction in whole, or in part, of any charge relating to the property of the company prescribed under section 82 of the Act.

(f) Verify that the provisions regarding redemption have been duly complied with. Debentures may be redeemable according to the terms of issue at specified dates by annual or other drawings or, at the option of the company, after due notice has been given of the intent to repay. While vouching entries in respect of debentures redeemed, the minutes of the Board of Directors authorising their redemption should be referred to for authority and the cancelled debenture bonds of stock certificates should be examined.

If some debentures have been purchased in the open market, it should be seen that these are being shown as an investment of Sinking Fund, if that is the case, in the Balance Sheet. Any surplus arising on redemption of debentures is capital profit. The balance left to the credit of the Sinking Fund Account, in excess of the value of debentures redeemed on account of profit made on sale of securities held as an investment of the Sinking Fund or due to debentures having been redeemed at a discount, would also be capital profit. However, according to Schedule III of the Companies Act, 2013, it is necessary to disclose the amount of such profits in the Statement of Profit and Loss of the company. When it is transferred directly to the Capital Reserve Account a note should be added to the Balance Sheet to disclose that fact.

If the debentures are redeemed at a premium, the amount of the premium should be written off by debit to the Statement of Profit and Loss.

If a Sinking Fund for redemption of debentures is being operated by means of an insurance policy it should be verified that the policy has been duly assigned in favour of trustees for debenture holders.

Debentures are treated as secured loans in the matter of disclosure of security provided against their repayment. The condition of redemption together with the earliest date it shall take place, are also disclosed.

If the company has redeemed certain debentures which it is authorised to reissue, particulars thereof also are disclosed. In the case of other loans, the provision for interest accrued but not matured for payment, is shown separately under the head 'Current Liabilities and Provisions' but that accrued and payable is shown along with the debentures. Such a distinction is made on the ground that whereas the first mentioned interest is a provision, the second is a debt.

Debenture Trustee and Trust Deed: Section 71 of the Companies Act, 2013 lays down the requirement of appointment of a debenture trustee by the company before the issue of prospectus or letter of offer for subscription of its debentures and not later than sixty days after the allotment of the debentures, execute a debenture trust deed to protect the interest of the debenture holders.

It shall be the duty of every debenture trustee to:

(i) inform the debenture holders immediately of any breach of the terms of issue of debentures or covenants of the trust deed;

(ii) ensure that the debentures have been converted or redeemed in accordance with the terms of the issue of debentures;

(iii) call for periodical status or performance reports from the company;

(iv) ensure that the assets of the company issuing debentures and of the guarantors, if any, are sufficient to discharge the interest and principal amount at all times and that such assets are free from any other encumbrances except those which are specifically agreed to by the debenture holders;

(v) perform such acts as are necessary for the protection of the interest of the debenture holders and do all other acts as are necessary in order to resolve the grievances of the debenture holders.

Where the company has issued any debentures, the auditor should also examine the debenture trust deed executed under section 71 of the Act. The auditor should pay particular attention to verify whether proper security has been created in favour of the debenture trust. The security creation can be verified by examining the relevant documents creating the charge in favour of the trustees for the debenture holders duly registered in the concerned Registrar's office if the security is an immovable property. Readers' attention is also invited to the Guidance Note on Certification of Documents for Registration of Charges issued by the Institute of Chartered Accountants of India. If the debentures have been issued towards the end of the year and the securities are created subsequently then, to present a complete and balanced picture while reporting the fact that the security in respect of debentures is yet to be created, the auditor would be well advised to also mention the reason for the same, viz., that the debentures have been issued only recently (specify the month of issue) and that the company is taking steps to create the security. However, he should report as above only where, as a result of his enquiries, he is satisfied that the non-creation of security is not due to deliberate or inadvertent delay on the part of the company and that it is in fact in the process of creation of security. If the company has not created any security, the auditor should report the fact in his report.

6.12 Contingent Liabilities

Accounting Standard 29 issued by the ICAI deals with the "Provisions, Contingent Liabilities and Contingent Assets". According to it a contingent liability is (a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or (b) a present obligation that arises from past events but is not recognized because: (i) it is not probable that an outflow of resource embodying economic benefits will be required to settle the obligation; or (ii) a reliable estimate of the amount of the obligation cannot be made. According to this statement, the contingent liabilities are not recognized because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future event not wholly within the control of the enterprise. In addition, the term "contingent liability is used for liabilities that do not meet the recognition criteria.

As per above definition, to be called contingent liability the following condition must be fulfilled: (a) possible obligation as a result of past event; (b) existence of which will be confirmed only by the occurrence or non-occurrence of future event; and (c) future event not wholly within the control of the enterprise.

An obligation is a possible obligation if based on the evidence available, its existence at the balance sheet date is considered not probable.

Some of the instances giving rise to contingent liabilities are:

(a) law suits, disputes and claims against the entity not acknowledged as debts.

(b) membership of a company limited by guarantee.

The following general procedures may be useful in verifying contingent liabilities:

(a) Review of minutes of the meetings of board of directors, committees of board of directors/other similar body.

(b) Review of contracts, agreements and arrangements.

(c) Review of list of pending legal cases, correspondence relating to taxes, duties, etc.

(d) Review of terms and conditions of grants and subsidies availed under various schemes.

(e) Review of records relating to contingent liabilities maintained by the entity.

(f) Enquiry of, and discussions with, the management and senior officials of the entity.

(g) Representations from the management.

The auditor should verify that contingent liabilities do not include any items which require an adjustment of relevant assets or liabilities.

Recognition Principles of Contingent Liability: An enterprise should not recognize the contingent liability but it should be disclosed in financial statement, unless the possibility of an outflow of resource embodying economic benefit is remote. In some cases an enterprise is jointly and severally liable for an obligation in that case, the part of the obligation that is expected to be met by other parties is treated as contingent liability. Contingent liabilities are continuously assessed and if it becomes probable that an outflow of future economic benefit will be required to settle obligation which is previously assessed as contingent liabilities, a provision is recognized.

From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statement as required by AS 29. As per, para 68 of AS 29 an enterprise should disclose for each class of contingent liability at the balance sheet date.

- A brief description of the nature of the contingent liability and where practicable.
- An estimate of the amount as per measurement principle as prescribed for provision in AS 29.
- Indication of the uncertainty relating to outflow.
- The possibility of any reimbursement.

Where any of the information as required above is not disclosed because it is not practicable to do so, that fact should be stated.

The Schedule III to the Companies Act, 2013 requires disclosure of following liabilities/commitments, to the extent not provided for, by way of a note:

(1) Classification of Contingent liabilities:
   - Claims against the company not acknowledged as debts;
   - Guarantees;
   - Other money for which the company is contingently liable.

(2) Classification of Commitments into:
   - Estimated amount of contracts remaining to be executed on capital account and not provided for
   - Uncalled liability on shares and other investments partly paid
   - Other commitments (specifying nature)

The amount of any guarantees given by the company on behalf of directors or other officers of the company shall be stated and where practicable, the general nature of each such contingent liability, if material shall also be specified.

The apprehended liabilities aforementioned usually are not easy to ascertain unless a comprehensive knowledge in regard to the working of the business is acquired from a study of the Minute Book of Directors, files of correspondence with legal advisers and on collection of information from the officials of the company in regard to undisputed claims and legal actions pending against the company.

6.13 Events Occurring After the Balance Sheet Date

Accounting Standard - 4 on "Contingencies and Events occurring after the Balance Sheet Date" deals with the treatment of contingencies and events occurring after the balance sheet date in financial statements. According to it, events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and in the case of any other entity by the corresponding approving authority. Some of such events may require adjustments to assets and liabilities as at the balance sheet date or may require disclosure. These are classified as under:

(a) Adjusting events are those significant events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date, *e.g.,* an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of the customer which occurs after the balance sheet date or that indicate that the fundamental accounting assumptions of going concern (*i.e.,* the continuance of existence or substratum of enterprise) is not appropriate.

(b) Non-adjusting events are those events which do not relate to conditions existing at the balance sheet date. An example is the decline in the market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in the market value do not normally relate to the condition of the investments at the balance sheet date but reflects circumstances which have occurred in the following periods. However, disclosure is generally made of such events in case these represent unusual changes affecting the existence or sub-stratum of the enterprise at the balance sheet date. For example the destruction of a major production plant by a fire after the balance sheet will not require any adjustment in the balance sheet as no conditions existed on the date of the balance sheet. Non-adjusting events may be of such significance that they may be required disclosure in the report of the approving authority representing material changes and commitments affecting the financial position of the enterprise. In case disclosure of events occurring after the balance sheet is required, the auditor should see that the following information has been provided:

    (i) the nature of the events; and

    (ii) an estimate of the financial effect or a statement that such an estimate cannot be made.

(c) There is another category of events which although take place after the balance sheet date are required to be reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the amount of dividend proposed or declared after the balance sheet in respect of the period covered by the financial statements.

6.14 Prior Period and Extraordinary Items and Changes in Accounting Policies

The objective of AS-5 on the above subject is to prescribe the classification and disclosure of certain items in the Statement of Profit and Loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this Statement requires the classification and disclosure of extraordinary and prior period items and the disclosure of certain items within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.

This Statement does not deal with the tax implications of extraordinary items, prior period items, change in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

Net Profit or Loss for the Period: All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss:

(a) profit or loss from ordinary activities, and

(b) extraordinary items.

Prior Period Items: Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

The nature and amount of 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.

Extraordinary Items: Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

When items of income and expense within profit and loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Profit or Loss from Ordinary Activities: When items of income and expense within profit or loss from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with the above paragraph include:

(a) the write-down of inventories to net realisable value as well as the reversal of such write-downs;

(b) a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;

(c) disposals of items of fixed assets;

(d) disposals of long-term investments;

(e) legislative changes having retrospective application;

(f) litigation settlements; and

(g) other reversals of provisions.

Changes in Accounting Estimates - In preparation of financial statements, it is inevitable to estimate certain items due to inherent uncertainties in business activities. For example estimates may be required of bad debts, inventory obsolescence or the useful lives of depreciable assets.

A change in accounting estimates is not equivalent to change in accounting policy. For example change from straight line method to WDV method would amount to change in accounting policy. Change in useful life would be treated as change in accounting estimate.

The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:

(a) the period of the change, if the change affects the period only; or

(b) the period of the change and future periods, if the change affects both.

The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

Changes in Accounting Policies - As per AS-1, consistency is one of the fundamental accounting assumptions. Moreover, users should be able to compare the financial statements of an enterprise over a period of time in order to identify trends in its financial position, performance and cash flows. Therefore, the same accounting policies are normally adopted for similar events or transactions in each period.

A change in an accounting policy should be made only if the adoption of a different accounting policy is required by status or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

Any change in an accounting policy which has a material effect should be disclosed. The impact of and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

7

The Company Audit – I

Learning Objectives

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.

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 RELATING TO AUDIT OF COMPANIES

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.**

7.1 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-

(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 rupees one lakh.

It may also be noted that the condition of rupees one lakh 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 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).]

Examples

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), 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. Further, as per proviso to this section, the relative of the auditor 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, an auditor), is having securities of ₹ 90,000 face Value in the ABC Pvt. 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*: "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 "BC & Co." is qualified from being appointed as an Auditor of "MWF 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. Further as per proviso to this Section, the relative of the auditor may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the instant case, BC & Co, will be disqualified for appointment as an auditor of MWF Ltd as the relative of Mr. C i.e. partner of BC & Co., is holding the securities in MWF Ltd which is exceeding the limit mentioned in proviso to section 141(3)(d)(i).

(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 rupees five lakh; 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 one lakh rupees.

(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;

Student 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.

(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) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

Section 144 of the Companies Act, 2013 is a new provision which 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;

(vi) investment banking services;

(vii) rendering of outsourced financial services;

(viii) management services; and

(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. Further, 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; 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.

(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

A, a chartered accountant has been appointed as auditor of Laxman Ltd. In the Annual General Meeting of the company held in September, 2013, which assignment he accepted. Subsequently in January, 2014 he joined 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.*

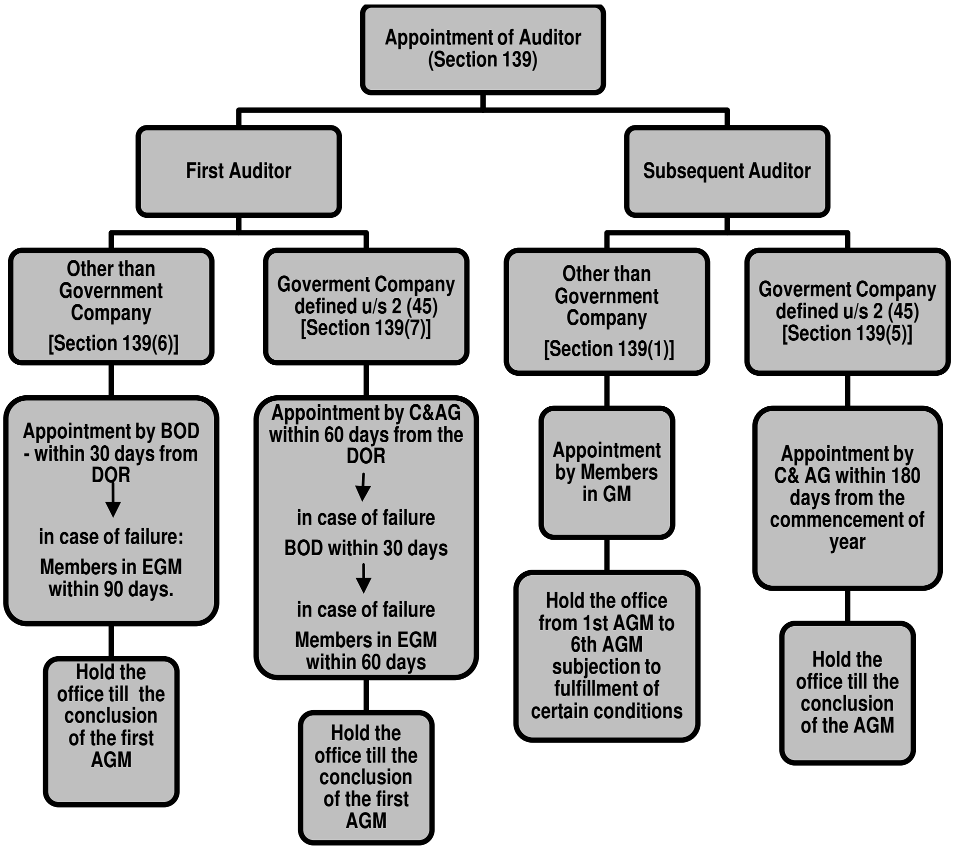
Conclusion: *In the present case, A, an auditor of M/s Laxman Ltd., joined as partner with B, who is Manager Finance of M/s Laxman Limited, has attracted sub-section (3)(c) of Section 141 and, therefore, he shall be deemed to have vacated office of the auditor of M/s Laxman Limited.*

7.2 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.



7.2.1 Appointment of First Auditor

7.2.1.1 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

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.

Provisions and Explanation: *Section 139(6) of the Companies Act, 2013 (the Act) 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.*

Conclusion: *In view of the above, the Managing Director of PQR Ltd should be advised not to appoint the first auditor of the company.*

7.2.1.2 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

The first auditor of M/s Healthy Wealthy Ltd., a Government company, was appointed by the Board of Directors.

Provisions and Explanation: *Section 139(6) of the Companies Act, 2013 (the Act) 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". Thus, the first auditor of a company can be appointed by the Board of Directors within 30 days from the date of registration of the company. However, 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. Hence in the case of M/s Healthy Wealthy Ltd., being a government company, the first auditors shall be appointed by the Comptroller and Auditor General of India.*

Conclusion: *Thus, the appointment of first auditors made by the Board of Directors of M/s Healthy Wealthy Ltd., is null and void.*

7.2.2 Appointment of Subsequent Auditor/Reappointment of Auditor

7.2.2.1 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) The company shall place the matter relating to such appointment of ratification by member at every Annual General Meeting.

(ii) 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.

(iii) The certificate shall also indicate whether the auditor satisfies the criteria provided in section 141.

(iv) 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.

7.2.2.2 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.

7.2.3 Filling of a Casual Vacancy

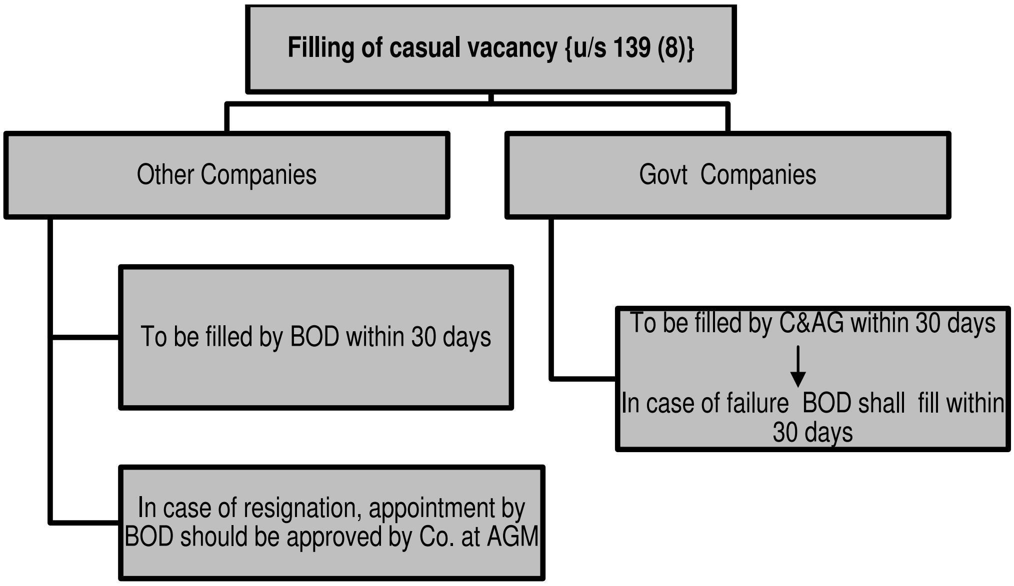
As per Section 139(8), any casual vacancy in the office of an auditor shall-

(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.



7.2.3.1 Casual Vacancy by Resignation: As per section 140(2) 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, and in case of the companies referred to in section 139(5) i.e. Government company, the auditor shall also file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees as per section 140(3).

Other Important Provisions Regarding Appointment of Auditors

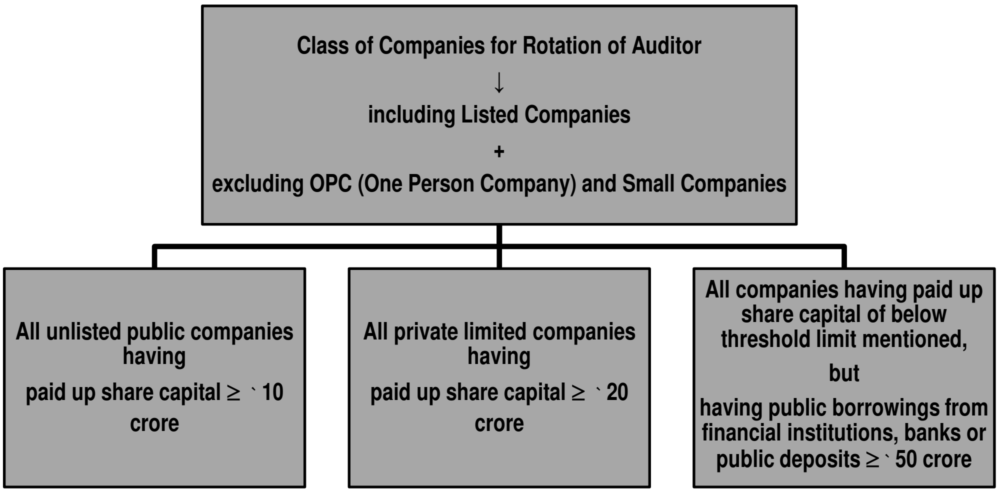
(1) A retiring auditor may be re-appointed at an annual general meeting, if-

- (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.

7. 3 Rotation of Auditor

7.3.1 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-



(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 twenty crore or more;

(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 Ltd. is a private limited Company, having paid up share capital of rupees 18 crore but having public borrowing from nationalized banks and financial institutions of rupees 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.

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., is 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 three years from the date of commencement of this Act.

> ***Example 1:*** *Mr. Raj, a Chartered Accountant, is an individual auditor of M/s Binaca Limited for last 5 years as on March, 2013 (i.e. existing on or before the date of Commencement of Companies Act, 2013), here a break in the term for a continuous period of five years will not be considered as fulfilling the requirement of rotation. Thus, Mr. Raj can continue the audit of M/s. Binaca Ltd. for another 3 years due to transitional effect i.e. aggregate period in the same company will be 8 years.*
>
> ***Example 2:*** *M/s Raj Associates, a Chartered Accountants Audit Firm, is doing audit of M/s Binaca Limited for last 11 years as on March, 2013 (i.e. existing on or before the date of Commencement of Companies Act, 2013), here a break in the term for a continuous period of two terms of five consecutive years will not be considered as fulfilling the requirement of rotation. Thus, M/s Raj Associates can continue the audit of M/s. Binaca Ltd. for another 3 years due to transitional effect, i.e. aggregate period in the same company will be 14 years.*

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

7.3.2 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.

7.3.2 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:

1. Audit Firm shall include other firms whose name or trade mark or brand is used by the firm or any of its partners.
2. 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.

7. 4 Provisions relating to Audit Committee

7.4.1 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.

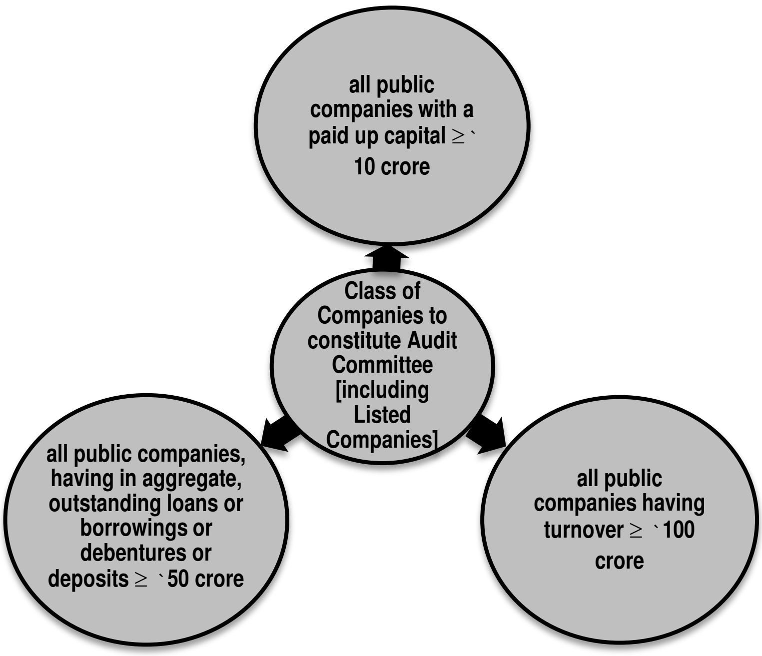


Diagram showing class of companies to constitute Audit Committee

It is important to know that in addition to **listed 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.

7.4.2 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:

It may be noted that such appointment shall be subject to ratification in every annual general meeting till the sixth such meeting by way of passing of an ordinary resolution.

Explanation- For the purposes of this rule, it is hereby clarified that, if the appointment is not ratified by the members of the company, the Board of Directors shall appoint another individual or firm as its auditor or auditors after following the procedure laid down in this behalf under the Act.

7.5 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.

7.6 Removal of Auditors

7.6.1 Removal of Auditor Before Expiry of Term: 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.

7.6.2 Appointment of Auditor Other Than Retiring Auditor: Section 140 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 field with the Registrar.

7.7 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, 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 × 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.

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.*

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 × 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	*= 20*3*	*= 60*
Number 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.

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. The ceiling limit was **increased** from 45 **to 60 numbers in the year 2014**. 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.

7.8 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 Section143(8).

Proviso to section 143(1) further extends the right of the auditor of a company, which is a holding company, to access to the records of all its subsidiaries in so far as it relates to the consolidation of its financial statements with that of its subsidiaries.

Case Study

While conducting the audit of a limited company for the year ended 31st March, 2014, the auditor wanted to refer to the Minute Books. The Board of Directors refused to show the Minute Books to the auditor.

Provisions and Explanation: *Section 143 of the Companies Act, 2013 grants powers to the auditor that every auditor has a right of access, at all times, to the books and account including all statutory records such as minute books, fixed assets register, etc. of the company for conducting the audit. In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company.*

It is, therefore, essential for the auditor to refer to the Minute Books. In the absence of the Minute Books, the auditor may not be able to vouch/verify certain transactions of the company.

Conclusion*: In case the directors have refused to produce the Minute Books, the auditor may consider extending the audit procedure as also consider qualifying his report in any appropriate manner.*

(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."

7.8.1. Powers / Rights of Comptroller and Auditor-General of India: 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 (discuss in the beginning of the chapter) 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 60 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 (1) 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.

7.9 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: 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 sub-section (2) of section 141 and 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 and shall be open to inspection by any member of the company.

(3) Duty to comply with Auditing Standards: As per sub-section 9 of section 143 of the Companies Act, 2013, every auditor shall comply with the auditing standards. Further as per sub-section 10 of section 143 of the Act, the Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority:

Students may note that until any auditing standards are notified, any standard, or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

(4) Duty to audit report: As per sub-section (3) of section 143, 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 direct 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 system in place and the operating effectiveness of such controls;

(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.

[Note: Students may note that the auditor is also required to report on certain additional matters specified under CARO, 2015 which is discussed later under Para 7.10.3 Reporting under Companies (Auditor's Report) Order, 2015]

(5) Duty to report on frauds: 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 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 within such time and in such manner prescribed in rule 13.

Rules 13 of the Companies (Audit and Auditors) Rules, 2014, prescribes that in case the auditor has sufficient 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 report the matter to the Central Government immediately but not later than 60 days of his knowledge and after following the procedure indicated herein below:

(i) auditor shall forward his report to the Board or the Audit Committee, as the case may be, immediately after he comes to knowledge of the fraud, seeking their reply or observations within 45 days;

(ii) 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 of receipt of such reply or observations;

(iii) 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 failed to receive any reply or observations within the stipulated time.

Further, 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. This report shall be on the letter-head of the auditor containing postal address, e-mail address and contact number and be signed by the auditor with his seal and shall indicate his Membership Number. The report shall be in the form of a statement as specified in **Form ADT-4.**

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 provision of this rule 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)

(6) Duty to report on any other matter specified by Central Government: 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 order, that the auditor's report shall also include a statement on such matters as may be specified therein.

(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 7.13 branch audit.**

(8) **Duty to state the reason for qualification or negative report:** As per sub-section 4 of section 143, 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.

7.10 Audit Report

Auditor's Report - An audit report should be clear, specific and complete, in order that anyone who has an occasion to read it may know exactly what is wrong with the company. An Auditor who gives the shareholders "the means of information" in respect of company's financial position, does so, at his peril and runs the serious risk of being held judicially to have failed to discharge his duty (Lindley L.J in Re London and General Bank).

The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements. This review and assessment 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 auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole.

Basic Elements of the Auditor's Report: As per SA 700 "Forming an opinion and reporting on financial statements", the auditor's report includes the following basic elements, ordinarily, in the following layout-

(1) **Title**: The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.

(2) **Addressee**: The auditor's report shall be addressed as required by the circumstances of the engagement.

(3) **Introductory Paragraph**: The introductory paragraph in 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 that comprises the financial statements;

 (d) Refer to the summary of significant accounting policies and other explanatory information; and

 (e) Specify the date or period covered by each financial statement comprising the financial statements.

(4) **Management's Responsibility for the Financial Statements**:

(a) This section of the auditor's report describes the responsibilities of those in the organisation that are responsible for the preparation of the financial statements. The auditor's report need not refer specifically to "management", but shall use the term that is appropriate in the context of the legal and/or regulatory framework applicable to the entity. In case of some entities, the appropriate reference may be to those charged with governance.

(b) The auditor's report shall include a section with the heading "Management's [or other appropriate term] Responsibility for the Financial Statements".

(c) The auditor's report shall describe management's responsibility for the preparation of the financial statements in the manner in which that responsibility is described in the terms of the audit engagement. The description shall include an explanation that management is responsible for the preparation of the financial statements in accordance with the applicable financial reporting framework; this responsibility includes the design, implementation and maintenance of internal control relevant to the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

(d) Where the financial statements are prepared in accordance with a fair presentation framework, the explanation of management's responsibility 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.

(5) **Auditor's Responsibility**: The auditor's report shall include a section with the heading "Auditor's Responsibility".

The auditor's report shall state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.

The auditor's report shall state that the audit was conducted in accordance with Standards on Auditing issued by the Institute of Chartered Accountants of India. The auditor's report shall also explain that those Standards require that the auditor comply with ethical requirements and that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

The auditor's report shall describe an audit by stating that:

(a) An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements;

(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

(c) An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of accounting estimates made by management, as well as the overall presentation of the financial statements.

Where the financial statements are prepared in accordance with a fair presentation framework, the description of the audit in the auditor's report shall refer to "the entity's preparation and fair presentation of the financial statements" or "the entity's preparation of financial statements that give a true and fair view", as appropriate in the circumstances.

The auditor's report shall state 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.

(6) **Auditor's Opinion:** The auditor's report shall include a section with the heading "Opinion".

[I] 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) The financial statements present fairly, in all material respects, in accordance with [the applicable financial reporting framework]; or

(b) The financial statements give a true and fair view of in accordance with [the applicable financial reporting framework].

[II] When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor's opinion shall be that the financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework].

If the reference to the applicable financial reporting framework, in the auditor's opinion, is not to the Accounting Standards promulgated by the Accounting Standards Board (ASB) of 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 promulgated by the Committee on Accounting Standards for Local Bodies (CASLB) of the Institute of Chartered Accountants of India, as may be applicable, the auditor's opinion shall identify the jurisdiction of origin of the framework.

(7) **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 responsibility under the SAs to report on the financial statements, these other reporting responsibilities shall be addressed in a separate section in the auditor's report that shall be sub-titled "Report on Other Legal and Regulatory Requirements," or otherwise as appropriate to the content of the section.

If the auditor's report contains a separate section on other reporting responsibilities, the headings, statements and explanations shall be under the sub-title "Report on the Financial Statements." The "Report on Other Legal and Regulatory Requirements" shall follow the "Report on the Financial Statements."

(8) **Signature of the Auditor:** The auditor's report shall be signed.

(9) **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 recognised authority have asserted that they have taken responsibility for those financial statements.

(10) **Place of Signature:** The auditor's report shall name specific location, which is ordinarily the city where the audit report is signed.

SA 705 deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. The succinct requirements of this SA 705 are given below:

Types of Modified Opinions:

This SA establishes three types of modified opinions, namely:

(i) a qualified opinion,

(ii) an adverse opinion, and

(iii) 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.

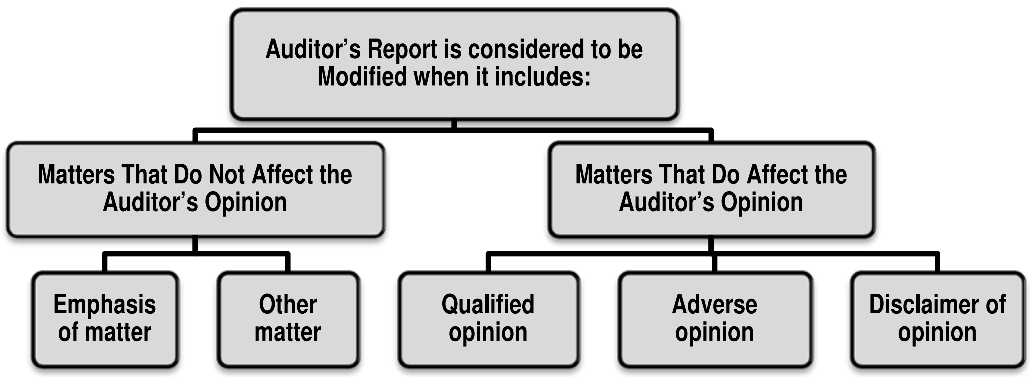
7.10.1 Unqualified Report: An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements. An unqualified opinion indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements. An unqualified opinion also indicates that:

(a) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied;

(b) the financial statements comply with relevant statutory requirements and regulations; and

(c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

7.10.2 Modified Reports: An auditor's report is considered to be modified when it includes:



(a) Matters That Do Not Affect the Auditor's Opinion
    - ✓ emphasis of matter
    - ✓ other matter

(b) Matters That Do Affect the Auditor's Opinion
    - ✓ qualified opinion
    - ✓ disclaimer of opinion
    - ✓ adverse opinion

The auditor shall modify the opinion in the auditor's report when:

(i) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(ii) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Uniformity in the form and content of each type of modified report will enhance the user's understanding of such reports.

(a) Matters That Do Not Affect the Auditor's Opinion:

(1) Emphasis of Matter paragraph: Sometimes 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 the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements.

The Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
- Early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

A widespread use of Emphasis of Matter paragraphs diminishes the effectiveness of the auditor's communication of such matters. Additionally, to include more information in an Emphasis of Matter paragraph than is presented or disclosed in the financial statements may imply that the matter has not been appropriately presented or disclosed; accordingly, it limits the use of an Emphasis of Matter paragraph to matters presented or disclosed in the financial statements

Such a paragraph shall refer only to information presented or disclosed in the financial statements. 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 either:

(i) The auditor expressing a qualified opinion or an adverse opinion, or disclaiming an opinion, when required by the circumstances of a specific audit engagement; or

(ii) Disclosures in the financial statements that the applicable financial reporting framework requires management to make.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(i) Include it immediately after the Opinion paragraph in the auditor's report;

(ii) Use the heading "Emphasis of Matter", or other appropriate heading;

(iii) Include in the paragraph a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements; and

(iv) Indicate that the auditor's opinion is not modified in respect of the matter emphasised.

(2) 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 and this is not prohibited by law or regulation, the auditor shall do so in a paragraph in the auditor's report, with the heading "Other Matter", or other appropriate heading. The auditor shall include this paragraph immediately after the Opinion paragraph and any Emphasis of Matter paragraph, or elsewhere in the auditor's report if the content of the Other Matter paragraph is relevant to the Other Reporting Responsibilities section.

***(b) Matters that Do Affect the Auditor's Opinion*:** An auditor may not be able to express an unqualified opinion when either of the following circumstances exists and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:

(i) there is a limitation on the scope of the auditor's work; or

(ii) there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The circumstances described in (i) above could lead to a qualified opinion or a disclaimer of opinion and the circumstances described in (ii) above could lead to a qualified opinion or an adverse opinion.

(1) A Qualified Opinion: The auditor shall express a qualified opinion when:

(i) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(ii) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

(2) A 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.

(3) **An 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. Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report. In circumstances where it is not practicable to quantify the effect of modifications made in the audit report accurately, the auditor may do so, on the basis of estimates made by the management after carrying out such audit tests as are possible and clearly indicate the fact that the figures are based on management estimates. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to 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 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 That May Result in Other Than an Unqualified Opinion

Limitation on Scope: 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.

If management refuses to remove the limitation, the auditor shall communicate the matter to those charged with governance and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

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) Resign from the audit, where practicable and not prohibited by law or regulation; or

   (ii) If resignation from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

If the auditor resigns as contemplated by above paragraph, before resigning, 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.

Disagreement with Management*:* The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. If such disagreements are material to the financial statements, the auditor should express a qualified or an adverse opinion.

Other Considerations Relating to an Adverse Opinion or Disclaimer of Opinion

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 report in these circumstances would contradict the auditor's adverse opinion or disclaimer of opinion on the financial statements as a whole.

7.10.3 Reporting under Companies (Auditor's Report) Order, 2015 [CARO, 2015]

The Central Government, after consultation with the Institute of Chartered Accountants of India, has issued the Companies (Auditor's Report) Order, 2015, (CARO, 2015) under section 143(11) of the Companies Act, 2013, dated 10th April, 2015. 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. For example, examination of the system of internal control is one of the basic audit procedures employed by the auditor. The fact that the Order requires a

statement regarding the internal control system applicable to purchases of inventory and fixed assets, and sale of goods and services only is no justification for the auditor to conclude that an examination of internal control regarding the other areas of a company's business is not important or not required.

Applicability of the Order: The CARO, 2015 is an additional reporting requirement Order. The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2O13.

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 with a paid up capital and reserves not more than ` 50 lakh and which does not have loan outstanding exceeding ` 25 lakh from any bank or financial institution and does not have a turnover exceeding ` 5 crore at any point of time during the financial year.

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.

(ii) (a) whether physical verification of inventory has been conducted at reasonable intervals by the management;

(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;

(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.*

(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,

(a) whether receipt of the principal amount and interest are also regular; and

(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.

(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.

(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?

(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.

(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 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).

(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 and rules made thereunder has been transferred to such fund within time.

(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.

(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.

(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.

(xi) whether term loans were applied for the purpose for which the loans were obtained.

(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.

***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 reasons for such unfavourable or qualified answer, as the case may be.*

Further, where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give an answer to such question.

***Consequential Amendment to the Format of the Auditor's Report of a Company**: The Auditing and Assurance Standards Board has 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:

....

............................"

7.11 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 quality their audit reports in case –

(a) accounting policies required to be disclosed under Revised Schedule VI or any other provisions of the Companies Act, 1956 (now Schedule III 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.

Examples of Disclosures

Where a partnership firm does not make adequate disclosures regarding the revaluation of its fixed assets.

"During the year, the enterprise revalued its land and buildings. The revalued amounts of land and buildings are adequately disclosed in the balance sheet. However, the method adopted to compute the revalued amounts has not been disclosed, which is contrary to Accounting Standard (AS) 10, 'Accounting for Fixed Assets' issued by the Institute of Chartered Accountants of India.

We report that………"

7.12 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.

With a view to providing a clear idea of the professional responsibility undertaken by the joint auditors, the Institute of Chartered Accountants of India had issued a statement on the Responsibility of Joint Auditors which now stands withdrawn with the issuance of SA 299, "Responsibility of Joint Auditors" w.e.f. April, 1996. It requires that 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 or with reference to periods of time. 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. Further, it states that in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible –

(a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

(c) in respect of 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) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(e) for ensuring that the audit report complies with the requirements of the relevant statute.

If any matters of the nature referred above are brought to the attention of the entity or other joint auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible for those matters.

[Note: Student may refer SA 299 "Responsibility of Joint Auditors" reproduced in "Auditing Pronouncements" for comprehensive knowledge.]

7.13 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 areas 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.

7.14 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.

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.

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, required to include cost records in their books of account. These companies include Foreign Companies defined in sub-section (42) of section 2 of the Act, but exclude a company classified as a Micro enterprise or a Small enterprise including as per the turnover criteria provided under Micro, Small and Medium Enterprises Development Act, 2006.*

The said rule has divided the list of companies into regulated sectors and non-regulated sectors. Some of the companies/industry/sector/product/service prescribed under the said rule are given below:

(A) Regulated Sectors-

- *(i) Telecommunication services made available to users by means of any transmission or reception of signs, signals, images etc. (other than broadcasting services) and regulated by the Telecom Regulatory Authority of India.*
- *(ii) Generation, transmission, distribution and supply of electricity regulated by the relevant regulatory body or authority under the Electricity Act, 2003, other than for captive generation.*
- *(iii) Petroleum products regulated by the Petroleum and Natural Gas Regulatory Board.*
- *(iv) Drugs and Pharmaceutical.*
- *(v) Sugar and industrial alcohol.*

(B) Non-Regulated Sectors-

- *(i) Machinery and mechanical appliances used in defence, space and atomic energy sectors excluding any ancillary item or items.*
- *(ii) Turbo jets and turbo propellers.*
- *(iii) Tyres and Tubes.*
- *(iv) Steel; Cement.*
- *(v) Production, import and supply or trading of following medical devices, such as heart valves; orthopaedic implants; pacemaker (temporary and permanent), etc. The rule excludes the foreign companies having only liaison offices.*

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, 2015, where maintenance of cost records has been specified by the Government under section 148(1) of the Companies Act, 2013, the auditor has to report whether such accounts and records have been made and maintained.

***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 in Practice 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 and Works 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. 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.

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 in practice, 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 in practice 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 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014. 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.

<u>Duty to Report on Fraud:</u> 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.

<u>Cost Audit Rules Not to Apply in Certain Cases:</u> Sub-rule (3) of rule 4 provides that 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.

<u>Penal Provisions in Case of Default</u>: 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.

7.15 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.

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 one lakh rupees but which may extend to twenty-five lakh rupees.

(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 any other persons 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 criminal as provided in this Act or in any other law for the time being in force, for such act shall be the partner or partners concerned of the audit firm and of the firm jointly and severally.

8

The Company Audit – II

Learning Objectives

After studying this chapter, you will be able to understanding –

- The general considerations in a company audit.
- The procedure of auditing of share capital, debentures, dividends and verification of issue of bonus shares.
- The presentation of financial statement, such as, balance sheet and statement of profit and loss.

The previous chapter basically dealt with provisions relating to company auditor i.e. his qualifications, disqualifications, rights, duties, rotation of auditor etc. In this Chapter, we shall concentrate on provisions relating to company accounts, some specific items of financial statements relating to companies and audit thereof. Students are also expected to know in detail the requirements of Schedule III to the Companies Act, 2013, while auditing different items contained in financial statements.

8.1 General Considerations in Company Audit

These have to be determined on a consideration of:

(1) objectives of audit;

(2) various provisions in the Companies Act, 2013, especially those concerning accounts and audit; and

(3) the scope of the report that the auditor of a company is required to make in pursuance of the provisions contained in section 143 of the Act.

The objectives of an audit are:

(i) Verification of statements of account so as to express an opinion;

(ii) Detection of errors and frauds; and

(iii) Prevention of occurrence of errors and frauds.

(Student may note that objective of an audit are discussed in detail in initial chapters.)

8.2 Specific Provisions as Regards Accounts in the Companies Act, 2013

8.2.1 Books of Account, etc., to be kept by Company: The provisions in the matter of books of account which a company is required to maintain are contained in section 128 of the Companies Act, 2013 (hereinafter referred as the Act).

The term **"Book and paper"** and **"Book or paper"** has been defined under section 2(12) of the Act**,** which includes books of account, deeds, vouchers, writings, documents, minutes and registers maintained on paper or in electronic form.

Further, **"Books of account"**, as defined under section 2(13) of the Act, includes records maintained in respect of—

(a) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place;

(b) all sales and purchases of goods and services by the company;

(c) the assets and liabilities of the company; and

(d) the items of cost as may be prescribed under section 148 in the case of a company which belongs to any class of companies specified under that section.

Provisions of section 128 of the Act are summarised below:

(i) Maintenance of books of accounts: Sub-section (1) of section 128 requires every company to 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.

Such books of Accounts are required to be kept on accrual basis and according to the double entry system of accounting.

(ii) Place of maintenance of books of accounts: As discussed above, sub-section (1) requires the company to keep its books of account and other relevant papers at the registered office of the company.

The company may also keep all or any of the books of accounts at any other place in India as the Board of directors may decide. In such a case, the company should file with the Registrar of Companies, a notice in writing giving the full address of that place within 7 days of the Boards' decision.

(iii) Electronic form of Books of accounts: Second proviso to section 128(1) read with the Companies (Accounts) Rules, 2014 allows a company to keep its books of account or other relevant papers in electronic mode.

However, the books of account and other relevant books and papers maintained in electronic mode shall comply with the following conditions:

(a) the books of account and other relevant books and papers shall remain accessible in India so as to be usable for subsequent reference.

(b) the books of account and other relevant books and papers shall be retained completely in the format in which they were originally generated, sent or received, or in a format which shall present accurately the information generated, sent or received and the information contained in the electronic records shall remain complete and unaltered.

(c) the information received from branch offices shall not be altered and shall be kept in a manner where it shall depict what was originally received from the branches.

(d) the information in the electronic record of the document shall be capable of being displayed in a legible form.

(e) there shall be a proper system for storage, retrieval, display or printout of the electronic records as the audit committee, if any, or the board may deem appropriate and such records shall not be disposed of or rendered unusable, unless permitted by law.

(f) the back-up of the books of account and other books and papers of the company maintained in electronic mode, including at a place outside India, if any, shall be kept in servers physically located in India on a periodic basis.

The company is required to intimate to the Registrar on an annual basis at the time of filing of financial statement, the following-

(a) The name of the service provider;

(b) The internet protocol address of service provider;

(c) The location of the service provider (wherever applicable);

(d) Where the books of account and other books and papers are maintained on cloud, such address as provided by the service provider.

(iv) Proper Books of Account in relation to a Branch of the Company: In case the company has a branch office in/or outside India, it shall be deemed to have complied with the provisions of section 128(1) if **-**

(a) Proper books of account relating to the transactions effected at the branch office in India or outside India are kept at that branch office; and

(b) Proper summarised returns periodically are sent by the branch office to the company at its registered office or the other place as decided by the Board of directors.

(v) Persons who can inspect books of account & other books and papers:

(a) The books of account and other books and papers maintained by the company within India shall be open for inspection at the registered office of the company or at such other place in India by any director during business hours.

(b) In the case of financial information, if any, maintained outside the country, copies of such financial information shall be maintained and produced for inspection by any director subject to such conditions as prescribed under the Companies (Accounts) Rules, 2014 which provides that-

(1) The summarised returns of the books of account of the company kept and maintained outside India shall be sent to the registered office at quarterly intervals, which shall be kept and maintained at the registered office of the company and kept open to directors for inspection.

(2) Where any other financial information maintained outside the country is required by a director, the director shall furnish a request to the company setting out the full details of the financial information sought, the period for which such information is sought.

(3) The company shall produce such financial information to the director within 15 days of the date of receipt of the written request.

(4) The financial information required under sub-rules (2) and (3) above shall be sought for by the director himself and not by or through his power of attorney holder or agent or representative.

(c) The inspection in respect of any subsidiary of the company shall be done only by the person authorised in this behalf by a resolution of the Board of Directors.

(d) The officers and other employees of the company shall give to the person making such inspection all assistance in connection with the inspection which the company may reasonably be expected to give.

(vi) Period of Maintenance: According to section 128(5), the books of account of every company together with the vouchers relevant to any entry in such books of accounts shall be kept in order by the company for a minimum period of 8 financial years immediately preceding a financial year.

However, where the company had been in existence for a period of less than 8 years, it shall maintain the books in respect of all such preceding years.

Where an investigation has been ordered in respect of the company, the Central Government may direct that the books of account may be kept for such longer period as it may deem fit.

(vii) Persons responsible for Maintenance & Penalty: Section 128(6) deals with the matters related to persons responsible for maintenance of books of account, and other relevant books and papers, and financial statement; and penalty in case of non-compliance. Provisions in brief are discussed below -

(a) The following persons are responsible for the maintenance of proper books of account-

(1) The managing director, the whole-time director in charge of finance, the Chief Financial Officer; or

(2) any other person of a company charged by the Board.

(b) If any of the persons mentioned above contravenes such provisions, they shall be punishable with:

(1) Imprisonment for a term which may extend to 1 year; or

(2) Fine which shall not be less than ` 50,000 but which may extend to ` 5 lakh; or

(3) Both with imprisonment or fine.

8.2.2 Financial Statements: As per section 2(40) of the Companies Act, 2013, "Financial Statement" in relation to a company, includes—

(a) a balance sheet as at the end of the financial year;

(b) a profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;

(c) cash flow statement for the financial year;

(d) a statement of changes in equity, if applicable; and

(e) any explanatory note annexed to, or forming part of, any document referred above.

However, the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement.

Section 129 prescribes norms for financial statements which are as under:

(i) Form of Financial statements: Sub-section (1) of section 129 provides that the financial statements shall-

(a) give a true and fair view of the state of affairs of the company or companies,

(b) comply with the accounting standards notified under section 133 and

(c) be in the form or forms as may be provided for different class or classes of companies in Schedule III[1] (Given as Appendix at the end of this chapter).

However, the items contained in such financial statements shall be in accordance with the accounting standards.

It may be noted that the above provisions relating to nature and content of financial statement shall not apply to following companies:

(a) Insurance Companies

(b) Banking companies

[1] *Students are advised to go through Schedule III to the Companies Act, 2013 carefully for preparation of financial statements of companies including consolidated financial statements reproduced in Appendix given at the end of this chapter.*

(c) Company engaged in the generation or supply of electricity

(d) Any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company.

However, the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, if the following disclosures are not made-

Type of Company	Matters
Insurance Company	Matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999
Banking company	Matters which are not required to be disclosed by the Banking Regulation Act, 1949
Company engaged in the generation or supply of electricity	Matters which are not required to be disclosed by the Electricity Act, 2003
Company governed by any other law	Matters which are not required to be disclosed by that law

Here, any reference to the financial statement shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes under this Act.

Section 129(2) requires the Board of directors of the company to lay the financial statements for the financial year at every annual general meeting of the company.

(ii) Consolidated Financial Statements: According to Section 129(3), where a company has one or more subsidiaries (including associate company and joint venture), it shall, in addition to its own financial statements prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own.

The Consolidated financial statements shall also be laid before the annual general meeting of the company along with the laying of its own financial statement.

The company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in Form AOC-1.

According to Companies (Accounts) Rules, 2014, the consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III to the Act and the applicable accounting standards. However, a company which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.

Further, section 129(4) of the said Act provides that the provisions applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, also apply to the consolidated financial statements.

(iii) Deviations from Accounting Standards: If the financial statements of a company do not comply with the accounting standards referred to in sub-section (1) of section 129, the company shall disclose in its financial statements the following namely:

(a) the deviation from the accounting standards,

(b) the reasons for such deviation, and

(c) the financial effects, if any, arising out of such deviation.

(iv) Exemptions: Section 129(6) states about exemptions as follows-

(a) The Central Government may, on its own or on an application by a class or classes of companies, by notification, exempt any class or classes of companies from complying with any of the requirements of section 129 or the rules made thereunder, if it is considered necessary to grant such exemption in the public interest.

(b) Any such exemption may be granted either unconditionally or subject to such conditions as may be specified in the notification.

(v) Contravention: Sub-section (7) levies the penalty in case of contravention of the provisions of section 129. It states that if a company contravenes the provisions of this section, the managing director, the whole-time director in charge of finance, the Chief Financial Officer or any other person charged by the Board with the duty of complying with the requirements of this section and in the absence of any of the officers mentioned above, all the directors shall be punishable with

(a) Imprisonment for a term which may extend to 1 year; or

(b) Fine which shall not be less than ` 50,000 but which may extend to ` 5 Lakhs; or

(c) Both with imprisonment and fine.

8.2.3 Central Government to prescribe Accounting Standards: Section 133 of the Companies Act, 2013 provides the provisions for Central Government to prescribe accounting standards. According to section 133 of the Companies Act, 2013, “Accounting Standards” means the standards of accounting or any addendum thereto as recommended by the Institute of Chartered Accountants of India (ICAI), as may be prescribed by the Central Government in consultation with and after examination of the recommendations made by the National Financial Reporting Authority constituted under section 132 of the Companies Act, 2013.

In respect of accounting standards, the role of National Financial Reporting Authority is limited to advise the Central Government on the accounting standards recommended by ICAI for adoption by companies.

The Ministry of Corporate Affairs (MCA) vide General Circular No. 15/2013 dated 13th September, 2013 has clarified that 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.

8.2.4 Financial Statement, Board's Report etc.: Section 134 of the Companies Act, 2013 provides for financial statement, Board's report, etc.

Provisions of section 134 are briefly summarised below:

(i) Authentication of Financial Statements: Section 134(1) provides that the financial statements, including consolidated financial statement, if any, shall be approved by the board of directors before they are signed on behalf of the board at least by the following-

(a) The chairperson of the company where he is authorised by the Board; or

(b) By two directors out of which one shall be managing director and

(c) The Chief Executive Officer, if he is a director in the company,

(d) The Chief Financial Officer, wherever he is appointed; and

(e) The company secretary of the company, wherever he is appointed.

However, in the case of a one person company, the financial statement shall be signed by only one director, for submission to the auditor for his report thereon.

As per section 134(2), the auditors' report shall be attached to every financial statement.

According to section 134(7), a signed copy of every financial statement, including consolidated financial statement, if any, shall be issued, circulated or published along with a copy each of—

(a) Any notes annexed to or forming part of such financial statement;

(b) The auditor's report; and

(c) The Board's report.

(ii) Board's Report: According to Companies (Accounts) Rules, 2014, the board's report shall be prepared based on the stand alone financial statements of the company and the report shall contain a separate section wherein a report on the performance and financial position of each of the subsidiaries, associates and joint venture companies included in the consolidated financial statement is presented.

Section 134(3) provides that there shall be attached to statements laid before a company in general meeting, a report by its board of directors, which shall include —

(a) the extract of the annual return as provided under sub-section (3) of section 92;

(b) number of meetings of the Board;

(c) Directors' Responsibility Statement;

(d) a statement on declaration given by independent directors under sub-section (6) of section 149;

(e) in case of a company covered under sub-section (1) of section 178, company's policy on directors' appointment and remuneration including criteria for determining qualifications, positive attributes, independence of a director and other matters provided under sub-section (3) of section 178;

(f) explanations or comments by the Board on every qualification, reservation or adverse remark or disclaimer made—

 (1) by the auditor in his report; and

 (2) by the company secretary in practice in his secretarial audit report;

(g) particulars of loans, guarantees or investments under section 186;

(h) particulars of contracts or arrangements with related parties referred to in sub-section (1) of section 188 in Form AOC-2;

(i) the state of the company's affairs;

(j) the amounts, if any, which it proposes to carry to any reserves;

(k) the amount, if any, which it recommends should be paid by way of dividend;

(l) material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the financial statements relate and the date of the report;

(m) the conservation of energy, technology absorption, foreign exchange earnings and outgo, in such manner as prescribed under the Companies (Accounts) Rules, 2014 which provides for:

 (A) Conservation of energy-

  (1) the steps taken or impact on conservation of energy;

  (2) the steps taken by the company for utilising alternate sources of energy;

  (3) the capital investment on energy conservation equipments;

 (B) Technology absorption-

  (1) the efforts made towards technology absorption;

  (2) the benefits derived like product improvement, cost reduction, product development or import substitution;

  (3) in case of imported technology (imported during the last three years reckoned from the beginning of the financial year)-

   (i) the details of technology imported;

   (ii) the year of import;

(iii) whether the technology been fully absorbed;

(iv) if not fully absorbed, areas where absorption has not taken place, and the reasons thereof; and

(4) the expenditure incurred on Research and Development.

(C) Foreign exchange earnings and Outgo- The Foreign Exchange earned in terms of actual inflows during the year and the Foreign Exchange outgo during the year in terms of actual outflows.

(n) a statement indicating development and implementation of a risk management policy for the company including identification therein of elements of risk, if any, which in the opinion of the Board may threaten the existence of the company;

(o) the details about the policy developed and implemented by the company on corporate social responsibility initiatives taken during the year;

(p) in case of a listed company and every other public company having a paid up share capital of 25 crore rupees or more calculated at the end of the preceding financial year shall include (as prescribed under the Companies (Accounts) Rules, 2014), in the report by its Board of directors, a statement indicating the manner in which formal annual evaluation has been made by the Board of its own performance and that of its committees and individual directors.

(q) The report of the Board shall also contain (as prescribed under the Companies (Accounts) Rules, 2014 –

(1) the financial summary or highlights;

(2) the change in the nature of business, if any;

(3) the details of directors or key managerial personnel who were appointed or have resigned during the year;

(4) the names of companies which have become or ceased to be its subsidiaries, joint ventures or associate companies during the year;

(5) the details relating to deposits like-

(i) accepted during the year;

(ii) remained unpaid or unclaimed as at the end of the year;

(iii) whether there has been any default in repayment of deposits or payment of interest thereon during the year and if so, number of such cases and the total amount involved-

(a) at the beginning of the year;

(b) maximum during the year;

(c) at the end of the year;

(6) the details of deposits which are not in compliance with the requirements of Chapter V of the Act;

(7) the details of significant and material orders passed by the regulators or courts or tribunals impacting the going concern status and company's operations in future;

(8) the details in respect of adequacy of internal financial controls with reference to the Financial Statements.

Board's Report in case of OPC: As per sub-section (4) of section 134, in case of a one person company, the report of the board of directors to be attached to the financial statement under this section shall, mean a report containing explanations or comments by the board on every qualification, reservation or adverse remark or disclaimer made by the auditor in his report.

(iii) Directors' Responsibility Statement: According to section 134(3)(c) of the Companies Act, 2013, the report of board of directors on annual accounts shall also include a 'Directors' Responsibility Statement'. However, the provisions related to Directors' Responsibility Statement are provided under section 134(5) of the Companies Act, 2013 which requires to state that-

(a) in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;

(b) the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;

(c) the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

(d) the directors had prepared the annual accounts on a going concern basis;

(e) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

Here, the term "internal financial controls" means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information; and

(f) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

(iv) Signing of Board's Report: Section 134(6) requires the Board's report and any annexures thereto to be signed by its chairperson of the company if he is authorised by the Board and where he is not so authorised, to be signed by at least two directors, one of whom shall be a managing director, or by the director where there is one director.

(v) Contravention: Sub-section (8) levies the penalty in case of contravention of the provisions of section 134. It states that-

(a) If a company contravenes any provisions of this section, the company shall be punishable with fine which shall not be less than ` 50,000 but which may extend to ` 25 Lacs.

(b) Every officer of the company who is in default shall be punishable with:

(1) Imprisonment for a term which may extend to 3 years; or

(2) fine which shall not be less than `50,000 but which may extend to ` 5 Lacs; or

(3) Both with imprisonment and fine.

8.3 Special Requirements of Company Audit

(i) Verification of the constitution and powers - A company can function within the limits prescribed by the documents on the basis of which it has been registered. It raises its capital from the public on certain conditions, specified in the Prospectus. Before commencing business, to purchase a property or to have subscription to its capital underwritten on this account, it is essential that the auditor, prior to starting the audit of a company, shall examine:

(a) The Memorandum of Association.

(b) The Articles of Association.

(c) Contracts entered into with vendors and other persons relating to purchase of property, payment of commission, etc.

A company cannot enter into a contract before it has been registered. What is more, a public company cannot commence business until the certificate of commencement of business has been granted to it by the Registrar of Companies. It is, therefore, the duty of the auditor to take into account, while examining the transaction entered into by the company, the dates when these were entered into for confirming the validity.

With a view to carrying out the audit effectively, it is necessary that the auditor should know the authority structure of the company and ensure the compliance of the same. For example as per Section 179 of the Act, the Board of Directors of a company are entitled to exercise all such powers, and to do all such acts and things, as the company is authorised to do. However, the Board shall not exercise any power or do any act or thing which is directed or required by any legislation (including the Companies Act) or by the memorandum or articles of the company, to be exercised or done by the company, in general meeting.

Section 179 specifies various types of decisions that can be taken by way of resolution by the Board of Directors only in Board's meetings, namely;

(a) to make calls on shareholders in respect of money unpaid on their shares;

(b) to authorise buy-back of securities under section 68;

(c) to issue securities, including debentures, whether in or outside India;

(d) to borrow monies;

(e) to invest the funds of the company;

(f) to grant loans or give guarantee or provide security in respect of loans;

(g) to approve financial statement and the Board's report;

(h) to diversify the business of the company;

(i) to approve amalgamation, merger or reconstruction;

(j) to take over a company or acquire a controlling or substantial stake in another company;

(k) any other matter which may be prescribed:

Apart from the above, a number of **other functions** are also carried out by the Board. A few of such functions are stated herein by way of examples:

(a) Adopting of accounts before the same submitted to the auditor for their report as given under section 134.

(b) Appointment of the first auditors and filling of casual vacancy as provided under section 139.

(c) Investment in shares of companies within the limits specified in Section 186.

(d) Entering into contracts with persons who are directors of the company or related to or associated with the directors as are specified in Section 188 of the Act.

Whereas some of the matters which only the shareholders can sanction at a general meeting like Appointment and fixation of remuneration of auditors in the annual general meeting - Section 139 and 142, Declaration of dividends etc.

(ii) Special considerations involved in the examination of certain documents

(a) Memorandum of Association - It is a charter containing particulars of business activities that the company can undertake and the powers it can exercise in regard thereto. Only on a consideration thereof it is possible for the auditor to determine whether a transaction which has been entered into by the company is *intra vires,* i.e. the company is authorised to enter into it. If a company enters into a transaction which is *ultra vires,* the shareholders, though entitled to claim the profit arising on such a transaction, may restrain the management from charging the loss, if any, has been suffered thereon, to the company. If the auditor fails to detect and report the transactions which are *ultra vires* the company, he would be guilty of negligence.

Generally the Memorandum of Association of companies is drawn up comprehensively in order that the company may be able to enter into a wide variety of transactions which it may be required to do for carrying out one or more of its objects. Nevertheless, sometimes occasions arise when a company, inadvertently, or deliberately, enters into a transaction which is *ultra vires* objects to powers. In such a case, the shareholders may decide to restrain the management from charging to the company the losses suffered by the company in respect of such a transaction.

(b) Articles of Association - These are rules and regulations for the internal management of the company; and they define the rights of different classes of shareholders, conditions under which calls can be made, the maximum and minimum number of directors the company can have, their qualifications, disqualifications and removal, etc. The terms and conditions of these provisions have relevance to the examination of transaction, that the auditor is required to carry out. He should, therefore, study the Articles and include extracts from them in his permanent audit file. The auditor, who fails to take note of the provisions in the Articles in the verification of statements of accounts, would be guilty of professional negligence. While delivering judgment in the case, *Leeds Estate Building and Investment Co.* v. *Shepherd, Starling J.* said, "It is the duty of the auditor to see that the balance sheet is a true and correct representation of the company's affairs. It was no excuse that the auditor had not seen the articles when he knew of their existence."

The auditor must, therefore, acquaint himself with the provision of the Articles of the company and should apply this knowledge in the verification of the transactions of the company.

(c) Prospectus - It is a formal document which a public company must issue before it makes the allotment of shares. It must contain all the terms and conditions on which subscription to the shares is sought to be obtained from the public *e.g.* the company may stipulate, that it would obtain a quotation for its shares at a Stock Exchange or that it shall purchase a property which is considered valuable for the company or that it has obtained the services of technical experts whose services will be valuable for setting up the factory. In case the company fails to carry out any of these undertakings or if any statement made by it ultimately is proven to be false, the shareholder has the option to claim refund of the amount paid by him. The auditor should, therefore, study carefully all the conditions and stipulations made in the prospectus and, in case any of them has not been carried out, to draw the attention of shareholders thereto. It may be noted that the right to claim refund is restricted to such of the shareholders who subscribed for shares on the basis of prospectus. A shareholder who has purchased the shares from stock exchange or otherwise cannot claim refund.

8.4 Audit of Share Capital

Almost the first function of a company is to raise capital. Excepting 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 to allotment, share capital. The object is to publicly announce the conditions on which allotment will be made, to specify the projects on which the amount raised will 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 also must verify that each party, has performed his part of the contract, within the allotted time.

The audit of share capital is necessary both on incorporation and afterwards whenever the directors decide to increase the subscribed share capital. However, except when fresh capital has been issued during the year under audit, for verification of capital it is enough if transfers of shares registered during the year are verified and the total number and value of shares held by different shareholders are reconciled with the total paid-up capital of the company.

8.4.1 General Programme for Verification of Share Capital

(a) Nominal or Authorised or Registered capital: This form of capital has been defined in section 2(8) of the Companies Act, 2013. "Authorised capital" or "Nominal capital" means such capital as is authorised by the memorandum of a company to be the maximum amount of share capital of the company Thus it is the sum stated in the memorandum as the capital of the company with which it is to be registered being the maximum amount which it is authorised to raise by issuing shares, and upon which it pays the stamp duty. It is usually fixed at the amount, which, it is estimated, the company will need, including the working capital and reserve capital, if any.

The authorised capital may be verified with reference to the amount shown in the Memorandum of Associations. Previous year audited balance sheet may also be seen.

(b) Issued Capital: Section 2(50) of the Companies Act, 2013 defines "issued capital" which means such capital as the company issues from time to time for subscription; It is that part of authorised capital which is offered by the company for subscription and includes the shares allotted for consideration other than cash.

Schedule III of the Companies Act, 2013, makes it obligatory for a company to disclose its issued capital in the balance sheet.

Verify the amount of issued capital with reference to last year audited balance sheet. Also see whether the Central Government has issued any notification for conversion of debenture or loan into equity share under section 62(4).

Further for verification of issue of capital the general points are given as under:

(i) Study the conditions of issue contained in the Memorandum and Articles of Association, Prospectus or Statement in lieu of Prospectus, shelf prospectus, red-herring prospectus and information memorandum, as the case may be, and see that all of them have fully been complied with.

(ii) Verify that the first allotment was not made until the amount of minimum subscription stated in the Prospectus had been subscribed and until then the amount received was kept deposited in a Scheduled bank as required by Section 39 of the Act.

(iii) Confirm that the brokerage and underwriting commission was paid only at the rates authorised by the Prospectus or the Articles of Association, having regard to the provisions contained in Section 40 of the Act.

(iv) Ensure that legal requirements as laid down in section 62 (dealing with right shares) have been complied with.

(v) Verify that preliminary contracts, if any, entered into for purchase of a property or business, for creating an organisation for management of the company, etc. have been carried out strictly according to the terms stated in the Prospectus.

(vi) Ensure that the company intending to offer shares to the public for subscription by the issue of a Prospectus has, before such issue, made an application to one or more recognised stock exchanges for permission for the shares intending to be so offered within the stock exchange or each stock exchange as required by the Companies Act, 2013.

(vii) Confirm that the guidelines issued by the Securities and Exchange Board of India (SEBI) have been followed. Compliance reports submitted by lead managers and reports submitted to SEBI may be examined in this regard.

(viii) Ascertain that there exists an internal check on receipt of amounts along with the application and that the same throughout has continued to function satisfactorily.

(ix) Verify compliance with legal provision relating to issue of shares at premium (section 52), Prohibition on issue of shares at discount (section 53), and issue of sweat equity shares (section 54).

8.4.2 Verification of Shares Issued for Cash: Usually, there are three stages in the issue of shares for cash, *viz*.-

(i) Receipt of applications for shares alongwith application money;

(ii) Allotment of shares and receipt of allotment; and

(iii) Making calls and receipt of call money.

The programme of work to be carried out in respect of each of the above mentioned three stages is stated below-

(1) **Applications:** Verify the amount received along with the applications for shares in the following manner-

(i) Check entries in the Application and Allotment Book (or Sheets) with the original applications;

(ii) Check entries in the Application and the Allotment Book as regards deposits of money, received with the applications, with those in the Cash Book;

(iii) Vouch amounts refunded to the unsuccessful applicants with copies of Letters of Regret;

(iv) Check the totals columns in the Application and Allotment Book and confirm the journal entry debiting Share Application Account and crediting Share Capital Account.

(2) **Allotment:**

(i) Examine Director's Minutes Book to verify approval of allotments.

(ii) Compare copies of letters of allotment with entries in the Application and Allotment Book.

(iii) Trace entries in the Cash book into the Application and Allotment Book for the verification of amounts collected on allotment.

(iv) Trace the amount collected on application as well as those on allotment from the Application and Allotment Book into the Share Register.

(v) Check whether the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on such application have been received by the company.

(vi) Check that the amount payable on the application on every security is not less than five percent of the nominal amount of security or such other percentage or amount as may be prescribed by the SEBI.

(vii) If the stated minimum amount has not been subscribed and the sum payable on subscription is not received within a period of thirty days from the date of issue of the prospectus or such period as my be specified by the SEBI, check that the amount received above is returned within a period of fifteen days from the closure of the issue and if in case the amount is not repaid within such period, the directors in default shall jointly and severally be liable to repay that amount with interest at the rate of fifteen percent per annum.

(viii) Check totals of amounts payable on allotment and verify the journal entry debiting Share Allotment Account and crediting Share Capital Account.

(3) **Calls:**

(i) Examine the Director's resolution making the call.

(ii) Vouch amounts received with the counterfoils of receipts.

(iii) Trace postings of the amounts received from the Calls Book (for calls due) and the Cash Book (for calls collected) into the Share Register.

(iv) Verify the journal entry, debiting the Call Account and crediting Share Capital with totals of the amounts due.

(v) Note the calls in arrears.

(4) **General:**

(i) Ascertain that the nominal value of shares allotted does not, exceed the authorised and issued capital and that allotments were made in accordance with conditions contained in the Prospectus.

(ii) See the returns of allotment have been filed with the Registrar of Companies.

(iii) Extract balances of shareholders' accounts contained in the Share Register and tally their total with the balance in the Share Capital Account.

(iv) If the issue was underwritten, examine the contract with the underwriters to ensure that all obligations under the contracts have been fully satisfied.

(v) Vouch payment of commission and brokerage, the first by reference to the underwriting contract and the second by reference to stamps of brokers on application forms.

(vi) See that the company has delivered share certificates within three months after the allotment of any of its shares in accordance with the procedure laid down under Section 53.

Note: The signatories to the Memorandum of Association being the first shareholder of the company, it is usual to make allotment in their favour.

8.4.3 Shares Issued for Consideration other than Cash: The contract, on the basis of which the shares have been allotted, should be referred to and the allotment confirmed by reference to the Minutes of the Board of Directors.

Sometimes, in view of the nature of the transaction, it may be difficult to know whether an allotment is for cash or for a consideration, other than cash, for instance, allotment of shares in adjustment of a debt owed by the company. In such a case, if the allotment is made in adjustment of a *bonafide* debt payable in money at once, the allotment should be considered as against cash. (Spargo's Case 1873, 3 Ch. A 407). This position should be kept in view when inquiring into matters stated in Section 143(1). Again if the shares are allotted on a cash basis, though the amount is actually paid later, it should constitute an allotment against cash.

8.4.4 Shares Issued at a Premium: Where 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. According to the section where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a "securities premium account" and 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.

8.4.5 Shares Issued at a Discount: A company cannot issue shares in disregard of Section 53 of the Companies Act, 2013. According to section 53, 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.

8.4.6 Issue of Sweat Equity Shares: As per section 54 of the Companies Act, 2013, the employees may be compensated in the form of 'Sweat Equity Shares".

"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.

The auditor may see that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions are fulfilled:

(a) the issue is authorised 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.

The rights, limitations, restrictions and provisions as are for the time being 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.

8.4.7 Power of Company to Purchase its Own Securities: The Companies Act, 2013 under Section 68(1) permits companies to buy-back their own shares and other specified securities out of:

(i) its free reserves; or

(ii) the securities premium account; or

(iii) the proceeds of the issue of any shares or other specified securities.

It may be noted that no buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

The other important provisions relating to the buyback are:

(1) Section 68(2) further states that no company shall purchase its own shares or other specified securities unless—

   (a) the buy-back is authorised by its articles;

   (b) a special resolution has been passed in general meeting of the company authorising the buy-back;

   However, the above provisions do not apply where the buy back is 10% or less of the paid up equity capital + free reserves and is authorized by a board resolution passed at a duly convened meeting of the directors. Hence, in case the buy back is upto 10% of paid up equity + free reserves, the same may be done with the authorization of the Board Resolution without the necessity of a special resolution of its members being passed at a general meeting of the company.

   (c) the buy-back is equal or less than 25% of the total paid-up capital and free reserves of the company.

   It may be noted that in respect of the buy-back of equity shares in any financial year, the reference to 25% shall be construed with respect to its total paid-up equity capital in that financial year.

(d) the ratio of the debt owed by the company (both secured and unsecured) after such buy - back is not more than twice the total of its paid up capital and its free reserves:

However, the Central Government may prescribe a higher ratio of the debt to capital and free reserves than that specified under this clause for a class or classes of companies.

(e) all the shares or other specified securities for buy-back are fully paid-up;

(f) the buy-back of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India in this behalf;

(g) the buy-back in respect of shares or other specified securities other than those specified in clause (f) is in accordance with the guidelines as may be prescribed.

It may be noted that no offer of buy back under this sub section shall be made within a period of one year reckoned from the date of closure of a previous offer of buy back if any. This means that there cannot be more than one buy back in one year.

(2) Every buy-back shall be completed within 1 year from the date of passing the special resolution, or the resolution passed by the board of directors where the buy back is upto 10% of the paid up equity capital + free reserves.

(3) The notice of the meeting at which special resolution is proposed to be passed shall be accompanied by an explanatory statement stating—

(a) a full and complete disclosure of all material facts;

(b) the necessity for the buy-back;

(c) the class of shares or securities intended to be purchased under the buy-back;

(d) the amount to be invested under the buy-back; and

(e) the time limit for completion of buy-back.

(4) The buy-back may be—

(a) from the existing shareholders or security holders on a proportionate basis; or

(b) from the open market; or

(c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

(5) Where a company has passed a special resolution under clause (b) of Sub-section (2) or a resolution under item (ii) of the proviso thereto, to buy-back its own shares or other securities under this section, it shall, before making such buy-back, file with the Registrar and the Securities and Exchange Board of India a declaration of solvency in the form as may be prescribed and verified by an affidavit to the effect that the Board has made a full inquiry into the affairs of the company as a result of which they have formed an opinion

that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board, and signed by at least two directors of the company, one of whom shall be the managing director, if any.

However, no declaration of solvency shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

(6) Where a company buys-back its own securities, it shall extinguish and physically destroy the securities so bought-back within 7 days of the last date of completion of buy-back.

(7) Where a company completes a buy-back of its shares or other specified securities under this section, it shall not make further issue of same kind of shares (including allotment of new shares under clause (a) of Sub-section (1) of Section (62) or other specified securities within a period of 6 months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option scheme, sweat equity or conversion of preference shares or debentures into equity shares.

(8) If a company makes default in complying with the provisions of this section or any regulations made by SEBI in this regard, the company shall be punishable with fine which shall not be less than ₹ 1 Lakh but which may extend to ₹ 3 lakh and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to 3 years or with fine of not less than ₹ 1 lakh but which may extend to ₹ 3 lakh, or with both.

(9) Section 69(1) states that where a company purchases its own shares out of the free reserves or securities premium account, a sum equal to the nominal value of shares so purchased shall be transferred to the Capital Redemption Reserve Account and details of such account shall be disclosed in the Balance Sheet.

(10) The Capital Redemption Reserve Account may be applied by the company in paying up unissued shares of the company to be issued to the members of the company as fully paid bonus shares.

(11) Where a company buy-back its securities under this section, it shall maintain a register of the securities so bought, the consideration paid for the securities bought-back, the date of cancellation of securities, the date of extinguishing and physically destroying of securities and such other particulars as may be prescribed.

(12) A company shall, after the completion of the buy-back under this section, file with the Registrar and the Securities and Exchange Board of India, a return containing such particulars relating to the buy-back within 30 days of such completion, as may be prescribed, provided that no return shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

Some Important Terms

(a) **"specified securities"** includes employees' stock option or other securities as may be notified by the Central Government from time to time;

(b) **"free reserves"** constitute those reserves which, as per latest audited balance-sheet of the company, are free for distribution as dividend and shall include balance to the credit of the securities premium account but shall not include share application money.]

Note: According to Section 69(1), where a company purchases its own shares out of free reserves or the securities premium account, then a sum equal to the nominal value of the share so purchased shall be transferred to the capital redemption reserve account and details of such account shall be disclosed in the balance sheet.

The auditor should ensure that the proper accounting entries have been passed immediately after the buy-back.

Prohibition for buy back in certain circumstances: As per provisions of Section 70 of the Companies Act 2013-

(1) No company shall directly or indirectly purchase its own shares or other specified securities—

  (a) through any subsidiary company including its own subsidiary companies; or

  (b) through any investment company or group of investment companies; or

  (c) if a default, by the company, in repayment of deposit or interest payable thereon, redemption of debentures or preference shares or payment of dividend to any shareholder or repayment of any term loan or interest payable thereon to any financial institutions or bank, is subsisting. Provided that the buy – back is not prohibited if the default is remedied and a period of three years has elapsed since the cessation of the default.

(2) No company shall directly or indirectly purchase its own shares or other specified securities in case such company has not complied with provisions of Sections 92, 123, 127 and 129. Section 92 relates to the filing of Annual Return, Section 123 and 127 to declaration and payment of dividend and Section 129 to the financial statement of the company.

8.4.8 Calls Paid in Advance: A company, if permitted by the articles, may accept from members, either the whole or part of the amount remaining unpaid on any shares held by him as calls in advance; but the amount so received cannot be treated as a part of the capital for the purpose of any voting rights until the same becomes presently payable and duly appropriated. A company, if so authorised by its Articles, may pay dividend in proportion to the amount paid upon each share, where a larger amount is paid up on some shares than that on other.

Unless the company exercises the right as aforementioned, the shareholders who have paid calls in advance would be entitled to receive interest at the rate specified in the Articles. The interest on calls in advance, though chargeable against profits, also can be paid out of capital when profits are not available for such a payment. In the event of a winding up, calls in advance repayable along with interest accrued thereon before any part of the capital is returned to shareholders.

8.4.9 Calls in Arrears: The amounts due from shareholders in respect of calls in arrears should be verified by reference to the Share register. If any calls are due from Directors, they should be shown separately in the balance sheet. Often the Articles provide that interest be charged on calls in arrears. The adjustment of interest in such a case should be verified.

8.4.10 Issue and Redemption of Preference Shares: "Preference share capital", with reference to any company limited by shares, means that part of the issued share capital of the company which carries or would carry a preferential right with respect to—

(i) payment of dividend, either as a fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income-tax; and

(ii) repayment, in the case of a winding up or repayment of capital, of the amount of the share capital paid-up or deemed to have been paid-up, whether or not, there is a preferential right to the payment of any fixed premium or premium on any fixed scale, specified in the memorandum or articles of the company;

Issue of Preference Shares: As per Section 55 of the Companies Act, 2013, no company limited by shares shall issue any preference shares which are irredeemable. Whereas a company limited by shares may, if so authorised by its articles, issue preference shares which are liable to be redeemed within a period not exceeding twenty years from the date of their issue subject to such conditions are prescribed in rules which are discussed below-

(1) A company having a share capital may, if so authorised by its articles, issue preference shares subject to the following conditions, namely:

  (i) the issue of such shares has been authorized by passing a special resolution in the general meeting of the company

  (ii) the company, at the time of such issue of preference shares, has no subsisting default in the redemption of preference shares issued either before or after the commencement of this Act or in payment of dividend due on any preference shares.

(2) A company issuing preference shares shall set out in the resolution, particulars in respect of the following matters relating to such shares, namely:

  (i) the priority with respect to payment of dividend or repayment of capital vis-a-vis equity shares;

  (ii) the participation in surplus fund;

  (iii) the participation in surplus assets and profits, on winding- up which may remain after the entire capital has been repaid;

  (iv) the payment of dividend on cumulative or non-cumulative basis;

(v) the conversion of preference shares into equity shares;

(vi) the voting rights;

(vii) the redemption of preference shares.

(3) The explanatory statement to be annexed to the notice of the general meeting pursuant to section 102 shall, inter-alia, provide the complete material facts concerned with and relevant to the issue of such shares, including-

(i) the size of the issue and number of preference shares to be issued and nominal value of each share;

(ii) the nature of such shares i.e. cumulative or non - cumulative, participating or non - participating , convertible or non – convertible;

(iii) the objectives of the issue;

(iv) the manner of issue of shares;

(v) the price at which such shares are proposed to be issued;

(vi) the basis on which the price has been arrived at;

(vii) the terms of issue, including terms and rate of dividend on each share, etc.;

(viii) the terms of redemption, including the tenure of redemption, redemption of shares at premium and if the preference shares are convertible, the terms of conversion;

(ix) the manner and modes of redemption;

(x) the current shareholding pattern of the company;

(xi) the expected dilution in equity share capital upon conversion of preference shares.

(4) Where a company issues preference shares, the Register of Members maintained under section 88 shall contain the particulars in respect of such preference share holder(s).

(5) A company intending to list its preference shares on a recognized stock exchange shall issue such shares in accordance with the regulations made by the Securities and Exchange Board of India in this behalf.

Further, as per proviso the section, a company may issue preference shares for a period exceeding twenty years for infrastructure projects, subject to the redemption of such percentage of shares as may be prescribed on an annual basis at the option of such preferential shareholders.

Redemption of Preference Shares: A company may redeem its preference shares only on the terms on which they were issued or as varied after due approval of preference shareholders and the preference shares may be redeemed-

(a) at a fixed time or on the happening of a particular event;

(b) any time at the company's option; or

(c) any time at the shareholder's option.

The Auditor should ensure that —

(a) no such shares shall be redeemed except out of the profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purposes of such redemption;

(b) no such shares shall be redeemed unless they are fully paid;

(c) where such shares are proposed to be redeemed out of the profits of the company, there shall, out of such profits, be transferred, a sum equal to the nominal amount of the shares to be redeemed, to a reserve, to be called the Capital Redemption Reserve Account, and the provisions of this Act relating to reduction of share capital of a company shall, except as provided in this section, apply as if the Capital Redemption Reserve Account were paid-up share capital of the company; and the capital redemption reserve account may, notwithstanding anything in this section, be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

(d) (i) in case of such class of companies, as may be prescribed and whose financial statement comply with the accounting standards prescribed for such class of companies under section 133, the premium, if any, payable on redemption shall be provided for out of the profits of the company, before the shares are redeemed:

Provided also that premium, if any, payable on redemption of any preference shares issued on or before the commencement of this Act by any such company shall be provided for out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.

(ii) in a case not falling under sub-clause (i) above, the premium, if any, payable on redemption shall be provided for out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.

Where a company is not in a position to redeem any preference shares or to pay dividend, if any, on such shares in accordance with the terms of issue (such shares hereinafter referred to as unredeemed preference shares), it may, with the consent of the holders of three-fourths in value of such preference shares and with the approval of the Tribunal on a petition made by it in this behalf, issue further redeemable preference shares equal to the amount due, including the dividend thereon, in respect of the unredeemed preference shares, and on the issue of such further redeemable preference shares, the unredeemed preference shares shall be deemed to have been redeemed.

It is provided that the Tribunal shall, while giving approval under this sub-section, order the redemption forthwith of preference shares held by such persons who have not consented to the issue of further redeemable preference shares.

Explanation—For the removal of doubts, it is hereby declared that the issue of further redeemable preference shares or the redemption of preference shares under this section shall not be deemed to be an increase or, as the case may be, a reduction, in the share capital of the company.

8.4.11 Alteration of Share Capital: Section 61 of the Companies Act, 2013 lays down power of limited company to alter its share capital. According to the provision a limited company having a share capital may, if so authorised by its articles, alter its memorandum in its general meeting to—

(a) increase its authorised share capital by such amount as it thinks expedient;

(b) consolidate and divide all or any of its share capital into shares of a larger amount than its existing shares, however no consolidation and division which results in changes in the voting percentage of shareholders shall take effect unless it is approved by the Tribunal on an application made in the prescribed manner;

(c) convert all or any of its fully paid-up shares into stock, and reconvert that stock into fully paid-up shares of any denomination;

(d) sub-divide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum, so, however, that in the sub-division the proportion between the amount paid and the amount, if any, unpaid on each reduced share shall be the same as it was in the case of the share from which the reduced share is derived;

(e) cancel shares which, at the date of the passing of the resolution in that behalf, have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled.

It may be noted that the cancellation of shares shall not be deemed to be a reduction of share capital.

Section 64 of the Companies Act, 2013 provides that within 30 days of the shares having been consolidated, converted, sub-divided, redeemed, or cancelled or the stock having been reconverted, notice should be given to the Registrar in the prescribed form along with an altered memorandum.

The auditor's duties in the circumstances shall be:

(i) to verify that the alteration of capital is authorised by the Articles;

(ii) to inspect the minutes of the shareholders authorising the alteration;

(iii) to obtain Allotment Lists containing details of the new holdings of share or stock by each member and to verify the same with the entries;

(iv) to inspect the directors' resolution in regard to allotment, consolidation, conversion or sub-division passed pursuant to the resolution of the members;

(v) to examine the cancelled share certificates, if any, and agree the same with the counterfoils of new certificates issued;

(vi) to see that the procedure, prescribed by the Articles in this regard, has been complied with;

(vii) to verify that the share capital account is correctly shown in the Balance Sheet; and

(viii) to see that the necessary intimation to the Registrar contemplated by Section 64 has been sent.

8.4.12 Reduction of Capital*: The duties of the auditor in this regard are following-

(i) Verifying that the meeting of the shareholder held to pass the special resolution was properly convened; also that the proposal was circularised in advance among the members.

(ii) Confirming that the Articles of Association authorise reduction of capital.

(iii) Examining the order of the Tribunal confirming the reduction and seeing that a copy of the order and the minutes have been registered and filed with the Registrar of Companies.

(iv) Inspecting the Registrar's Certificate as regards reduction of capital.

(v) Vouching the journal entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also seeing that the requirements of Schedule III, Part I, have been complied with.

(vi) Confirming that the revaluation of assets have been properly disclosed in the Balance Sheet.

(vii) Verifying the adjustment made in the members' accounts in the Register of Members and confirming that either the paid up amount shown on the old share certificates have been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled.

(viii) Confirming 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) Verifying that the Memorandum of Association of the company has been suitably altered.

***[Note:** Reduction of Capital is discussed in section 100 of the Companies Act, 1956, which is replaced by the section 66 of the Companies Act, 2013. This section is not yet notified.**]**

8.4.13 Forfeiture of Shares

(a) Verification of Forfeiture of Shares: The auditor should-

(i) ascertain that the Articles authorise the Board of Directors to forfeit shares and that the power has been exercised by the Board in the best interest of the company;

(ii) verify the amount of call or instalment of calls which was outstanding in respect of each of the share forfeited;

(iii) ascertain that the procedure in the Articles has been followed, viz., the notice given to the defaulting shareholders, warning them that in the event of non-payment, by a specified date, of the amount of call already made on the shares standing in their names, together with interest, if any, the shares shall be forfeited; see that the proper resolutions of Directors, first as regards issuance of notice and afterwards in respect of forfeiture of shares; and

(iv) verify the entries recorded in the books of account consequent upon forfeiture of shares to confirm that the premium, if any, received on the issue of shares has not been transferred to the Forfeited Shares Account.

(b) Re-issue of Forfeited Shares: The auditor should-

(i) ascertain that the Board of Directors has the authority under the Articles to re-issue forfeited shares;

(ii) refer to the resolution of the Board of Directors, re-allotting forfeited shares;

(iii) vouch the amounts collected from person to whom the shares have been allotted and verify the entries recorded from re-allotment and see that the total amount received on the share, including that received prior to forfeiture, is not less than the par value;

(iv) verify that computation of the amount of surplus resulting on the reissue of shares credited to the Capital Reserve Account; and

(v) Where partly paid shares are forfeited for non-payment of call, and re-issued as fully paid, the reissue is considered as an allotment at a discount and compliance of the provisions of Section 53 of the Companies Act, 2013 is essential as issuance of shares at discount other than sweat equity share are void.

8.5 Option on Share Capital

Schedule III, Part I, requires disclosure of the particulars of any option on unissued share capital. An option on shares arises when a person has acquired a right under an agreement with the company to subscribe for share in the company if he so chooses.

Such options generally arise under the following circumstances:

(i) Under the promoter’s agreements, subsequently ratified by the company;

(ii) Collaboration agreement;

(iii) Loan agreements, debenture deeds (Refer to Section 81 of the Companies Act);

(iv) Agreements to convert preference shares into equity shares; and

(v) Other contracts, such as for supply of capital goods and/or merchandise.

8.6 Shares Transfer Audit

Frequently, big companies require auditors to undertake audit of share transfer recorded by the company during the previous year. The object of such an audit is detection of mistakes in the registration of transfers which may have the effect of saddling the company with the liability for damages claimed by a shareholder on account of losses suffered in consequence thereof.

As per section 56 of the Companies Act, 2013 read with Rule 11 of the Companies (Share Capital and Debentures) Rules, 2014, the following aspects are required to be examined by the auditor in conducting the share transfer audit:

(1) No transfer of securities or the interest of a member takes place in case of a company having no share capital, other than the transfer between persons both of whose names are entered as holders of beneficial interest in the records of a depository.

(2) Check where an instrument of transfer of securities held in physical form is in Form No. SH. 4 duly stamped, dated and executed by or on behalf of the transferor and the transferee and specifying the name, address and occupation, if any, of the transferee has been delivered to the company by the transferor or the transferee within a period of sixty days from the date of execution, along with the certificate relating to the securities, or if no such certificate is in existence, along with the letter of allotment of securities.

(3) Check where the instrument of transfer has been lost or the instrument of transfer has not been delivered within the prescribed period, the company registers the transfer on such terms as to indemnity as the Board may think fit.

(4) Company has the power to register, on receipt of an intimation of transmission of any right to securities by operation of law from any person to whom such right has been transmitted.

(5) Where an application is made by the transferor alone and relates to partly paid shares, examine that the transfer is not registered, unless the company gives the notice of the application in Form No. SH. 5 to the transferee and the transferee gives no objection to the transfer within two weeks from the receipt of notice.

(6) Examine that the company, unless prohibited by any provision of law or any order of Court, Tribunal or other authority, delivers the certificates of all securities allotted, transferred or transmitted—

  (a) within a period of two months from the date of incorporation, in the case of subscribers to the memorandum;

  (b) within a period of two months from the date of allotment, in the case of any allotment of any of its shares;

  (c) within a period of one month from the date of receipt by the company of the instrument of transfer under sub-section (1) or, as the case may be, of the intimation of transmission under sub-section (2), in the case of a transfer or transmission of securities;

(d) within a period of six months from the date of allotment in the case of any allotment of debenture:

(7) where the securities are dealt with in a depository, examine that the company intimates the details of allotment of securities to depository immediately on allotment of such securities.

(8) If there any default made in complying with the provisions. Verify the amount of fine paid.

Note - Students should also refer to study material on Company Law for restrictions on transfer of shares.

8.7 Verification of Issue of Bonus Shares

Section 63 of the Companies Act, 2013 allows a company to issue fully paid-up bonus shares to its members, in any manner whatsoever, out of-

(i) its free reserves;

(ii) the securities premium account; or

(iii) the capital redemption reserve account.

The auditor should ensure that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

Further, he should also ensure the compliance of condition for capitalization of profits or reserves for the issuing fully paid-up bonus shares like-

(a) it is authorised by its articles;

(b) it has, on the recommendation of the Board, been authorised in the general meeting of the company;

(c) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;

(d) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;

(e) the partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;

(f) it complies with such conditions as may be prescribed like the company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same.

(g) The bonus shares shall not be issued in lieu of dividend.

8.8 Audit of Debentures

8.8.1 Allotment of Debentures: As in the case of shares, in the case of debentures also, it is necessary for the auditor to verify whether allotment was made having regard to the terms and conditions contained in the prospectus or the Statement in lieu of Prospectus. The Companies Act, has made it compulsory for every company intending to offer debentures to the public for subscription by the issue of a prospectus shall, before such issue, make an application to one or more recognised stock exchanges for permission for the debentures intending to be so offered to be dealt with in the stock exchange or each such stock exchange. The auditor also must ascertain that the directors, while issuing the debentures, had acted within their powers having regard to restrictions contained in Section 180 and any further restrictions which may be contained in the Articles of Association. Section 71 has now made it compulsory for filing of Debenture Trust Deed and creation of Debenture Redemption Reserve as per section 71. It is specified that Debenture Trust Deed shall be open for inspection and can be made available on payment. Section 71 has also made it compulsory appointment of debenture trustees and specified their duties. Further, the auditor should ensure that the issue of debentures with an option to convert such debentures into shares, wholly or partly at the time of redemption, are approved by a special resolution passed at a general meeting.

In addition the auditor should verify that no company shall issue any debentures carrying any voting rights and he should also confirm the compliance of terms and conditions for issuance of Secured debentures which are given below:

(i) an issue of secured debentures may be made, provided the date of its redemption shall not exceed ten years from the date of issue. It is also provided that a company engaged in the setting up of infrastructure projects may issue secured debentures for a period exceeding ten years but not exceeding thirty years;

(ii) such an issue of debentures shall be secured by the creation of a charge, on the properties or assets of the company, having a value which is sufficient for the due repayment of the amount of debentures and interest thereon;

(iii) the company shall appoint a debenture trustee before the issue of prospectus or letter of offer for subscription of its debentures and not later than sixty days after the allotment of the debentures, execute a debenture trust deed to protect the interest of the debenture holders; and

(iv) the security for the debentures by way of a charge or mortgage shall be created in favour of the debenture trustee on any specific movable property of the company (not being in the nature of pledge); or any specific immovable property wherever situate, or any interest therein.

Debenture Redemption Reserve Account: Where debentures are issued by a company under this section, the company shall create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account shall not be utilised by the company except for the redemption of debentures.

The company should create Debenture Redemption Reserve for the purpose of redemption of debentures, in accordance with the conditions given below-

(a) the Debenture Redemption Reserve shall be created out of the profits of the company available for payment of dividend;

(b) the company shall create Debenture Redemption Reserve equivalent to notified rate i.e at least 25 percent of the amount raised through the debenture issue before debenture redemption commences;

(c) every company required to create Debenture Redemption Reserve shall on or before the 30th day of April in each year, invest or deposit, as the case may be, a sum which shall not be less than fifteen percent, of the amount of its debentures maturing during the year ending on the 31st day of March of the next year, in any specified method;

(d) in case of partly convertible debentures, Debenture Redemption Reserve shall be created in respect of non-convertible portion of debenture issue in accordance with this sub-rule;

(e) the amount credited to the Debenture Redemption Reserve shall not be utilised by the company except for the purpose of redemption of debentures.

Normally the auditor should take following steps for such verification:

(i) Verify that the Prospectus or the Statement in lieu of Prospectus had been duly filed with the Registrar before the date of allotment.

(ii) Check the applications for debentures with the Application and Allotment Book to verify that the name, address of the applicants and the number of debentures applied for are correctly recorded.

(iii) Verify the allotment of debentures by reference to the Directors' Minute Book.

(iv) Vouch the amounts collected as are entered in the Cash Book with the counterfoils of receipts issued to the applicants; also trace the amounts into the Application and Allotment Book.

(v) Check postings of allotments of debentures and the amounts received in respect thereof from the Application and Allotment Book, into the Debentures Register.

(vi) Verify the entries on the counterfoils of debentures issued with the Debentures Register.

(vii) Extract balances in the Debentures Register in respect of amounts paid by the debenture holders and agree their total with the balance in the Debentures Account in the General Ledger.

(viii) Examine a copy of the Debenture Trust Deed and note the conditions including creation of Debenture Redemption Reserve contained therein as to issue and repayment.

(ix) If the debentures are covered by a mortgage or charge, it should be verified that the charge has been correctly recorded in the Register of Mortgages and Charges and that it has also been registered with the Registrar of Companies. Further, that the charge is clearly disclosed in the Balance Sheet.

(x) Compliance with SEBI Guidelines should also be seen.

Where debentures have been issued as fully paid up to vendors as a part of the purchase consideration, the contract in this regard should be referred to.

8.8.2 Issue of Debentures: Debentures may be issued at par or at a premium or at a discount. When these are issued at a premium, the amount of premium collected should be credited to Premium on Debenture Account. Since it would be a capital profit, the balance to the credit of this account subsequently should be transferred to the Capital Reserve Account.

Where debentures have been issued at a discount, the amount of discount should be debited to Discount on Debenture Account so that the Debenture Account is credited with the full normal value of debentures. The balance in this account shall appear in the Balance Sheet until written off. Usually, the debentures will continue to stand in the books of the company. Where, however, the debentures are irredeemable, the amount of discount should be written off over a reasonable period of the time.

8.8.3 Redemption of Debentures at a Premium: The provision for the premium payable on redemption of debentures may be made in either of the following two ways-

(i) The total amount of premium payable on redemption may be debited to an account denominated as “Loss on Issue of Debentures” and credited to “Premium payable on Redemption of Debentures Account or subsequently, the debit balance in the first mentioned account should be carried forward till it is written off, while the latter account would be closed on payment of the premium, on redemption of debentures.

(ii) The fact that the debentures will have to be redeemed at a premium may be disclosed by way of a note in the Balance Sheet along with the date of redemption and, as and when redemption is made, the amount paid as a premium should be debited to the Premium on Redemption of Debentures Accounts.

It may be noted that the second method is only a slight variation of the first in so far that, in the latter case, the premium paid on debentures is written off subsequent to the redemption.

8.8.4 Interest on Debentures: The payment of interest should be vouched with the acknowledgment of the debenture holders, endorsed warrants and in the case of bearer debentures, with the coupons surrendered. The total amount paid should be reconciled with the total amount due and payable with the amount of interest outstanding for payment. Interest on debentures is payable whether or not any profit is made. Therefore, a provision should be made unless it has been specially agreed with the debenture holders that interest in such a case would be waived by them. The interest paid on debentures, like that on other fixed loans, must be disclosed as a separate item in the Statement of Profit and Loss.

8.9 Audit of Dividends

8.9.1 Verification of Dividends: In Unit 1 of Chapter-2 of IPCC study material on Accounting, the various conditions subject to which profits earned by a company can be distributed as a dividend have been discussed. Therefore, only the procedure for the verification of payment of dividends is stated below-

(i) Examine the company's Memorandum and Articles of Association to ascertain the dividend rights of different classes of shares.

(ii) Confirm that the profits appropriated for payment of dividend are distributable having regard to the provisions contained in Section 123 of the Companies Act, 2013. If the company proposes to pay the dividend out of past profit in reserves, see that either this is in accordance with the rules framed by the Central Government in this behalf or the consent of the Government has been obtained.

(iii) Inspect the Shareholders' Minute Book to verify the amount of dividend declared and confirm that the amount recommended by the directors.

(iv) If a separate bank account was opened for payment of dividends, check the transfer of the total amount of dividends payable from the Dividends Accounts.

(v) Check the particulars of members as are entered in the Dividend Register or Dividend List by reference to the Register of Members, test check the calculation of the gross amount of dividend payable to each shareholder on the basis of the number of the shares held and the amount of CDT, if applicable. Verify the casts and crosscast of the different columns.

(vi) Check the amount of dividend paid with the dividend warrants surrendered. Reconcile the amount of dividend warrants outstanding with the balance in the Dividend Bank Account.

(vii) Examine the dividend warrants in respect of previous years, presented during the year for payment and verify that by their payment, any provision contained in the Articles in the matter of period of time during which amount of unclaimed dividend can be paid had not been contravened.

(viii) According to section 123, it is compulsory for a company to transfer the total amount of dividend which remains unpaid or unclaimed, within 30 days of the declaration of the dividend to a special bank account entitled "Unpaid Dividend Account". Such an account is to be opened only in a scheduled bank. The transfer must be made within 7 days from the date of expiry of 30 days.

(ix) In case any money transferred to the unpaid dividend account of a company remain unpaid or unclaimed for a period of 7 years from the date of such transfer shall be transferred to Investor Education and Protection Fund established.

(x) Ensure the compliance, in case dividend is paid in case of inadequate profits.

8.9.2 Interim Dividends: A company may distribute part of its profits during the two annual general meetings. That means, a company may declare dividends before the close of the accounting year and finalisation of accounts. Board may from time to time pay to the members such interim dividend as appeared to be justified by the company. However, the definition of "dividend" includes the interim dividend.

Section 123(3) of the Companies Act, 2013 provides that the Board of directors may declare interim dividend during any financial year. However, sub-section (4) requires the amount of dividend including interim dividend to be deposited in a separate bank account within 7 days from the date of declaration of such dividend.

The provisions contained in sections 123, 124, 125, 126 and 127 shall, as far as may be, also apply to any interim dividend.

Therefore, conditions and procedures laid down in section 123, 124*, 125*, 126 and 127 would have to be complied with while declaring interim dividends.

Right to dividend, Right Shares and Bonus Shares to be held in abeyance pending registration of transfers of shares - Section 126 of the Companies Act, 2013 requires that where any instrument of transfer of shares has been delivered to any company for registration and a transfer of such shares has not been registered by the company, the company shall transfer the dividend in relation to such shares to the Unpaid Dividend Account unless the company is authorised by the registered holder of such shares in writing to pay such dividend to the transferee specified in such instrument of transfer. Further, the company shall also keep in abeyance in relation to such shares, any offer of right shares and any issue of fully paid up bonus shares in respect of such shares which have not been registered by the company. However, the company may transfer the dividend in case it has been authorised by the registered holder of such shares in writing to pay such dividend to the transferee specified in such instrument of transfer.

Penalty for failure to distribute dividend within the prescribed period, i.e., thirty day, has been made quite stiff by prescribing imprisonment for two year. Rupees one thousand everyday for which the default continues as also liability to pay simple interest at the rate of 18% p.a.

(* **Note:** Section 124 and 125 of the Companies Act, 2013 are not yet notified)

APPENDIX

Schedule III to the Companies Act, 2013

(See section 129)

General Instructions for preparation of Balance Sheet and Statement of Profit and Loss of A Company

General Instructions

1. Where compliance with the requirements of the Act including Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head/sub-head or any changes inter se, in the financial statements or statements forming part thereof, the same shall be made and the requirements of this Schedule shall stand modified accordingly.
2. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 2013. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the notes to accounts in addition to the requirements set out in this Schedule.
3. (i) Notes to accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required (a) narrative descriptions or disaggregations of items recognized in those statements and (b) information about items that do not qualify for recognition in those statements.

   (ii) Each item on the face of the Balance Sheet and Statement of Profit and Loss shall be cross-referenced to any related information in the notes to accounts. In preparing the Financial Statements including the notes to accounts, a balance shall be maintained between providing excessive detail that may not assist users of financial statements and not providing important information as a result of too much aggregation.
4. (i) Depending upon the turnover of the company, the figures appearing in the Financial Statements may be rounded off as given below:

Turnover	Rounding off
(a) less than one hundred crore rupees	to the nearest hundreds, thousands, lakhs or millions, or decimals thereof
(b) one hundred crore rupees or more	to the nearest, lakhs, millions or crores, or decimals thereof.

(ii) Once a unit of measurement is used, it shall be used uniformly in the Financial Statements.

5. Except in the case of the first Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes shall also be given.

6. For the purpose of this Schedule, the terms used herein shall be as per the applicable Accounting Standards.

Note: This part of Schedule sets out the minimum requirements for disclosure on the face of the Balance Sheet, and the Statement of Profit and Loss (hereinafter referred to as "Financial Statements" for the purpose of this Schedule) and Notes. Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the company's financial position or performance or to cater to industry/sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act or under the Accounting Standards.

PART I – BALANCE SHEET

Name of the Company……………………..
Balance Sheet as at ………………………

(Rupees in………..)

			Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of previous reporting period
			1	2	3	4
			EQUITY AND LIABILITIES			
1.			Shareholders' funds			
	a		Share capital			
	b		Reserves and Surplus			
	c		Money received against share warrants			
2.			Share application money pending allotment			
3.			Non-current liabilities			
	a		Long-term borrowings			
	b		Deferred tax liabilities (Net)			
	c		Other long term liabilities			

	d		Long-term provisions			
4.			Current liabilities			
	a		Short-term borrowings			
	b		Trade Payables			
	c		Other current liabilities			
	d		Short-term provisions			
			Total			
			ASSETS			
1			Non-current assets			
	a		Fixed assets			
		i	Tangible assets			
		ii	Intangible assets			
		iii	Capital Work-in-progress			
		iv	Intangible assets under development			
	b		Non-current investments			
	c		Deferred tax assets (Net)			
	d		Long-term loans and advances			
	e		Other non-current assets			
2			Current assets			
	a		Current investments			
	b		Inventories			
	c		Trade receivables			
	d		Cash and cash equivalents			
	e		Short-term loans and advances			
	f		Other current assets			
			Total			

See accompanying notes to Financial Statements.

Notes

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An asset shall be classified as current when it satisfies any of the following criteria:

   (a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;

   (b) it is held primarily for the purpose of being traded;

(c) it is expected to be realized within twelve months after the reporting date; or

(d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.

3. A liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the reporting date; or

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

6. A company shall disclose the following in the notes to accounts:

A. Share Capital

For each class of share capital (different classes of preference shares to be treated separately):

(a) the number and amount of shares authorized;

(b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;

(c) par value per share;

(d) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;

(e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;

(f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;

(g) shares in the company held by each shareholder holding more than 5 percent shares specifying the number of shares held;

(h) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;

(i) for the period of five years immediately preceding the date as at which the Balance Sheet is prepared:

  (A) Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash.

  (B) Aggregate number and class of shares allotted as fully paid up by way of bonus shares.

  (C) Aggregate number and class of shares bought back.

(j) terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date.

(k) calls unpaid (showing aggregate value of calls unpaid by directors and officers)

(l) forfeited shares (amount originally paid up)

B. Reserves and Surplus

(i) Reserves and Surplus shall be classified as:

  (a) Capital Reserves;

  (b) Capital Redemption Reserve;

  (c) Securities Premium Reserve;

  (d) Debenture Redemption Reserve;

  (e) Revaluation Reserve;

  (f) Share Options Outstanding Account;

  (g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);

  (h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

  (Additions and deductions since last balance sheet to be shown under each of the specified heads)

(ii) A reserve specifically represented by earmarked investments shall be termed as a 'fund'.

(iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

C. Long-Term Borrowings

(i) Long-term borrowings shall be classified as:

(a) Bonds/debentures.

(b) Term loans

(A) From banks.

(B) From other parties

(c) Deferred payment liabilities.

(d) Deposits.

(e) Loans and advances from related parties.

(f) Long term maturities of finance lease obligations

(g) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due.

(v) Particulars of any redeemed bonds/ debentures which the company has power to reissue shall be disclosed.

(vi) Terms of repayment of term loans and other loans shall be stated.

(vii) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.

D. Other Long Term Liabilities

Other Long term Liabilities shall be classified as:

(a) Trade payables

(b) Others

E. Long-term provisions

The amounts shall be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

F. Short-term borrowings

(i) Short-term borrowings shall be classified as:

(a) Loans repayable on demand

(A) From banks

(B) From other parties

(b) Loans and advances from related parties.

(c) Deposits.

(d) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Period and amount of default as on the balance sheet date in repayment of loans and interest shall be specified separately in each case.

G. Other current liabilities

The amounts shall be classified as:

(a) Current maturities of long-term debt;

(b) Current maturities of finance lease obligations;

(c) Interest accrued but not due on borrowings;

(d) Interest accrued and due on borrowings;

(e) Income received in advance;

(f) Unpaid dividends

(g) Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under 'Other current liabilities'

(h) Unpaid matured deposits and interest accrued thereon

(i) Unpaid matured debentures and interest accrued thereon

(j) Other payables (specify nature);

H. Short-term provisions

The amounts shall be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

I. Tangible assets

(i) Classification shall be given as:

(a) Land.

(b) Buildings.

(c) Plant and Equipment.

(d) Furniture and Fixtures.

(e) Vehicles.

(f) Office equipment.

(g) Others (specify nature).

(ii) Assets under lease shall be separately specified under each class of asset.

(iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

(iv) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

J. Intangible assets

(i) Classification shall be given as:

(a) Goodwill.

(b) Brands /trademarks.

(c) Computer software.

(d) Mastheads and publishing titles.

(e) Mining rights.

(f) Copyrights, and patents and other intellectual property rights, services and operating rights.

(g) Recipes, formulae, models, designs and prototypes.

(h) Licenses and franchise.

(i) Others (specify nature).

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.

(iii) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

K. Non-current investments

(i) Non-current investments shall be classified as trade investments and other investments and further classified as:

(a) Investment property;

(b) Investments in Equity Instruments;

(c) Investments in preference shares

(d) Investments in Government or trust securities;

(e) Investments in debentures or bonds;

(f) Investments in Mutual Funds;

(g) Investments in partnership firms

(h) Other non-current investments (specify nature)

Under each classification, details shall be given of names of the bodies corporate [indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities] in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.

(iii) The following shall also be disclosed:

(a) Aggregate amount of quoted investments and market value thereof;

(b) Aggregate amount of unquoted investments;

(c) Aggregate provision for diminution in value of investments.

L. Long-term loans and advances

(i) Long-term loans and advances shall be classified as:

(a) Capital Advances;

(b) Security Deposits;

(c) Loans and advances to related parties (giving details thereof);

(d) Other loans and advances (specify nature).

(ii) The above shall also be separately sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

M. Other non-current assets

Other non-current assets shall be classified as:

(i) Long Term Trade Receivables (including trade receivables on deferred credit terms);

(ii) Others (specify nature)

(iii) Long term Trade Receivables, shall be sub-classified as:

(a) (A) Secured, considered good;

(B) Unsecured considered good;

(C) Doubtful

(b) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(c) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

N. Current Investments

(i) Current investments shall be classified as:

(a) Investments in Equity Instruments;

(b) Investment in Preference Shares

(c) Investments in government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firms

(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate [indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities] in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) The following shall also be disclosed:

(a) The basis of valuation of individual investments

(b) Aggregate amount of quoted investments and market value thereof;

(c) Aggregate amount of unquoted investments;

(d) Aggregate provision made for diminution in value of investments.

O. Inventories

(i) Inventories shall be classified as:

(a) Raw materials;

(b) Work-in-progress;
(c) Finished goods;
(d) Stock-in-trade (in respect of goods acquired for trading);
(e) Stores and spares;
(f) Loose tools;
(g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

P. Trade Receivables

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the Date they are due for payment should be separately stated.

(ii) Trade receivables shall be sub-classified as:
(a) Secured, considered good;
(b) Unsecured considered good;
(c) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q. 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.

R. Short-term loans and advances

(i) Short-term loans and advances shall be classified as:

(a) Loans and advances to related parties (giving details thereof);

(b) Others (specify nature).

(ii) The above shall also be sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

S. Other current assets (specify nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent liabilities and commitments (to the extent not provided for)

(i) Contingent liabilities shall be classified as:

(a) Claims against the company not acknowledged as debt;

(b) Guarantees;

(c) Other money for which the company is contingently liable

(ii) Commitments shall be classified as:

(a) Estimated amount of contracts remaining to be executed on capital account and not provided for;

(b) Uncalled liability on shares and other investments partly paid

(c) Other commitments (specify nature).

U. The amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on preference shares shall also be disclosed separately.

V. Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of note how such unutilized amounts have been used or invested.

W. If, in the opinion of the Board, any of the assets other than fixed assets and non-current investments do not have a value on realization in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion, shall be stated.

PART II – STATEMENT OF PROFIT AND LOSS

Name of the Company…………………….

Profit and loss statement for the year ended ………………………

(Rupees in…………)

Particulars		Note No.	Figures for the current reporting period		Figures for the previous reporting period	
1		2	3		4	
I.	Revenue from operations			xxx		xxx
II.	Other income			xxx		xxx
III.	Total Revenue (I + II)			xxx		xxx
IV.	Expenses:			xxx		xxx
	Cost of materials consumed			xxx		xxx
	Purchases of Stock-in-Trade			xxx		xxx
	Changes in inventories of finished goods			xxx		xxx
	work-in-progress			xxx		xxx
	and Stock-in-Trade			xxx		xxx
	Employee benefits expense			xxx		xxx
	Finance costs			xxx		xxx
	Depreciation and amortization expense			xxx		xxx
	Other expenses			xxx		xxx
	Total expenses			xxx		xxx
V.	Profit before exceptional and extraordinary items and tax (III-IV)			xxx		xxx
VI.	Exceptional items			xxx		xxx
VII.	Profit before extraordinary items and tax (V - VI)			xxx		xxx
VIII.	Extraordinary Items			xxx		xxx
IX.	Profit before tax (VII- VIII)			xxx		xxx
X	Tax expense:					
	(1) Current tax		xxx		xxx	
	(2) Deferred tax		xxx	xxx	xxx	xxx

XI	Profit (Loss) for the period from continuing operations (VII-VIII)		xxx	Xxx
XII	Profit/(loss) from discontinuing operations		xxx	Xxx
XIII	Tax expense of discontinuing operations		xxx	Xxx
XIV	Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)		xxx	Xxx
XV	Profit (Loss) for the period (XI + XIV)		xxx	xxx
XVI	Earnings per equity share: (1) Basic (2) Diluted		 xxx xxx	 xxx xxx

See accompanying notes to the financial statements.

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-clause (ii) of Clause (40) of Section 2 in like manner as they apply to a statement of profit and loss.

2. (A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from

   (a) Sale of products;

   (b) Sale of services;

   (c) Other operating revenues;

   Less:

   (d) Excise duty.

   (B) In respect of a finance company, revenue from operations shall include revenue from

   (a) Interest; and

   (b) Other financial services

   Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.

3. Finance Costs

   Finance costs shall be classified as:

   (a) Interest expense;

   (b) Other borrowing costs;

(c) Applicable net gain/loss on foreign currency transactions and translation.

4. Other income

   Other income shall be classified as:

   (a) Interest Income (in case of a company other than a finance company);

   (b) Dividend Income;

   (c) Net gain/loss on sale of investments

   (d) Other non-operating income (net of expenses directly attributable to such income).

5. Additional Information

   A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:-

   (i) (a) Employee Benefits Expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses].

   (b) Depreciation and amortization expense;

   (c) Any item of income or expenditure which exceeds one per cent of the revenue from operations or ₹ 1,00,000, whichever is higher;

   (d) Interest Income;

   (e) Interest Expense;

   (f) Dividend Income;

   (g) Net gain/ loss on sale of investments;

   (h) Adjustments to the carrying amount of investments;

   (i) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);

   (j) Payments to the auditor as

      (a) auditor,

      (b) for taxation matters,

      (c) for company law matters,

      (d) for management services,

      (e) for other services,

      (f) for reimbursement of expenses;

(k) In case of companies covered u/s 135, amount of expenditure incurred on corporate social responsibility activities.

(l) Details of items of exceptional and extraordinary nature;

(m) Prior period items;

(ii) (a) In the case of manufacturing companies,-

(1) Raw materials under broad heads.

(2) goods purchased under broad heads.

(b) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.

(c) In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.

(d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.

(e) In the case of other companies, gross income derived under broad heads.

(iii) In the case of all concerns having works in progress, works-in-progress under broad heads.

(iv) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the balance-sheet is made up.

(b) The aggregate, if material, of any amounts withdrawn from such reserves.

(v) (a) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.

(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(vi) Expenditure incurred on each of the following items, separately for each item:-

(a) Consumption of stores and spare parts.

(b) Power and fuel.

(c) Rent.

(d) Repairs to buildings.

(e) Repairs to machinery.

(f) Insurance

(g) Rates and taxes, excluding, taxes on income.

(h) Miscellaneous expenses,

(vii) (a) Dividends from subsidiary companies.

(b) Provisions for losses of subsidiary companies.

(viii) The profit and loss account shall also contain by way of a note the following information, namely:-

(a) Value of imports calculated on C.I.F basis by the company during the financial year in respect of –

I. Raw materials;

II. Components and spare parts;

III. Capital goods;

(b) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters;

(c) Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;

(d) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;

(e) Earnings in foreign exchange classified under the following heads, namely:-

I. Export of goods calculated on F.O.B. basis;

II. Royalty, know-how, professional and consultation fees;

III. Interest and dividend;

IV. Other income, indicating the nature thereof

Note: Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of financial statements.

GENERAL INSTRUCTIONS FOR THE PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS

1. Where a company is required to prepare Consolidated Financial Statements, i.e., consolidated balance sheet and consolidated statement of profit and loss, the company shall mutatis mutandis follow the requirements of this Schedule as applicable to a company in the preparation of balance sheet and statement of profit and loss. In addition, the consolidated financial statements shall disclose the information as per the requirements specified in the

applicable Accounting Standards including the following:

(i) Profit or loss attributable to "minority interest" and to owners of the parent in the statement of profit and loss shall be presented as allocation for the period.

(ii) "Minority interests" in the balance sheet within equity shall be presented separately from the equity of the owners of the parent.

2. In Consolidated Financial Statements, the following shall be disclosed by way of additional information:

Name of the entity in the	Net Assets, i.e., total assets minus total liabilities		Share in profit or loss	
	As % of consolidated net assets	Amount	As % of consolidated profit or loss	Amount
1	2	3	4	5
Parent Subsidiaries Indian 1. 2. 3. . . Foreign 1. 2. 3. . . Minority Interests in all subsidiaries Associates (Investment as per the equity method)				
Indian 1. 2. 3. . . Foreign 1.				

2. 3. . . Joint Ventures (as per proportionate consolidation/investment as per the equity method) Indian 1. 2. 3. . . Foreign 1. 2. 3. . .				
TOTAL				

3. All subsidiaries, associates and joint ventures (whether Indian or foreign) will be covered under consolidated financial statements.

4. An entity shall disclose the list of subsidiaries or associates or joint ventures which have not been consolidated in the consolidated financial statements along with the reasons of not consolidating.

9

Special Audits

Learning Objectives

After studying this chapter, you will be able to –

- Understand the procedures to be adopted for auditing of government audit, local bodies, NGO's.
- Gain knowledge on auditing procedure of a firm, small companies, charitable institutions, educational institutions, hospitals, clubs, cinema and hotels.
- Audit hire purchase and leasing companies accounts.

9.1 Government Audit

9.1.1 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 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 define 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 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 executive of the spending agencies to the sanctioning or controlling authorities. The purposes 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.

9.1.2 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 prescribed.

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.

9.1.3 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 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.

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.

9.1.4 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:

(1) 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.

(2) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

(3) 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.

9.1.5 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 credit 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.

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.

9.1.6 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.

9.1.7 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

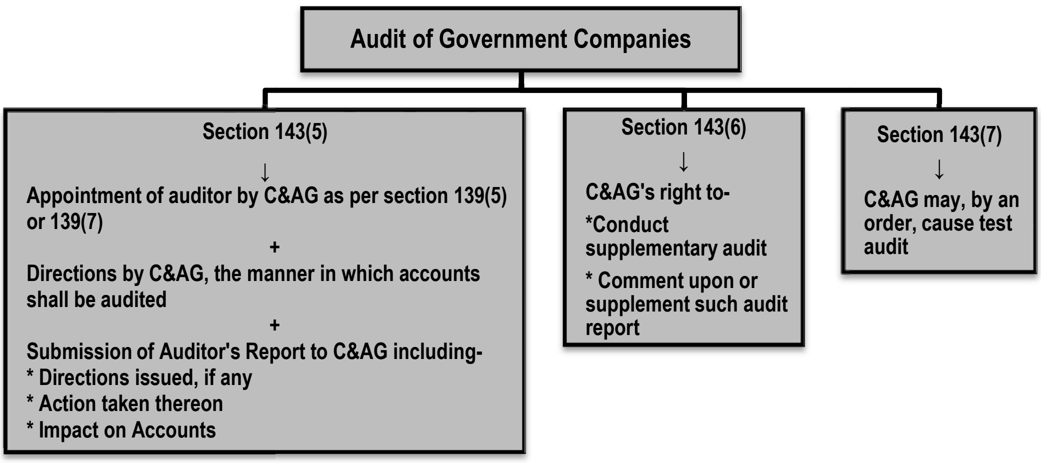
Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken 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 (1) 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)(a) 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 a 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.

9.1.8 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 debars 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 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.

9.2 Audit of Local Bodies

9.2.1 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 ofMumbai, 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 the 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.

9.2.2 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.

9.2.3 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').

9.2.4 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.

9.3 Audit of Non-Governmental Organisations (NGO's)

9.3.1 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. 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.

9.3.2 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.

9.3.3 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 statues 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.

9.4 Miscellaneous Audits

9.4.1 Audit of a 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. As such, he can determine the scope of the audit as well as the conditions under which it will be carried out. For 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 discussed in following paragraphs of audit in case of a sole trader are much the same as those in the case of a partnership.

9.4.2 Audit of a Firm: 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.

The Indian Partnership Act, 1932 does not prescribe audit of a partnership firm. Nevertheless, for the verification of adjustment in the accounts of partners made in respect of profits and losses, interest and remuneration of partners, their contribution to capital, etc., it is necessary that the auditor should have a knowledge of the provisions in this regard under the Act—especially that of powers and duties of partners and their right to profit and capital under different situations and circumstances. 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. 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.

In the absence of a partnership agreement, the provisions of the Act which concern the auditor are the following:

(i) Each partner is required to contribute an equal amount of capital.

(ii) The partners share equally in profits and losses.

(iii) The partners are not entitled to any interest on capital.

(iv) Where a partner is entitled to interest on the capital subscribed by him, such interest will be payable only out of profits.

(v) A partner is entitled to interest at 6 per cent per annum on his advances and loans over and above the capital.

(vi) Every partner can take part in the management of the business. A partner is, however, not entitled to receive any remuneration for taking part in the conduct of the business.

(vii) Every partner has the right to inspect and to take a copy of any of the books of the firm.

(viii) A partner is entitled to be indemnified for all payments made and liabilities incurred by him in the ordinary course of business or in the preservation of the firm's property.

(ix) The property of the firm must be held and used by the partners exclusively for the purpose of business.

(x) If a partner derives any profit for himself from any transaction of the firm or from the use of the property or business connections of the firm or the firm name, he must account for that profit and pay it to the firm; also the profit from any competing business carried on by a partner without other partners' consent must also be accounted for and paid to the firm.

(xi) In the absence of any usage or custom of trade to the contrary, the implied authority of partner does not empower him to:

  (a) submit a dispute relating to the business of the firm to arbitration;

(b) open a bank account on behalf of the firm in his own name;

(c) compromise or relinquish any claim or portion of a claim by the firm;

(d) withdraw a suit or proceeding filed on behalf of the firm;

(e) admit any liability in a suit or proceeding against the firm;

(f) acquire immovable property on behalf of the firm;

(g) transfer immovable property belonging to the firm; or

(h) enter into partnership on behalf of the firm.

(xii) The firm is liable to third parties:

(a) if a partner, acting within the scope of his apparent authority, receives money and misapplies it, or

(b) if the firm in the ordinary course of the business receives money, which is misapplied by a partner.

(xiii) No person can be introduced as a partner without the consent of the other partners.

(xiv) Any differences arising as to ordinary matters connected with the business are to be decided by the majority of the partners, but no change can be made in the nature of the business without the consent of all the partners.

(xv) If, on the death or retirement of a partner, no final settlement has been effected and the business is carried on by the surviving or continuing partners, the outgoing partner or his estate has the option of claiming:

(a) such share of profits as may be attributable to his share of the assets; or

(b) interest at 6 per cent per annum on his share of partnership assets.

(xvi) On dissolution of the partnership, every partner has the right to have the goodwill of the business sold for the common benefit of all the partners.

(xvii) On a dissolution of the firm, the losses, including deficiencies of capital must be made good:

(a) first out of profits;

(b) next out of capital; and

(c) lastly, by the partners individually in the proportion in which they share profits.

(xviii) On the dissolution of the firm, assets are to be applied in the following order:

(a) in paying the firm's liabilities to third parties;

(b) in repaying partner's advances and loans;

(c) in repaying partner's capital; and

(d) the residue if any, is to be divided amongst the partners in the proportion in which they share profits.

Advantages - 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) The accounts of a partnership, which have been audited, are generally accepted by the Income Tax Department as the basis for computing the assessable income of the partners and also for the settlement of their liability in respect of Wealth Tax.

(4) 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.

(5) 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.

(6) 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.

Reports on accounts of sole traders and partnerships: There is no statutory form of auditor's report in the case of sole traders and partnerships. Often the auditors of sole traders and firms have nothing to say on the audited accounts except "Audited and found correct" or "Examined and found correct". This form of reporting is not recommended as it gives no indication of the extent of the examination of accounts that has been carried out.

The Guidance Note on Members' Duties regarding Engagements involving Compilation of Financial Statements to provide guidance on the professional responsibilities of the members of the Institute of Chartered Accountants of India, when an engagement to compile financial statements or other financial information is undertaken and the form and content of the report issued in connection with such a compilation so that the association of the name of the member with the financial statements is not misconstrued by a user of the statements as the same having been audited by him.

For the member, the objective of a compilation engagement is to use accounting expertise, as opposed to auditing expertise, to collect, classify and summarise financial information. This ordinarily entails reducing detailed data to a manageable and understandable form without the requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the member to express any opinion on the financial information. However, users of the compiled financial information derive some benefit as a result of the member's involvement because the service has been performed with professional competence and due care.

A compilation engagement would ordinarily include the preparation of financial statements (which may or may not be a complete set of financial statements) but may also include the collection, classification and summarisation of other financial information. Engagements to provide limited assistance to a client in the preparation of financial statements (for example, on the selection of an appropriate accounting policy) do not constitute an engagement to compile financial information.

It is essential that the member clearly brings out the nature of association with the financial statements and the nature of the work performed by him. The following recommendations are made in this regard:

(i) The title of the report should be "Accountant's Report on Unaudited Financial Statements "and not an 'Auditor's Report".

(ii) The report should be addressed to the appointing authority.

(iii) The report should identify the financial information compiled, also stating that it is based on the information provided by the management.

(iv) The report should clearly state that the financial statements are not audited.

(v) In describing the engagement, ambiguous terms such as 'review', 'general review', 'check' etc., should not be used.

(vi) Date of the report should be mentioned.

(vii) Name and address of the firm of the member appointed for carrying out the compilation engagement should be mentioned.

(viii) Signatures and the designation (sole proprietor/partner) and membership number should appear in the report.

An example of the report is given below:

Example of an Accountant's Report on Unaudited Financial Statements

To.......

On the basis of information provided by management we have compiled the balance sheet of .... *(name of the entity)* as of March 31, XXXX and the statement of profit and loss for the period then ended. The balance sheet and the statement of profit and loss are in agreement with the books of account. We have not audited or reviewed these financial statements and accordingly express no opinion thereon.

Date:

For A & Co.
Signature (Name of the partner and membership number)
Partner
Chartered Accountants

9.4.3 Audit of Small Companies: The duties and responsibilities of the auditors in respect of the individual small company client are the same as in larger audits and the satisfactory accomplishment of the work requires the skilful adaptation and application of the principles of auditing to the individual case. Because the relationship with the directors is frequently less formal, it is particularly important that the arrangement and scope of the work should be clearly defined and recorded. A number of problems relating to small companies and procedural matters of importance in this respect are, therefore, given in the following paragraphs:

(1) Letter of Engagement - It is advisable for the auditor to submit to their client and to receive an acknowledgement of the precise scope of their responsibilities both in respect of the audit and any additional work to be undertaken. At the time of engagement, the auditors should explain to the director's management's responsibilities for the preparation of the accounts and establishing a system of internal control appropriate to the needs of the business. The letter should also explain the reliance which the auditors can place upon an effective system. This should subsequently be confirmed in writing, possibly in the engagement letter.

(2) Internal control - At an early stage in the audit, the auditors should take care to bring to the directors' attention their findings on the system of internal control.

Problems in small companies arise in the application of auditing principles and procedures. Due to inadequate staff they are unable to apply these principles in totality. These problems mainly arise from:

(a) substantial domination of the accounting and financial functions by one person; and

(b) limitations in the effectiveness from the audit point of view of the system of internal control rendered inevitable by the small number of employees.

Either or both of the above points can be present to a significant extent in most of the small companies.

The major difference from the audit point of view between the small company and the large company will be the extent to which the system of internal control and staff organisation provide a check on the work of one person so that it is proved independently by or is complementary to the work of another. Whilst internal control and internal check in a small company may be effective for its primary purpose as a check for management use, they would be defective as a check on management itself. These limitations in the effectiveness of the internal control from the audit point of view may so reduce its value that the auditors will need to consider extending their audit procedures. This will require them to increase the amount of testing of transactions and to intensify the procedures for the verification of liabilities and assets including, for example, verification of inventory taking and confirmation of trade receivable balances by direct communication.

Where shortcomings in internal control arise because of small number of employees the internal control letter whilst acknowledging this should include suggestions for improvement. In such circumstances these would frequently take the form of suggestions for strengthening the director's supervision and control.

In the audits of small companies it will become necessary, despite an extension of detailed audit procedures to rely to a more significant extent on the representations of management, frequently not directly confirmed by outside evidence or by opening of or records maintained by other personnel of the company. In these circumstances, the auditors must consider whether their examination of records of the company, the evidence available to them and their knowledge of all the circumstances affecting the company are consistent with and support the representations of management and for which direct confirmatory evidence is not available may not be relied on by the auditors. They must consider whether the surrounding evidence as a whole is consistent with and sufficient in their judgment to support these representations to their satisfaction.

If in the circumstances the auditors form the opinion that the records are adequate and have been properly maintained, they may place reliance on them as a basis for the preparation of accounts showing a true and fair view.

However, if they are not able to do this, it will be necessary for them to state clearly in the report the reservation they have to make.

(3) Letter of representations - After discussion with the directors at the conclusion of the audit and before signing the auditor's report, a letter of representation on the company's letter head addressed to the auditors should be obtained. The purpose of such letters is to place on record representation of management on significant matters affecting the account such as the ownership and basis of stating the amount of assets, liabilities, and contingent liabilities. In addition, they act as a reminder to management of their responsibilities. Such letters, however, do not relieve the auditors of any of their responsibilities.

9.4.4 Audit of Charitable Institutions: In the case of the 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. It may be registered as a society under the Societies Registration Act, 1860, as a company limited by guarantee or as a trust. If the charitable institution is a public trust, the provision of the State Legislation, if any, affecting its accounts and audit should be taken into account.
- (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) **Rents**

(i) Examining the rent roll and inspecting tenancy agreements, noting in each case:

(a) the amounts of the rents, and

(b) the due dates.

(ii) Vouching the rents 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.

9.4.5 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.

(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.

9.4.6 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.

9.4.7 Audit of Club: A club is usually constituted as a company limited by guarantee. Therefore, various provisions of the Companies Act, 2013 relating to the audit of accounts of companies are also applicable to its audit. 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.

9.4.8 Audit of Cinema: The special steps involved in its audit are stated below-

(1) Verify-

(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.

(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 which are higher, as compared to those admissible in the case of other businesses, in respect of similar assets.

(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.

9.4.9 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 assume 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 problems 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 over stressed. 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 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 at 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 renovation and redecoration are treated as deferred 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.

(viii) In large hotels it is usual to operate a booth to facilitate conversion of foreign currencies to Indian rupees. The auditor should ensure compliance with the various applicable provisions of Foreign Exchange Management Act, 1999 and the rules framed by Foreign Exchange Dealers Association.

9.4.10 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, and

(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 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.

FEEDBACK FORM

(1)	Name of the Student					
(2)	Registration No.					
	Contact detail with e-mail id, mobile number, etc.					
(3)	Subject & Paper No.	Paper: 6 : Audit and Assurance				
(4)	Name of Publication	Study Material				
(5)	Edition	July, 2015				
(6)	Do you find the publication student-friendly?					
(7)	Do the illustrations in the Study Material assist in understanding of the provisions contained in the Study Material?					
(8)	Does the Practice Manual contain adequate and sufficient questions to help in better understanding of the concepts explained in the Study Material?					
(9)	Are there any errors which you have noticed in the publication? If yes, give the specific details :					
	Type of Error (Specify nature of error)	**Chapter No. (Unit No., if applicable)**	**Page No.**	**Para No. & line of the para**	**Text or problem (containing the error) as per the publication**	**Suggested Correction**
	Typographical/ Printing/ Computational/ Conceptual/ Updation					
(10)	Do you feel that the publication can be made more value additive? If so, please give your specific suggestions.					

Note: Use separate sheet, if necessary. You are also encouraged to send your response by e-mail at feedbackbos@icai.in

Please send feedback form to :

Director, Board of Studies

The Institute of Chartered Accountants of India

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INTERMEDIATE (IPC) COURSE STUDY MATERIAL

AUDITING PRONOUNCEMENTS

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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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.

On many occasions, guidance is required on certain procedural aspects of audits of financial statements, which may not, per se, specifically be dealt with by the Standards or they might need additional guidance on carrying out assurance engagements in terms of requirements of some specific laws or regulations. These Guidance Notes are recommendatory 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 has been divided into two parts for the convenience of the students.

- First part contains the Authority and Preface, Glossary of Terms, Standards on Quality Control, Framework for Assurance engagements and Standards on Auditing.
- Second part of the book carries the applicable Guidance Notes prescribed at CA Intermediate (IPC) Level which is given in CD.

Happy Reading and Best Wishes!

CONTENTS

AUDITING PRONOUNCEMENT

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 Institute[1]

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 Committee[2], '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.

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[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. 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 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 Committee[8], 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

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[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.

[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.

'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 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

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[10] Refer footnote 2. 'Statements on Standard Auditing Practices' have been renamed as 'Engagement and Quality Control Standards'.

[11] *ibid.*

[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.

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.**

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) 1[14], "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) 3[15], "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 confidentially 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 auditor[16]. 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.

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[*] 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."

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.

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) 33[17], 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) 28[18], 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

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[**] 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.

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 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 13[19], "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

[19] Now known as Standard on Auditing (SA) 320.

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, 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 5[20], "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 22[21], "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

[20] Now known as Standard on Auditing (SA) 500.
[21] Now known as Standard on Auditing (SA) 510.

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 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:

* Issued in August, 2009.

"83. The needs of the firm for retention

………………………………

..

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

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* Issued in January, 2010.

** Issued in May, 2010.

*** Issued in August, 2010.

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.

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.

* Issued in April, 2011.

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. 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-fifth[22] 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."

[22] The said RBI circular requires that the amount of amortisation should be at least one-fifth of the total amount involved every year.

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.
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.

* Issued in October, 2011.

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 statuary 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*

[*] Issued in January, 2012.

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 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 statuary 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

* Issued in April, 2012.

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 –

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 22rd 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:

* Issued in May, 2012.

(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, 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 is 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."

D. List of Mandatory Statements and Standards on Auditing

I. List of Statements on Auditing as on 01.07.2013

1. Statement on the Companies (Auditor's Report) Order, 2003 (Revised 2005).[23]
2. Statement on Reporting under section 227 (1A) of the Companies Act, 1956[24].

II. List of Engagement and Quality Control Standards as on 01.07.2013

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	October		✓		

[23] 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.

[24] 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'.

	Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements	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**
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	December2007		✓		
250	Consideration of Laws and Regulations in an Audit of Financial Statements	December2008		✓		
260	Communication with Those Charged with Governance	December2008		✓		
265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	December2009			✓	
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	December2007	✓			

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 Identified during the Audit	August 2009			✓	
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	December2008		✓		
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 Statements	February 2010				✓
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				✓

* 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.

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			✓	
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			

PART-I

PART – I : STANDARDS

Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Services[1]

(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 (SQCs), 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 200[2].

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[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 firms[3] 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 accountant[4] 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 them[5]. 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

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[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.

otherwise clear, the reasons for the departure. Further, his report should draw attention to such departures. However, a 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.

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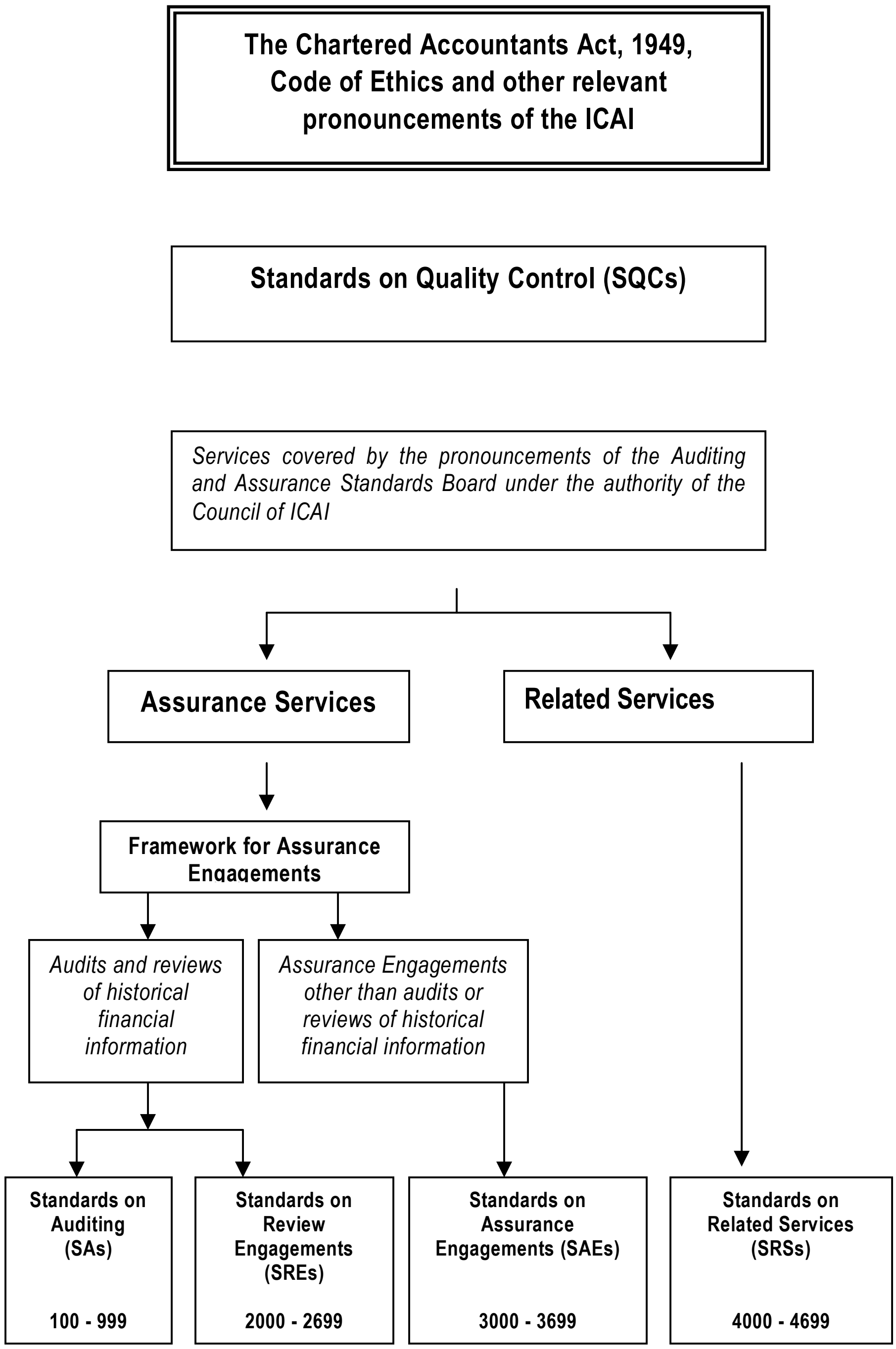
[6] Attention of the members is also drawn to Clause 9 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, whereby, a member is deemed to be guilty of professional misconduct if he fails to invite attention to any material departure from the generally accepted procedures of audit 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 advice 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 540[1] 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.

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*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 810[2]) - 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

[2] SA 810, "Engagements to Report on Summary Financial Statements."

practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement.

> *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 engagement[3] 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 statements[4] 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.

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[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 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.

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 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.

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 805[6])— 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.

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5 SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements."

6 SA 805, "Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement.".

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 person[7] 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 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.

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7 Such other person should be a member of the Institute of Chartered Accountants of India.

8 SA 620, "Using the Work of an Auditor's Expert," paragraph 6(a), defines the term "auditor's expert".

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.

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.

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9 SA 200, paragraph 13(a).

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.

(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 250[10]) - 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.

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[10] SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements".

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.

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 premise[11] on which an audit is conducted.

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11 SA 200, paragraph 13(j).

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

(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 402[12] (Revised) as a Type 1 report) - A report that comprises:

[12] SA 402, "Audit Considerations Relating to an Entity Using a Service Organization".

(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:

    (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.

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13 SA 200, paragraph 13(a).

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.

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.

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14 SA 200, paragraph 13(f).

15 For discussion of the diversity of governance structures, see paragraphs A1-A8 of SA 260, "Communication with Those Charged with Governance."

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.

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.

[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.

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 Institute[1] (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 firm[2] 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.

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[*] 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 person[3] 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 employee[4] (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 the following elements:

[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.

(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 years[5].**

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.
- Background searches of relevant databases.

[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.

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 interest[6]. 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.

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[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 years[7] 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.

[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.

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.

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:
  - New developments in professional standards and regulatory and legal requirements, and how they are reflected in the firm's policies and procedures where appropriate;
  - Written confirmation of compliance with policies and procedures on independence;
  - Continuing professional development, including training; and
  - 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 practice[1] (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 engagements[2]

(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.

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* 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 India[4]; and

(d) Standards on Quality Control (SQCs), which establish standards and provide guidance on a firm's system of quality control[5].

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,

[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.

presentation 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 engagement[6] 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.

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[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) engagements[7], 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:

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[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

[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 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:

- 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 misstated[9]. 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]

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[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.

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 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 2400[11] (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,

[11] Published in May 2010 issue of the Journal.

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 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,[12]

  The 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.

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[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).

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 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 Engage-ment	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 engage-ment circum-stances and a positive form of expression of the conclusion (Paragraph 57)

[13] A detailed discussion of evidence-gathering requirement is only possible within SAEs for specific subject matters.

Limited Assurance Engagement	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 (Paragraph 10)	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances, but in which procedures are deliberately limited relative to reasonable assurance engagement (Paragraph 52)	Description of the engagement circumstances, and a 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

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inappropriate opinion 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 statements[1]. 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 regulations[2].

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 230 [3]. (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.

[3] SA 230, "Audit Documentation", paragraph 8(c).

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, 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 framework[4]. SA 800 deals with special considerations when financial statements are prepared in accordance with a special purpose framework[5].

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 engagement[6]. The auditor is also required to obtain written representations about whether

[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).

management and, where appropriate, those charged with governance have fulfilled those responsibilities[7].

Considerations Specific to Central/State Governments and Related Government Entities

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.

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[7] SA 580, "Written Representations", paragraphs 10-11.

A17. Standard on Quality Control (SQC) 1[8] 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 relevant ethical requirements, including those pertaining to independence[9]. 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 engagement[10]. 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 evidence[11]. 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

[8] 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".

[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.

determine what modifications or additions to audit procedures are necessary to resolve the matter[12].

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 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 220[13], 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 audit[14]. 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.

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[12] SA 240, paragraph 13; SA 500, paragraph 11; and SA 505, paragraphs 10-11, and 16.

[13] SA 220, paragraph 18.

[14] SA 230, paragraph 8.

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 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[15]) 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

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[15] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 9.

- 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.

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 performed[16].

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.

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[16] SA 330, "The Auditor's Reponses to Assessed Risks", paragraphs 7-17.

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 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 300 [17] 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

[17] SA 300, "Planning an Audit of Financial Statements".

practices, including indicators of possible bias in management's judgments[18].

The Nature of Audit Procedures

A47. There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

- 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 activities[19]; and
- Use testing and other means of examining populations in a manner that provides a reasonable basis

[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.

[19] SA 315, paragraphs 5-10.

for the auditor to draw conclusions about the population[20].

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 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

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[20] SA 330; SA 500; SA 520, "Analytical Procedures", and SA 530, "Audit Sampling".

[21] SA 550, "Related Parties".

[22] SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements".

[23] SA 570, "Going Concern".

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)

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 610 [24] 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 scope[25] represents an explicit conditional requirement.
- The requirement to communicate significant deficiencies in internal control identified during the audit to those charged with governance[26], 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 framework[27], which depends on that framework requiring or permitting such disclosure, represent implicit conditional requirements.

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[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.

Departure from a Requirement (Ref: Para. 23)

A73. SA 230 establishes documentation requirements in those exceptional circumstances where the auditor departs from a relevant requirement[28]. 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 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.

[28] SA 230, paragraph 12.

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 220[1] 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 framework[2] in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise[3] 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)

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*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 Standards[4] 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 705[5]. (Ref: Para. A33)

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[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 706[6] ; 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 misunderstanding[7].

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 SAs[8]. (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 characteristics[9]. The auditor's responsibilities in respect of ethical requirements in the context of the acceptance of an audit engagement and in so far as they

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[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.

are within the control of the auditor are dealt with in SA 220[10]. 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 users[11]. 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]

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[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.

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 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

[13] SA 200, Paragraph A2.

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.

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 responsibilities[14]. 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 evidence[15]. 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 control[16].

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

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[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.

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 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 Agreement[18] (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

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[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.

the audit engagement letter on the auditor's responsibilities may be based on SA 200[19]. 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:

- 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;

[19] SA 200, paragraph 3-9.

- 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 standards[20].

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 audit[21]. 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

[20] SA 700, “Forming an Opinion and Reporting on Financial Statements”, paragraph 15.

[21] SA 200, paragraph 20.

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 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 Standards[22] *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*

[22] Refer footnote 6.

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*]

You[24] 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*

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[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.

[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 S*tatement 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".

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:

(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, billings[28] and other specific terms, as appropriate*.]

[Reporting]

[*Insert appropriate reference to the expected form and content of the auditor's report.*]

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[26] Use terminology as appropriate in the circumstances.

[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".

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
…………………………
(Signature)

Date : (Name of the Member)

Place : (Designation[29])

Acknowledged on behalf of ABC Company by

……………………..
(Signature)
Name and Designation
Date

Example of an Audit Engagement Letter

Audit of Financial Statements under the Companies Act 2013 and the Rules Thereunder

(When Reporting u/s 143(3)(i) is Applicable)
Part A: Audit of Financial Statements

To, the Board of Directors of .... (name of the Entity)

(Address)

Dear Sirs,

I / We refer to the letter dated _________ informing me / us about my / our (re) appointment/ratification as the auditors of the Company. You have requested that I / we audit the financial statements of the Company as defined in Section 2(40) of the Companies Act, 2013 ('2013 Act'), for the financial year(s) beginning April 1, 20XX and ending March 31, 20YY[30]. The financial statements of the Company include, where applicable, consolidated financial statements of the Company and of all its subsidiaries, associate companies and joint ventures. I am / We are pleased to confirm my / our acceptance and my / our understanding of this audit engagement by means of this letter.

My / Our audit will be conducted with the objective of me / our expressing an opinion if the aforesaid financial statements give the information required by the 2013 Act in the manner so required, and give a true and fair view in conformity with the applicable accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 20YY, and its profit/loss and its cash flows for the year ended on that date which, *inter alia*, includes reporting in conjunction whether the Company has an adequate internal financial

[29] Partner or proprietor, as the case may be.

[30] An Engagement Letter may need to be entered into for each year of the period covered by the Eligibility Letter issued by the auditor u/s 139 and the Appointment Letter received from the Company, to supplement / update for any subsequent changes. This may be required because the appointment would need to be ratified at each AGM u/s 139 of the 2013 Act.

controls system over financial reporting in place and the operating effectiveness of such controls. In forming my / our opinion on the financial statements, I / we will rely on the work of branch auditors appointed by the Company and my / our report would expressly state the fact of such reliance.[31]

I / We will conduct my / our audit in accordance with the Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI) and deemed to be prescribed by the Central Government in accordance with Section 143(10) of the 2013 Act. Those Standards require that I / we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements. An audit involves performing procedures to obtain audit evidence about the amounts and the 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 financial control relevant to the Company'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.

The terms of reference for my / our audit of internal financial controls over financial reporting carried out in conjunction with our audit of the Company's financial statements will be as stated in the separate engagement letter for conducting such audit and should be read in conjunction with this letter. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of accounting estimates made by the Management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, including the possibility of collusion or improper management override of controls, there is an unavoidable risk that material misstatements due to fraud or error may occur and not be detected, even though the audit is properly planned and performed in accordance with the SAs. Also, projections of any evaluation of the internal financial controls over financial reporting to future periods are subject to the risk that the internal financial control over financial reporting may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

My / Our audit will be conducted on the basis that the Management and those charged with governance (Audit Committee / Board) acknowledge and understand that they have the responsibility:

(a) For the preparation of financial statements that give a true and fair view in accordance with the applicable Financial Reporting Standards and other generally accepted accounting principles in India. This includes:
    - Compliance with the applicable provisions of the 2013 Act;
    - Proper maintenance of accounts and other matters connected therewith;
    - The responsibility for the preparation of the financial statements on a going concern basis;
    - The preparation of the annual accounts in accordance with, the applicable accounting standards and providing proper explanation relating to any material departures from those accounting standards;
    - Selection of accounting policies and applying them consistently and making judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs

[31] Delete sentence on branch auditors where not applicable

of the Company at the end of the financial year and of the profit and loss of the Company for that period;

- Taking 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;
- Laying down internal financial controls to be followed by the Company and that such internal financial controls are adequate and were operating effectively; and
- Devising proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

(b) Identifying and informing me / us of financial transactions or matters that may have any adverse effect on the functioning of the Company.

(c) Identifying and informing me / us of :

- All the pending litigations and confirming that the impact of the pending litigations on the Company's financial position has been disclosed in its financial statements;
- All material foreseeable losses, if any, on long term contracts including derivative contracts and the accrual for such losses as required under any law or accounting standards; and
- Any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company.

(d) Informing me / us of facts that may affect the financial statements, of which Management may become aware during the period from the date of my / our report to the date the financial statements are issued.

(e) Identifying and informing me / us as to whether any director is disqualified as on March 31, 20YY from being appointed as a director in terms of Section 164 (2) of the 2013 Act. This should be supported by written representations received from the directors as on March 31, 20YY and taken on record by the Board of Directors.

(f) To provide me / us, inter alia, with:

(i) Access, at all times, to all information, including the books, accounts, vouchers and other records and documentation of the Company, whether kept at the Head Office or elsewhere, of which the Management is aware that are relevant to the preparation of the financial statements such as records, documentation and other matters. This will include books of account maintained in electronic mode;

(ii) Access, at all times, to the records of all the subsidiaries (including associate companies and joint ventures as per Explanation to Section 129(3) of the 2013 Act) of the Company in so far as it relates to the consolidation of its financial statements, as envisaged in the 2013 Act;

(iii) Access to reports, if any, relating to internal reporting on frauds (e.g., vigil mechanism reports etc.), including those submitted by cost accountant or company secretary in practice to the extent it relates to their reporting on frauds in accordance with the requirements of Section 143(12) of the 2013 Act;

(iv) Additional information that I / we may request from the Management for the purposes of my / our audit;

(v) Unrestricted access to persons within the Company from whom I / we deem it necessary to obtain audit evidence. This includes my / our entitlement to require from the officers of the Company such information and explanations as I / we may think necessary for the performance of my / our duties as the auditors of the Company; and

(vi) All the required support to discharge my / our duties as the statutory auditors as stipulated under the Companies Act, 2013/ ICAI standards on auditing and applicable guidance.

As part of my / our audit process, I / we will request from the Management written confirmation concerning representations made to me / us in connection with my / our audit.

My / Our report prepared in accordance with relevant provisions of the 2013 Act would be addressed to the shareholders of the Company for adoption of the accounts at the Annual General Meeting. In respect of other services, my / our report would be addressed to the Board of Directors. The form and content of my / our report may need to be amended in the light of my / our audit findings.

In accordance with the requirements of Section 143(12) of the 2013 Act, if in the course of performance of my / our duties as auditor, I / we have reason to believe that an offence involving fraud is being or has been committed against the Company by officers or employees of the Company, I / we will be required to report to the Central Government, in accordance with the rules prescribed in this regard which, inter alia, requires me / us to forward my / our report to the Board or Audit Committee, as the case may be, seeking their reply or observations, to enable me / us to forward the same to the Central Government.

As stated above, given that I am / we are required as per Section 143(12) of the Act to report on frauds, such reporting will be made in good faith and, therefore, cannot be considered as breach of maintenance of client confidentiality requirements or be subject to any suit, prosecution or other legal proceeding since it is done in pursuance of the 2013 Act or of any rules or orders made thereunder.

I / We also wish to invite your attention to the fact that our audit process is subject to 'peer review' / ‘quality review’ under the Chartered Accountants Act, 1949. The reviewer(s) may inspect, examine or take abstract of my / our working papers during the course of the peer review/quality review.

I / We may involve specialists and staff from our affiliated network firms to perform certain specific audit procedures during the course of my / our audit.

In terms of Standard on Auditing 720 – “The Auditor’s Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements” issued by the ICAI and deemed to be prescribed by the Central Government in accordance with Section 143(10) of the 2013 Act , I / we request you to provide to me / us a Draft of the Annual Report containing the audited financial statements so as to enable me / us to read the same and communicate material inconsistencies, if any, with the audited financial statements, before issuing the auditor’s report on the financial statements.

{Other relevant information}

{Insert Other information, such as fee arrangements, billings[32] and other specific terms, as appropriate.}

This letter should be read in conjunction with my / our letter dated ___ for the Audit of Internal Financial Controls Over Financial Reporting under the 2013 Act, in respect of which separate fees have been fixed/will be mutually agreed.

I / We look forward to full cooperation from your staff during my / our audit.

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[32] For example, “My / Our fees and out-of-pocket expenses for the audit of the financial statements for the year have been fixed by the members at the Annual General Meeting at Rs.____________, plus out-of-pocket expenses and indirect taxes/ will be mutually agreed between the Board of Directors of the Company and me / ourselves.* I / We will bill as the work progresses. I / We will notify you promptly of any circumstances I / we encounter that could significantly affect my / our estimate of fees and discuss with you any additional fees, as necessary.”

* delete as applicable

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for my / our audit of the financial statements including our respective responsibilities.

Yours faithfully,

(signature)

(Name of the Member)

(Designation)[33]

(Name of the Firm)

Date:

Place:

Copy to: Chairman, Audit Committee

Acknowledged on behalf of <<Name of the entity>>

Name and Designation: _________________

Date: ______________

Example of an Audit Engagement Letter

Audit of Financial Statements When Reporting u/s 143(3)(i) is Applicable

Part B: Audit of Internal Financial Controls Over Financial Reporting

(Refer Illustrative Format Provided in Appendix 1 of the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting)

[33] Partner or proprietor, as the case may be.

Example of an Audit Engagement Letter
Audit of Financial Statements under the Companies Act 2013 and the Rules Thereunder
(When Reporting u/s 143(3)(i) of the Companies Act, 2013 is Not Applicable)

To,

The Board of Directors of .... *(name of the Entity)*

(Address)

Dear Sirs,

I / We refer to the letter dated _________ informing me / us about my / our (re) appointment/ratification as the auditors of the Company. You have requested that I / we audit the financial statements of the Company as defined in Section 2(40) of the Companies Act, 2013 ('2013 Act'), for the financial year(s) beginning April 1, 20XX and ending March 31, 20YY[34]. The financial statements of the Company include, where applicable, consolidated financial statements of the Company and of all its subsidiaries, associate companies and joint ventures. I am / We are pleased to confirm my / our acceptance and my / our understanding of this audit engagement by means of this letter.

My / Our audit will be conducted with the objective of me / our expressing an opinion if the aforesaid financial statements give the information required by the 2013 Act in the manner so required, and give a true and fair view in conformity with the applicable accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 20YY, and its profit/loss and its cash flows for the year ended on that date. In forming my / our opinion on the financial statements, I / we will rely on the work of branch auditors appointed by the Company and my / our report would expressly state the fact of such reliance.[35]

I / We will conduct my / our audit in accordance with the Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI) and deemed to be prescribed by the Central Government in accordance with Section 143(10) of the 2013 Act. Those Standards require that I / we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements. An audit involves performing procedures to obtain audit evidence about the amounts and the 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 the accounting policies used and the reasonableness of accounting estimates made by the Management, as well as evaluating the overall presentation of the financial statements.

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[34] An Engagement Letter may need to be entered into for each year of the period covered by the Eligibility Letter issued by the auditor u/s 139 and the Appointment Letter received from the Company, to supplement / update for any subsequent changes. This may be required because the appointment of auditors would need to be ratified at each AGM u/s 139 of the 2013 Act.

[35] Delete sentence on branch auditors where not applicable.

Because of the inherent limitations of an audit, including the possibility of collusion or improper management override of controls, there is an unavoidable risk that material misstatements due to fraud or error may occur and not be detected, even though the audit is properly planned and performed in accordance with the 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.

My / Our audit will be conducted on the basis that the Management and those charged with governance (Audit Committee / Board) acknowledge and understand that they have the responsibility:

(a) For the preparation of financial statements that give a true and fair view in accordance with the applicable Financial Reporting Standards and other generally accepted accounting principles in India. This includes:

- ♦ Compliance with the applicable provisions of the 2013 Act;
- ♦ Proper maintenance of accounts and other matters connected therewith;
- ♦ The responsibility for the preparation of the financial statements on a going concern basis;
- ♦ The preparation of the annual accounts in accordance with, the applicable accounting standards and providing proper explanation relating to any material departures from those accounting standards;
- ♦ Selection of accounting policies and applying them consistently and making judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the Company at the end of the financial year and of the profit and loss of the Company for that period;
- ♦ Taking 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;
- ♦ Laying down internal financial controls to be followed by the Company and that such internal financial controls are adequate and were operating effectively; and
- ♦ Devising proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

(b) Identifying and informing me / us of financial transactions or matters that may have any adverse effect on the functioning of the Company.

(c) Identifying and informing me / us of :

- ♦ All the pending litigations and confirming that the impact of the pending litigations on the Company's financial position has been disclosed in its financial statements;
- ♦ All material foreseeable losses, if any, on long term contracts including derivative contracts and the accrual for such losses as required under any law or accounting standards; and
- ♦ Any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company.

(d) Informing me / us of facts that may affect the financial statements, of which Management may become aware during the period from the date of my / our report to the date the financial statements are issued.

(e) Identifying and informing me / us as to whether any director is disqualified as on March 31, 20YY from being appointed as a director in terms of Section 164 (2) of the 2013 Act. This should be supported by written representations received from the directors as on March 31, 20YY and taken on record by the Board of Directors.

(f) To provide me / us, inter alia, with:

(i) Access, at all times, to all information, including the books, accounts, vouchers and other records and documentation of the Company, whether kept at the Head Office or elsewhere, of which the Management is aware that are relevant to the preparation of the financial statements such as records, documentation and other matters. This will include books of account maintained in electronic mode;

(ii) Access, at all times, to the records of all the subsidiaries (including associate companies and joint ventures as per Explanation to Section 129(3) of the 2013 Act) of the Company in so far as it relates to the consolidation of its financial statements, as envisaged in the 2013 Act;

(iii) Access to reports, if any, relating to internal reporting on frauds (e.g., vigil mechanism reports etc.), including those submitted by cost accountant or company secretary in practice to the extent it relates to their reporting on frauds in accordance with the requirements of Section 143(12) of the 2013 Act;

(iv) Additional information that I / we may request from the Management for the purposes of my / our audit;

(v) Unrestricted access to persons within the Company from whom I / we deem it necessary to obtain audit evidence. This includes my / our entitlement to require from the officers of the Company such information and explanations as I / we may think necessary for the performance of my / our duties as the auditors of the Company; and

(vi) All the required support to discharge my / our duties as the statutory auditors as stipulated under the Companies Act, 2013/ ICAI standards on auditing and applicable guidance.

As part of my / our audit process, I / we will request from the Management written confirmation concerning representations made to me / us in connection with my / our audit.

My / Our report prepared in accordance with relevant provisions of the 2013 Act would be addressed to the shareholders of the Company for adoption of the accounts at the Annual General Meeting. In respect of other services, my / our report would be addressed to the Board of Directors. The form and content of my / our report may need to be amended in the light of my / our audit findings.

In accordance with the provisions of Section 143(12) and 143(13) of the 2013 Act, if in the course of performance of my / our duties as auditor, I / we have reason to believe that an offence involving fraud is being or has been committed against the Company by officers or employees of the Company, I / we will be required to report to the Central Government, in accordance with the rules prescribed in this regard which, inter alia, requires me / us to forward my / our report to the Board or Audit Committee, as the case may be, seeking their reply or observations, to enable me / us to forward the same to the Central Government. Such reporting will be made in good faith and, therefore, cannot be considered as breach of maintenance of client confidentiality requirements or be subject to any suit, prosecution or other legal proceeding since it is done in pursuance of the 2013 Act or of any rules or orders made thereunder.

I / We also wish to invite your attention to the fact that my / our audit process is subject to 'peer review' / ‘quality review’ under the Chartered Accountants Act, 1949. The reviewer(s) may inspect, examine or take abstract of my / our working papers during the course of the peer review/quality review.

I / We may involve specialists and staff from my / our affiliated network firms to perform certain specific audit procedures during the course of my / our audit.

In terms of Standard on Auditing 720 – "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements" issued by the ICAI and deemed to be prescribed by the Central Government in accordance with Section 143(10) of the 2013 Act, I / we request you to provide to me / us a Draft of the Annual Report containing the audited financial statements so as to enable me / us to read the same and communicate material inconsistencies, if any, with the audited financial statements, before issuing the auditor's report on the financial statements.

{Other relevant information}

{Insert Other information, such as fee arrangements, billings[36] and other specific terms, as appropriate.}

I / We look forward to full cooperation from your staff during my / our audit.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for my / our audit of the financial statements including our respective responsibilities.

Yours faithfully,

(signature)

(Name of the Member)

(Designation)[37]

(Name of the Firm)

Date:

Place:

Copy to: Chairman, Audit Committee

Acknowledged on behalf of <<Name of the entity>>

Name and Designation: _________________

Date: ______________

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[36] For example, "My / Our fees and out-of-pocket expenses for the audit of the financial statements for the year have been fixed by the members at the Annual General Meeting at Rs.____________, plus out-of-pocket expenses and indirect taxes/ will be mutually agreed between the Board of Directors of the Company and me / ourselves.* I / We will bill as the work progresses. I / We will notify you promptly of any circumstances I / we encounter that could significantly affect my / our estimate of fees and discuss with you any additional fees, as necessary."

[37] Partner or proprietor, as the case may be.

*delete as applicable

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.

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 circumstances[1].

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.

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* 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 person[2] 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.

[2] Such other person should be a member of the Institute of Chartered Accountants of India.

(n) Relevant ethical requirements – Ethical requirements to which the engagement team and engagement 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 employee[3] (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)

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[3] Such employee should be a member of the Institute of Chartered Accountants of India.

Assignment of Engagement Teams

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 client[4]. 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

[4] SQC 1, paragraph 28.

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.

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 200[5].
- 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.

[5] SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph 15.

- 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 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 members[6].

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

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[6] SQC 1, paragraph 50.

- 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 reviews[7].

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 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 statements[8]. 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

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[7] SA 230, "Audit Documentation", paragraph 9(c).

[8] SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 41.

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 regard[9].

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.

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 315[10], and the responses to those risks in accordance with SA 330[11], including the engagement team's assessment of, and response to, the risk of fraud in accordance with SA 240[12].
- 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

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[9] SA 230, paragraphs 14-16 and A21-A24.

[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".

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)

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 effectively[13].

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.

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[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 220[1].
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections in accordance with SQC 1[2].
- 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:

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* 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.

(a) A sufficient and appropriate record of the basis for the auditor's report; and

(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 315[3].

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

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[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).

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 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 220[5] 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

[5] SA 220, paragraph17.

(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 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 320[6], 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 relevant[7] 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 610[8] 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 220[10], 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

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[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.

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.

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 years[14] 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

* Published in December, 2007 issue of the Journal.

planned and performed in accordance with the SAs.[1]

6. As described in SA 200[2], 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.

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[1] SA 200, paragraph A51.

[2] SA 200, paragraph A51.

Requirements

Professional Skepticism

12. In accordance with SA 200[3], 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 discussion[4]. 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 315[5], 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)

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[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 entity[6], 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 disclosures[7].

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)

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[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 estimates[10] for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor

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[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".

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 procedures[12] 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)

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[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".

Auditor Unable to Continue the Engagement

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 Governance[13], 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 315[14] 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 330[15] 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

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[13] Reference may be made to SA 260, "Communication with Those Charged with Governance".

[14] SA 315, paragraph 32.

[15] SA 330, paragraph 28.

pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.

- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.
- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

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.

[16] SA 200, paragraph A47.

Discussion among the Engagement Team (Ref: Para. 15)

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.

[17] SA 315, paragraph 23 and SA 610, "Using the Work of Internal Auditors".

- 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, 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

[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.

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:

- 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:

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[19] SA 315, paragraph A48.

- 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.
- 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;

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[20] SA 330, paragraph 25.

[21] SA 450, "Evaluation of Misstatements Identified during the Audit", paragraphs 12-19.

(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/ 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 others[22].

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

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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".

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 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

[24] SA 260, Paragraph A42.

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 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.

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[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.

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

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* 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

[3] SA 200, paragraph 52.

[4] SA 200, paragraph 15.

and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;

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

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

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

[5] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 11.

paragraphs 12-16.

Audit Procedures When Non-Compliance is Identified or Suspected

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 705[7], 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

[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.

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 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 framework[9]. 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:

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[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).

- An internal audit function.
- An audit committee.
- 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 700[10] or SA 800[11] 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.

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[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.

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;
- 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

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[12] SA 580, "Written Representations", paragraph 3.

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 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

[13] SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", paragraph 8.

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 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 260*
Communication with Those Charged with Governance

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

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

3. Recognising the importance of effective two-way communication during an audit of financial statements, this SA provides an overarching framework for the auditor's communication with those charged with governance, and identifies some specific matters to be communicated with them. Additional matters to be communicated, which complement the requirements of this SA, are identified in other SAs. In addition, SA 265[1] establishes specific requirements regarding the communication of significant deficiencies in internal control the auditor has identified during the audit to those charged with governance. Further matters, not required by this or other SAs, may be required to be communicated by laws or regulations, by agreement with the entity, or by additional requirements applicable to the engagement. Nothing in this SA precludes the auditor from communicating any other matters to those charged with governance. *(Ref: Para. A28-A31)*

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objectives

5. The objectives of the auditor are to:

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

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

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

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* Published in December, 2008 issue of the Journal.

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

(d) Promote effective two-way communication between the auditor and those charged with governance. *(Ref: Para. A1-A4)*

Definitions

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

(a) ***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 those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector undertakings or an owner-manager. For discussion of the diversity of governance structures, see paragraphs A5-A12.

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

Requirements

Those Charged with Governance

7. The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate. *(Ref: Para. A5-A8)*

Communication with a Subgroup of Those Charged with Governance

8. When the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body. *(Ref: Para. A9-A11)*

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

9. In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this SA are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role. These matters are noted in paragraph 12(c). The auditor shall nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. *(Ref: Para. A12)*

Matters to be Communicated

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

10. The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:

(a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and

(b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. *(Ref: Para. A13-A14)*

Planned Scope and Timing of the Audit

11. The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit. *(Ref: Para. A15-A19)*

Significant Findings from the Audit

12. The auditor shall communicate with those charged with governance: *(Ref: Para. A20)*

(a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework[2], not to be most appropriate to the particular circumstances of the entity; *(Ref: Para. A21)*

(b) Significant difficulties, if any, encountered during the audit; *(Ref: Para. A22)*

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

 (i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and *(Ref: Para. A23)*

 (ii) Written representations the auditor is requesting; and

(d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process. *(Ref: Para. A24)*

Auditor Independence

13. In the case of listed entities, the auditor shall communicate with those charged with governance: *(Ref: Para. A25-A27)*

(a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms[3] have complied with relevant ethical requirements regarding independence; and

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

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

The Communication Process

Establishing the Communication Process

14. The auditor shall communicate with those charged with governance the form, timing and expected general content of communications. *(Ref: Para. A32-A40)*

Forms of Communication

15. The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit when, in the auditor's professional judgment, oral communication would not be adequate. Written communications need not include all matters that arose during the course of the audit. *(Ref: Para. A41-A43)*

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[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] SQC 1, definition of "Network firm", paragraph, 6 (j).

16. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required by paragraph 13.

Timing of Communications

17. The auditor shall communicate with those charged with governance on a timely basis. *(Ref: Para. A44-A45)*

Adequacy of the Communication Process

18. The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and shall take appropriate action. *(Ref: Para. A46-A48)*

Documentation

19. Where matters required by this SA to be communicated are communicated orally, the auditor shall document them, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation.[4] *(Ref: Para. A49)*

Application and Other Explanatory Material

The Role of Communication (Ref: Para. 5)

A1. This SA focuses primarily on communications from the auditor to those charged with governance. Nevertheless, effective two-way communication is important in assisting:

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

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

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

A2. Although the auditor is responsible for communicating matters required by this SA, management also has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of this responsibility. Similarly, communication by management with those charged with governance of matters that the auditor is required to communicate does not relieve the auditor of the responsibility to also communicate them. Communication of these matters by management may, however, affect the form or timing of the auditor's communication with those charged with governance.

A3. Clear communication of specific matters required to be communicated by SAs is an integral part of every audit. SAs do not, however, require the auditor to perform procedures specifically to identify any other matters to communicate with those charged with governance.

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[4] SA 230, "Audit Documentation", paragraphs 8-11, and paragraph A6.

Legal or Regulatory Restrictions on Communicating with Those Charged with Governance

A4. Laws or regulations may restrict the auditor's communication of certain matters with those charged with governance. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider obtaining legal advice.

Those Charged with Governance (Ref: Para. 7)

A5. Governance structures may vary reflecting different size and ownership characteristics. For example:

- In most of the entities, those charged with governance hold positions that are an integral part of the entity's legal structure, for example, company directors. In others, for example, some government undertakings a body that is not part of the entity is charged with governance.
- In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.
- In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases management has this responsibility).

A6. In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, a council of governors, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities. Alternatively, a subgroup or individual may have specific, legally identified responsibilities that differ from those of the governing body.

A7. Such diversity means that it is not possible for this SA to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organisations, and some government entities. In such cases, the auditor may need to discuss and agree with the engaging party the relevant person(s) with whom to communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained in accordance with SA 315[5] is relevant. The appropriate person(s) with whom to communicate may vary depending on the matter to be communicated.

A8. Proposed Revised SA 600, "Special Considerations- Audits of Group Financial Statements (Including the Work of Component Auditors)[6]", includes specific matters to be communicated by group auditors with those charged with governance. When the entity is a component of a group, the appropriate person(s) with whom the component auditor communicates depends on the engagement circumstances and the matter to be communicated. In some cases, a number of components may be conducting the same businesses within the same system of internal control and using the same accounting practices. Where those charged with

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[5] SA 315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment".

[6] Currently, SA 600, 'Using the Work of Another Auditor' is in force. The standard is being revised in light of the corresponding international standard.

governance of those components are the same (e.g., common board of directors), duplication may be avoided by dealing with these components concurrently for the purpose of communication.

Communication with a Subgroup of Those Charged with Governance (Ref: Para. 8)

A9. When considering communicating with a subgroup of those charged with governance, the auditor may take into account such matters as:

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

A10. When deciding whether there is also a need to communicate information, in full or in summary form, with the governing body, the auditor may be influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor may make explicit in agreeing the terms of engagement that, unless prevented by laws or regulations, the auditor retains the right to communicate directly with the governing body.

A11. Audit committees (or similar subgroups with different names) exist in many jurisdictions. Although their specific authority and functions may differ, communication with the audit committee, where one exists, has become a key element in the auditor's communication with those charged with governance. Good governance principles suggest that:

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

When All of Those Charged with Governance are Involved in Managing the Entity (Ref: Para. 9)

A12. In some cases, all of those charged with governance are involved in managing the entity, and the application of communication requirements is modified to recognise this position. In such cases, communication with person(s) with management responsibilities may not adequately inform all of those with whom the auditor would otherwise communicate in their governance capacity. For example, in a company where all directors are involved in managing the entity, some of those directors (e.g., one responsible for marketing) may be unaware of significant matters discussed with another director (e.g., one responsible for the preparation of the financial statements).

Matters to be Communicated

***The Auditor's Responsibilities in Relation to the Financial Statement Audit* (Ref: Para. 10)**

A13. The auditor's responsibilities in relation to the financial statement audit are often included in the engagement letter or other suitable form of written agreement that records the agreed terms of the engagement. Providing those charged with governance with a copy of that engagement letter or other suitable form of written agreement may be an appropriate way to communicate with them regarding such matters as:

- The auditor's responsibility for performing the audit in accordance with SAs, which is directed towards the expression of an opinion on the financial statements. The matters that SAs require to be communicated, therefore, include significant matters arising from the audit of the financial statements that are relevant to those charged with governance in overseeing the financial reporting process.

- The fact that SAs do not require the auditor to design procedures for the purpose of identifying supplementary matters to communicate with those charged with governance.
- When applicable, the auditor's responsibility for communicating particular matters required by laws or regulations, by agreement with the entity or by additional requirements applicable to the engagement.

A14. Laws or regulations, an agreement with the entity or additional requirements applicable to the engagement may provide for broader communication with those charged with governance. For example, (a) an agreement with the entity may provide for particular matters to be communicated when they arise from services provided by a firm or network firm other than the financial statement audit; or (b) the mandate of a public sector auditor may provide for matters to be communicated that come to the auditor's attention as a result of other work, such as performance audits.

Planned Scope and Timing of the Audit (Ref: Para. 11)

A15. Communication regarding the planned scope and timing of the audit may:

(a) Assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and the concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures; and

(b) Assist the auditor to understand better the entity and its environment.

A16. Care is required when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

A17. Matters communicated may include:

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.
- The auditor's approach to internal control relevant to the audit.
- The application of the concept of materiality in the context of an audit.[7]

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.
- The views of those charged with governance of:
  - The appropriate person(s) in the entity's governance structure with whom to communicate.
  - The allocation of responsibilities between those charged with governance and management.
  - The entity's objectives and strategies, and the related business risks that may result in material misstatements.
  - Matters, which those charged with governance, consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
  - Significant communications with regulators.

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

- Other matters, which, those charged with governance, consider may influence the audit of the financial statements.

♦ The attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.

♦ The actions of those charged with governance in response to developments in accounting standards, corporate governance practices, exchange listing rules, and related matters.

♦ The responses of those charged with governance to previous communications with the auditor.

A19. While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Significant Findings from the Audit (Ref: Para. 12)

A20. The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

Significant Qualitative Aspects of Accounting Practices (Ref: Para. 12(a))

A21. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures. Open and constructive communication about significant qualitative aspects of the entity's accounting practices may include comment on the acceptability of significant accounting practices. Appendix 1 identifies matters that may be included in this communication.

Significant Difficulties Encountered During the Audit (Ref: Para. 12(b))

A22. Significant difficulties encountered during the audit may include such matters as:

♦ Significant delays in management providing required information.

♦ An unnecessarily brief time within which to complete the audit.

♦ Extensive unexpected effort required to obtain sufficient appropriate audit evidence.

♦ The unavailability of expected information.

♦ Restrictions imposed on the auditor by management.

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

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.[8]

Significant Matters Discussed, or Subject to Correspondence with Management (Ref: Para. 12(c)(ii))

A23. Significant matters discussed, or subject to correspondence with management may include such matters as:

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[8] SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

- Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.
- Concerns about management's consultations with other accountants on accounting or auditing matters.
- Discussions or correspondence in connection with the initial or recurring appointment of the auditor regarding accounting practices, the application of auditing standards, or fees for audit or other services.

Other Significant Matters Relevant to the Financial Reporting Process (Ref: Para. 12(d))

A24. Other significant matters arising from the audit that are directly relevant to those charged with governance in overseeing the financial reporting process may include such matters as material misstatements of fact or material inconsistencies in information accompanying the audited financial statements that have been corrected.

Auditor Independence (Ref: Para. 13)

A25. The auditor is subject to independence and other ethical requirements as enunciated in the Code of Ethics issued by the ICAI[9].

A26. The relationships and other matters, and safeguards to be communicated, vary with the circumstances of the engagement, but generally address:

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

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

The communication required by paragraph 13(a) may include an inadvertent violation of relevant ethical requirements as they relate to auditor independence, and any remedial action taken or proposed.

A27. The communication requirements relating to auditor independence that apply in the case of listed entities may also be relevant in the case of some other entities, particularly those that may be of significant public interest because, as a result of their business, their size or their corporate status, they have a wide range of stakeholders. Examples of entities that are not listed entities, but where communication of auditor independence may be appropriate, include public sector entities, credit institutions, insurance companies, and retirement benefit funds. On the other hand, there may be situations where communications regarding independence may not be relevant, for example, where all of those charged with governance have been informed of relevant facts through their management activities. This is particularly likely where the entity is owner-managed, and the auditor's firm and network firms have little involvement with the entity beyond a financial statement audit.

Supplementary Matters (Ref: Para. 3)

A28. Those charged with governance are responsible for ensuring, through oversight of management, that the entity establishes and maintains internal control to provide reasonable assurance with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

A29. The auditor may become aware of supplementary matters that do not necessarily relate to the oversight of the financial reporting process but which are, nevertheless, likely to be significant to the responsibilities of those charged with governance in overseeing the strategic direction of the entity or the entity's obligations related to accountability. Such matters may include, for example, significant issues

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[9] Attention of the members is also invited, for instance, to the *Guidance Note on Independence of Auditors*, issued by the ICAI.

regarding governance structures or processes, and significant decisions or actions by senior management that lack appropriate authorisation.

A30. In determining whether to communicate supplementary matters with those charged with governance, the auditor may discuss matters of this kind, of which the auditor has become aware, with the appropriate level of management, unless it is inappropriate to do so in the circumstances.

A31. If a supplementary matter is communicated, it may be appropriate for the auditor to make those charged with governance aware that:

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

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

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

The Communication Process

Establishing the Communication Process (Ref: Para. 14)

A32. Clear communication of the auditor's responsibilities, the planned scope and timing of the audit, and the expected general content of communications helps establish the basis for effective two-way communication.

A33. Matters that may also contribute to effective two-way communication include discussion of:

- The purpose of communications. When the purpose is clear, the auditor and those charged with governance are better placed to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
- The form in which communications will be made.
- The person(s) in the audit team and amongst those charged with governance who will communicate regarding particular matters.
- The auditor's expectation that communication will be two-way, and that those charged with governance will communicate with the auditor, matters they consider relevant to the audit, for example, strategic decisions that may significantly affect the nature, timing and extent of audit procedures, the suspicion or the detection of fraud, and concerns with the integrity or competence of senior management.
- The process for taking action and reporting back on matters communicated by the auditor.
- The process for taking action and reporting back on matters communicated by those charged with governance.

A34. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor's view of the significance of matters to be communicated. Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and those charged with governance is not adequate for the purpose of the audit (see paragraph A48).

Considerations Specific to Smaller Entities

A35. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of listed or larger entities.

Communication with Management

A36. Many matters may be discussed with management in the ordinary course of an audit, including matters required by this SA to be communicated with those charged with governance. Such discussions recognise management's executive responsibility for the conduct of the entity's operations and, in particular, management's responsibility for the preparation of the financial statements.

A37. Before communicating matters with those charged with governance, the auditor may discuss them with management, unless that is inappropriate. For example, it may not be appropriate to discuss questions of management's competence or integrity with management. In addition to recognising management's executive responsibility, these initial discussions may clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with the internal auditor before communicating with those charged with governance.

Communication with Third Parties

A38. Those charged with governance may wish to provide third parties, for example, bankers or certain regulatory authorities, with copies of a written communication from the auditor. In some cases, disclosure to third parties may be illegal or otherwise inappropriate. When a written communication prepared for those charged with governance is provided to third parties, it may be important in the circumstances that the third parties be informed that the communication was not prepared with them in mind, for example, by stating in written communications with those charged with governance:

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

(b) That no responsibility is assumed by the auditor to third parties; and

(c) Any restrictions on disclosure or distribution to third parties.

A39. The auditor may be required by laws or regulations to, for example:

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

A40. Unless required by laws or regulations to provide a third party with a copy of the auditor's written communications with those charged with governance, the auditor may need the prior consent of those charged with governance before doing so.

Forms of Communication (Ref: Para. 15-16)

A41. Effective communication may involve structured presentations and written reports as well as less structured communications, including discussions. The auditor may communicate matters other than those identified in paragraphs 15 and 16 either orally or in writing. Written communications may include an engagement letter that is provided to those charged with governance.

A42. In addition to the significance of a particular matter, the form of communication (e.g., whether to communicate orally or in writing, the extent of detail or summarisation in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:

- Whether the matter has been satisfactorily resolved.
- Whether management has previously communicated the matter.
- The size, operating structure, control environment, and legal structure of the entity.
- In the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.

- Legal requirements. In some jurisdictions, a written communication with those charged with governance is required in a prescribed form by local law.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The amount of ongoing contact and dialogue the auditor has with those charged with governance.
- Whether there have been significant changes in the membership of a governing body.

A43. When a significant matter is discussed with an individual member of those charged with governance, for example, the chair of an audit committee, it may be appropriate for the auditor to summarise the matter in later communications so that all of those charged with governance have full and balanced information.

Timing of Communications (Ref: Para. 17)

A44. The appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by those charged with governance. For example:

- Communications regarding planning matters may often be made early in the audit engagement and, for an initial engagement, may be made as part of agreeing the terms of the engagement.
- It may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion. Similarly, the auditor may communicate orally to those charged with governance as soon as practicable significant deficiencies in internal control that the auditor has identified prior to communicating these in writing as required by SA 265.[10]
- Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards, for example, when accepting an engagement to provide non-audit services, and at a concluding discussion. A concluding discussion may also be an appropriate time to communicate findings from the audit, including the auditor's views about the qualitative aspects of the entity's accounting practices.
- When auditing both general purpose and special purpose financial statements, it may be appropriate to co-ordinate the timing of communications.

A45. Other factors that may be relevant to the timing of communications include:

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

Adequacy of the Communication Process (Ref: Para. 18)

A46. The auditor need not design specific procedures to support the evaluation of the two-way communication between the auditor and those charged with governance; rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include:

- The appropriateness and timeliness of actions taken by those charged with governance in response to matters raised by the auditor. Where significant matters raised in previous communications have not

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[10] SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management," paragraphs 9 and A14.

been dealt with effectively, it may be appropriate for the auditor to inquire as to why appropriate action has not been taken, and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.

- The apparent openness of those charged with governance in their communications with the auditor.
- The willingness and capacity of those charged with governance to meet with the auditor without management present.
- The apparent ability of those charged with governance to fully comprehend matters raised by the auditor, for example, the extent to which those charged with governance probe issues, and question recommendations made to them.
- Difficulty in establishing with those charged with governance a mutual understanding of the form, timing and expected general content of communications.
- Where all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.
- Whether the two-way communication between the auditor and those charged with governance meets applicable legal and regulatory requirements.

A47. As noted in paragraph A1, effective two-way communication assists both the auditor and those charged with governance. Further, SA 315 identifies participation by those charged with governance, including their interaction with internal audit, if any, and external auditors, as an element of the entity's control environment.[11] Inadequate two-way communication may indicate an unsatisfactory control environment and influence the auditor's assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.

A48. If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take such actions as:

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

Documentation (Ref: Para. 19)

A49. Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

Material Modifications to ISA 260, Communication with Those Charged with Governance

The SA 260, "Communication with Those Charged with Governance" does not contain any material modifications *vis-a-vis* ISA 260.

[11] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph A70.

Appendix

(Ref: Para. 12(a), and A21)

Qualitative Aspects of Accounting Practices

The communication required by paragraph 12(a), and discussed in paragraph A21, may include such matters as:

Accounting Policies

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

Accounting Estimates

- For items for which estimates are significant, issues discussed in SA 540[12] including, for example:
    - Management's identification of accounting estimates.
    - Management's process for making accounting estimates.
    - Risks of material misstatement.
    - Indicators of possible management bias.
    - Disclosure of estimation uncertainty in the financial statements.

Financial Statement Disclosures

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

Related Matters

- The potential effect on the financial statements of significant risks, exposures and uncertainties, such as pending litigation, that are disclosed in the financial statements.
- The extent to which the financial statements are affected by unusual transactions, including non-recurring amounts recognised during the period, and the extent to which such transactions are separately disclosed in the financial statements.
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets. The communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements.
- The selective correction of misstatements, for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings.

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

SA 265*
Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

(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 communicate appropriately to those charged with governance and management deficiencies in internal control[1] that the auditor has identified in an audit of financial statements. This SA does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of SA 315 and SA 330[2]. SA 260[3] establishes further requirements and provides guidance regarding the auditor's responsibility to communicate with those charged with governance in relation to the audit.

2. The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement[4]. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. This SA specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.

3. Nothing in this SA precludes the auditor from communicating to those charged with governance and management other internal control matters that the auditor has identified during the audit.

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

5. The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

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* Published in September, 2009 issue of the Journal.

1 SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraphs 4 and 12.

2 SA 330, "The Auditor's Responses to Assessed Risks".

3 SA 260, "Communication with Those Charged with Governance".

4 SA 315, paragraph 12.

Definitions

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

(a) Deficiency in internal control – This exists when:

(i) 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

(ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

(b) 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. (Ref: Para. A5)

Requirements

7. The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. (Ref: Para. A1-A4)

8. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. (Ref: Para. A5-A11)

9. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12- A18, A27)

10. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: (Ref: Para. A19, A27)

(a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and (Ref: Para. A14, A20-A21)

(b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. (Ref: Para. A22- A26)

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

(a) A description of the deficiencies and an explanation of their potential effects; and (Ref: Para. A28)

(b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A29-A30)

(i) The purpose of the audit was for the auditor to express an opinion on the financial statements;

(ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and

(iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Application and Other Explanatory Material

Determination of Whether Deficiencies in Internal Control Have Been Identified (Ref: Para. 7)

A1. In determining whether the auditor has identified one or more deficiencies in internal control, the auditor may discuss the relevant facts and circumstances of the auditor's findings with the appropriate level of management. This discussion provides an opportunity for the auditor to alert management on a timely basis to the existence of deficiencies of which management may not have been previously aware. The level of management with whom it is appropriate to discuss the findings is one that is familiar with the internal control area concerned and that has the authority to take remedial action on any identified deficiencies in internal control. In some circumstances, it may not be appropriate for the auditor to discuss the auditor's findings directly with management, for example, if the findings appear to call management's integrity or competence into question (see paragraph A20).

A2. In discussing the facts and circumstances of the auditor's findings with management, the auditor may obtain other relevant information for further consideration, such as:

- Management's understanding of the actual or suspected causes of the deficiencies.
- Exceptions arising from the deficiencies that management may have noted, for example, misstatements that were not prevented by the relevant information technology (IT) controls.
- A preliminary indication from management of its response to the findings.

Considerations Specific to Smaller Entities

A3. While the concepts underlying control activities in smaller entities are likely to be similar to those in larger entities, the formality with which they operate will vary. Further, smaller entities may find that certain types of control activities are not necessary because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A4. Also, 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-manager may be able to exercise more effective oversight than in a larger entity. This higher level of management oversight needs to be balanced against the greater potential for management override of controls.

Significant Deficiencies in Internal Control (Ref: Para. 6(b), 8)

A5. The significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may therefore exist even though the auditor has not identified misstatements during the audit.

A6. Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process; for example:

- General monitoring controls (such as oversight of management).
- Controls over the prevention and detection of fraud.
- Controls over the selection and application of significant accounting policies.
- Controls over significant transactions with related parties.
- Controls over significant transactions outside the entity's normal course of business.
- Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).

- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The interaction of the deficiency with other deficiencies in internal control.

A7. Indicators of significant deficiencies in internal control include, for example:

- Evidence of ineffective aspects of the control environment, such as:
  - Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
  - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
  - Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
- Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).
- Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
- Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss[5].
- Evidence of management's inability to oversee the preparation of the financial statements.

A8. Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, misstatements[6]. For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency. However, a combination of deficiencies affecting the same account balance or disclosure,

[5] 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.

[6] SA 315, paragraph A66.

relevant assertion, or component of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency.

A9. Law or regulation in some jurisdictions may establish a requirement (particularly for audits of listed entities) for the auditor to communicate to those charged with governance or to other relevant parties (such as regulators) one or more specific types of deficiency in internal control that the auditor has identified during the audit. Where law or regulation has established specific terms and definitions for these types of deficiency and requires the auditor to use these terms and definitions for the purpose of the communication, the auditor uses such terms and definitions when communicating in accordance with the legal or regulatory requirement.

A10. Where the jurisdiction has established specific terms for the types of deficiency in internal control to be communicated but has not defined such terms, it may be necessary for the auditor to use judgment to determine the matters to be communicated further to the legal or regulatory requirement. In doing so, the auditor may consider it appropriate to have regard to the requirements and guidance in this SA. For example, if the purpose of the legal or regulatory requirement is to bring to the attention of those charged with governance certain internal control matters of which they should be aware, it may be appropriate to regard such matters as being generally equivalent to the significant deficiencies required by this SA to be communicated to those charged with governance.

A11. The requirements of this SA remain applicable notwithstanding that law or regulation may require the auditor to use specific terms or definitions.

Communication of Deficiencies in Internal Control

Communication of Significant Deficiencies in Internal Control to Those Charged with Governance (Ref: Para. 9)

A12. Communicating significant deficiencies in writing to those charged with governance reflects the importance of these matters, and assists those charged with governance in fulfilling their oversight responsibilities. SA 260 establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.[7]

A13. In determining when to issue the written communication, the auditor may consider whether receipt of such communication would be an important factor in enabling those charged with governance to discharge their oversight responsibilities. In addition, in case of listed entities, those charged with governance may need to receive the auditor's written communication before the date of approval of the financial statements in order to discharge specific responsibilities in relation to internal control for regulatory or other purposes. For other entities, the auditor may issue the written communication at a later date. Nevertheless, in the latter case, as the auditor's written communication of significant deficiencies forms part of the final audit file, the written communication is subject to the overriding requirement[8] for the auditor to complete the assembly of the final audit file on a timely basis. SA 230 states that 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[9].

A14. Regardless of the timing of the written communication of significant deficiencies, the auditor may communicate these orally in the first instance to management and, when appropriate, to those charged with governance to assist them in taking timely remedial action to minimize the risks of material misstatement. Doing so, however, does not relieve the auditor of the responsibility to communicate the significant deficiencies in writing, as this SA requires.

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[7] SA 260, paragraph 9.

[8] SA 230, "Audit Documentation", paragraph 14.

[9] SA 230, paragraph A21.

A15. The level of detail at which to communicate significant deficiencies is a matter of the auditor's professional judgment in the circumstances. Factors that the auditor may consider in determining an appropriate level of detail for the communication include, for example:

- The nature of the entity. For instance, the communication required for a public interest entity may be different from that for a non-public interest entity.
- The size and complexity of the entity. For instance, the communication required for a complex entity may be different from that for an entity operating a simple business.
- The nature of significant deficiencies that the auditor has identified.
- The entity's governance composition. For instance, more detail may be needed if those charged with governance include members who do not have significant experience in the entity's industry or in the affected areas.
- Legal or regulatory requirements regarding the communication of specific types of deficiency in internal control.

A16. Management and those charged with governance may already be aware of significant deficiencies that the auditor has identified during the audit and may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management and those charged with governance. Accordingly, the requirement in paragraph 9 applies regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.

A17. The fact that the auditor communicated a significant deficiency to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If a previously communicated significant deficiency remains, the current year's communication may repeat the description from the previous communication, or simply reference the previous communication. The auditor may ask management or, where appropriate, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

Considerations Specific to Smaller Entities

A18. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of larger entities.

Communication of Deficiencies in Internal Control to Management (Ref: Para. 10)

A19. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the deficiencies in internal control and to take the necessary remedial action. For significant deficiencies, the appropriate level is likely to be the chief executive officer or chief financial officer (or equivalent) as these matters are also required to be communicated to those charged with governance. For other deficiencies in internal control, the appropriate level may be operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action.

Communication of Significant Deficiencies in Internal Control to Management (Ref: Para. 10(a))

A20. Certain identified significant deficiencies in internal control may call into question the integrity or competence of management. For example, there may be evidence of fraud or intentional non-compliance with laws and regulations by management, or management may exhibit an inability to oversee the preparation of adequate financial statements that may raise doubt about management's competence. Accordingly, it may not be appropriate to communicate such deficiencies directly to management.

A21. SA 250 establishes requirements and provides guidance on the reporting of identified or suspected non-compliance with laws and regulations, including when those charged with governance are themselves involved in such non-compliance[10]. SA 240 establishes requirements and provides guidance regarding communication to those charged with governance when the auditor has identified fraud or suspected fraud involving management[11].

Communication of Other Deficiencies in Internal Control to Management (Ref: Para. 10(b))

A22. During the audit, the auditor may identify other deficiencies in internal control that are not significant deficiencies but that may be of sufficient importance to merit management's attention. The determination as to which other deficiencies in internal control merit management's attention is a matter of professional judgment in the circumstances, taking into account the likelihood and potential magnitude of misstatements that may arise in the financial statements as a result of those deficiencies.

A23. The communication of other deficiencies in internal control that merit management's attention need not be in writing but may be oral. Where the auditor has discussed the facts and circumstances of the auditor's findings with management, the auditor may consider an oral communication of the other deficiencies to have been made to management at the time of these discussions. Accordingly, a formal communication need not be made subsequently.

A24. If the auditor has communicated deficiencies in internal control other than significant deficiencies to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period. The auditor is also not required to repeat information about such deficiencies if it has been previously communicated to management by other parties, such as internal auditors or regulators. It may, however, be appropriate for the auditor to re-communicate these other deficiencies if there has been a change of management, or if new information has come to the auditor's attention that alters the prior understanding of the auditor and management regarding the deficiencies. Nevertheless, the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency requiring communication with those charged with governance. Whether this is the case depends on the auditor's judgment in the circumstances.

A25. In some circumstances, those charged with governance may wish to be made aware of the details of other deficiencies in internal control the auditor has communicated to management, or be briefly informed of the nature of the other deficiencies. Alternatively, the auditor may consider it appropriate to inform those charged with governance of the communication of the other deficiencies to management. In either case, the auditor may report orally or in writing to those charged with governance as appropriate.

A26. SA 260 establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity[12] .

A27. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the auditors may have additional responsibilities to communicate deficiencies in internal control that the auditor has identified during the audit, in ways, at a level of detail and to parties not envisaged in this SA. For example, significant deficiencies may have to be communicated to the legislature or other governing body. Law, regulation or other authority may also mandate that the auditors report deficiencies in internal control, irrespective of the significance of the potential effects of those deficiencies. Further, legislation may require the auditors to report on broader internal control-related matters than the deficiencies in internal control required to be communicated by this SA, for example, controls related

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[10] SA 250, Consideration of Laws and Regulations in an Audit of Financial Statements, paragraphs 22-28.

[11] SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraph 41.

[12] SA 260, paragraph 9.

to compliance with legislative authorities, regulations, or provisions of contracts or grant agreements.

Content of Written Communication of Significant Deficiencies in Internal Control (Ref: Para. 11)

A28. In explaining the potential effects of the significant deficiencies, the auditor need not quantify those effects. The significant deficiencies may be grouped together for reporting purposes where it is appropriate to do so. The auditor may also include in the written communication suggestions for remedial action on the deficiencies, management's actual or proposed responses, and a statement as to whether or not the auditor has undertaken any steps to verify whether management's responses have been implemented.

A29. The auditor may consider it appropriate to include the following information as additional context for the communication:

- An indication that if the auditor had performed more extensive procedures on internal control, the auditor might have identified more deficiencies to be reported, or concluded that some of the reported deficiencies need not, in fact, have been reported.
- An indication that such communication has been provided for the purposes of those charged with governance, and that it may not be suitable for other purposes.

A30. Law or regulation may require the auditor or management to furnish a copy of the auditor's written communication on significant deficiencies to appropriate regulatory authorities. Where this is the case, the auditor's written communication may identify such regulatory authorities.

Material Modifications to ISA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management"

Deletions

1 Paragraph A7 of ISA 265 provides the examples of the indicators of significant deficiencies in internal control which may include restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud. 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.

2. Paragraph A27 of ISA 265 deals with the additional responsibilities of the public sector auditors to communicate/report deficiencies in internal control to the legislature or governing 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 additional responsibilities may also be imposed on the auditor 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 A22, highlighting the fact, has been retained though a specific reference to public sector entities has been deleted.

SA 299
Responsibility of Joint Auditors
(Effective for all audits relating to accounting periods beginning on or after April 1, 1996)

Introduction

1. The practice of appointing more than one auditor to conduct the audit of large entities is in vogue these days. Such auditors, known as joint auditors, conduct the audit jointly and report on the financial statements of the entity. This Standard deals with the professional responsibilities which the auditors undertake in accepting such appointments as joint auditors. The 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 divisions or branches included in the financial statements of the entity, e.g., the relationship between a company auditor appointed under section 224 of the Companies Act, 1956 and a branch auditor appointed under section 228 of the said Act.[1]

Division of Work

2. 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 or with reference to periods of time. 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.

3. The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

Coordination

4. Where, in the course of his work, 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 judgement by, other joint auditors, he should communicate the same to all the other joint auditors in writing. This should be done by the submission of a report or note prior to the finalisation of the audit.

Relationship Among Joint Auditors

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

(a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature,

[1] These aspects have been dealt with in Standard on Auditing (SA) 600, "Using the Work of Another Auditor".

timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

(c) in respect of 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) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(e) for ensuring that the audit report complies with the requirements of the relevant statute.

6. If any matters of the nature referred to in paragraph 4 above are brought to the attention of the entity or other joint auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible for those matters.

7. Subject to paragraph 5(b) above, it is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him. The issues such as appropriateness of using test checks or sampling should be decided by each joint auditor in relation to his own area of work. This responsibility is not shared by the other joint auditors. Thus, it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him. Similarly, the nature, timing and extent of the enquiries to be made in the course of audit as well as the other audit procedures to be applied are solely the responsibility of each joint auditor.

8. In the case of audit of a large entity with several branches, including those required to be audited by branch auditors, the branch audit reports/returns may be required to be scrutinised 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 him and to ensure that they are properly incorporated into the accounts of the entity. 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 returns. It is also the separate and specific responsibility of each joint auditor to exercise his judgement with regard to the necessity of visiting such divisions/branches in respect of which the work is allocated to him.

9. A significant part of the audit work 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 appropriate information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by him.

10. Each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures.[2] 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. Each joint auditor is entitled to rely upon the other joint auditors for bringing to his notice any departure from generally accepted accounting principles or any material error noticed in the course of the audit.

11. Where separate 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

[2] Reference may be made in this regard to the Standards on Auditing and other mandatory Statements relating to auditing matters issued by the Council of the Institute from time to time.

legal and professional requirements regarding the disclosures to be made and present a true and fair view of the state of affairs and of the working results of the division/branch concerned, subject to such observations as may be communicated by the joint auditor concerned.

Reporting Responsibilities

12. Normally, the joint auditors are able to arrive at an agreed report. However, where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Effective Date

13. This Standard on Auditing becomes operative in respect of all audits relating to accounting periods beginning on or after April 1, 1996.

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 220[1], "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 220[2]; and*

(c) *Establishing an understanding of the terms of the engagement, as required by SA 210[3]. (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;*

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*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 engagement[4]; 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.

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[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 process[5].

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.

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[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.

A7. Performing these preliminary engagement activities enables the auditor to plan an audit engagement for 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 work[6].

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 body[7].

[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.

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 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 510[8] "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.

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[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 320[9], 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.

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[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

* Published in February, 2008 issue of the Journal.

risks of material 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:
    (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,

[1] SA 610, "Using the Work of Internal Auditors", paragraph 7(a).

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 320[2];
- 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;
- 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 240[3], "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

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[2] SA 320, "Materiality in Planning and Performing an Audit".

[3] SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraphs 12-24.

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.
- 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

[*] SA 520, "Analytical Procedures", paragraphs A1-A3 describe the nature of analytical procedures.

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:

- 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.

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 experience[5].

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.

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[4] SA 240, paragraph 15.

[5] SA 220, "Quality Control for an Audit of Financial Statements", paragraph 14.

- 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.

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

[6] SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", paragraph 10.

[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.

(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 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]

[8] SA 550, 'Related Parties', paragraph A7.

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 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-manager[9] 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

[9] Owner-manager refers to the proprietor of an entity who is involved in running the entity on a day-to-day basis.

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 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 procedures[10].

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.

[10] SA 330, paragraphs A2-A3.

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 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

[11] SA 330, paragraphs 15 and 21.

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.

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

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[12] SA 240, paragraph 25-27.

[13] SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", Paragraph A7.

[14] SA 330, paragraph 8.

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.

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

[15] SA 300, paragraphs 7 and 9.

[16] SA 330, paragraph 8.

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 450[1], 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:

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* 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".

(a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;

(b) Understand that financial statements are prepared, presented and audited to levels of materiality;

(c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

(d) Make reasonable economic decisions on the basis of the information in the financial statements.

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

[3] SA 450, paragraph A16.

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. (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 level[5]. 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[6]. Materiality and audit risk are considered throughout the audit, in particular, when:

    (a) Identifying and assessing the risks of material misstatement[7];

[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 procedures[8]; and

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report[9].

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

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[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 330*
The Auditor's Responses to Assessed Risks
(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 design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315, "Identifying and Assessing Risks of Material Misstatement Through Understanding the Entity and Its Environment" in a financial statement audit.

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 obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

Definitions

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

(a) Substantive procedure – 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.

(b) Test 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.

Requirements

Overall Responses

5. The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: Para. A1-A3)

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

6. The auditor shall 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. (Ref: Para. A4-A8)

7. In designing the further audit procedures to be performed, the auditor shall:

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* Published in February, 2008 issue of the Journal.

(a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:

  (i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk); and

  (ii) Whether the risk assessment takes into account the relevant controls (i.e., the control risk), thereby requiring the auditor to obtain audit evidence to determine whether 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); and (Ref: Para. A9-A18)

(b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: Para. A19)

Tests of Controls

8. 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. (Ref: Para. A20-A24)

9. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. (Ref: Para. A25)

Nature and Extent of Tests of Controls

10. In designing and performing tests 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. (Ref: Para. A26-A29)

(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. (Ref: Para. A30-A31)

Timing of Tests of Controls

11. The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to paragraphs 12 and 15 below, in order to provide an appropriate basis for the auditor's intended reliance. (Ref: Para. A32)

Using audit evidence obtained during an interim period

12. When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:

(a) Obtain audit evidence about significant changes to those controls subsequent to the interim period; and

(b) Determine the additional audit evidence to be obtained for the remaining period. (Ref: Para. A33-A34)

Using audit evidence obtained in previous audits

13. 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. (Ref: Para. A35)

14. 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. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:

(a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit. (Ref: Para. A36)

(b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A37-A39)

Controls over significant risks

15. When the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.

Evaluating the Operating Effectiveness of Controls

16. 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. (Ref: Para. A40)

17. 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 tests of controls that have been performed provide an appropriate basis for reliance on the controls;

(b) Additional tests of controls are necessary; or

(c) The potential risks of misstatement need to be addressed using substantive procedures. (Ref: Para. A41)

Substantive Procedures

18. 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. (Ref: Para. A42-A47)

19. The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. (Ref: Para. A48-A51)

Substantive Procedures Related to the Financial Statement Closing Process

20. 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. (Ref: Para. A52)

Substantive Procedures Responsive to Significant Risks

21. 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. (Ref: Para. A53)

Timing of Substantive Procedures (Ref: Para.A54)

22. When substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing:

(a) substantive procedures, combined with tests of controls for the intervening period; or

(b) if the auditor determines that it is sufficient, further substantive procedures only;

that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. (Ref: Para. A55-A57)

23. If misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor shall evaluate whether the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified. (Ref: Para. A58)

Adequacy of Presentation and Disclosure

24. The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework. (Ref: Para. A59)

Evaluating the Sufficiency and Appropriateness of Audit Evidence

25. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate before the conclusion of the audit whether the assessments of the risks of material misstatement at the assertion level remain appropriate. (Ref: Para. A60-A61)

26. The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. (Ref: Para. A62)

27. If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or a disclaimer of opinion.

Documentation

28. The auditor shall document:

(a) The overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed;

(b) The linkage of those procedures with the assessed risks at the assertion level; and

(c) The results of the audit procedures, including the conclusions where these are not otherwise clear. (Ref: Para. A63)

29. If the auditor plans to use audit evidences about the operating effectiveness of controls obtained in previous audits, the auditor shall document the conclusions reached about relying on such controls that were tested in a previous audit.

30. The auditors' documentation shall demonstrate that the financial statements agree or reconcile with the underlying accounting records.

Application and Other Explanatory Material

Overall Responses (Ref: Para. 5)

A1. Overall responses to address the assessed risks of material misstatement at the financial statement level may include:

- Emphasizing to the audit team the need to maintain professional skepticism.
- Assigning more experienced staff or those with special skills or using experts.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.

A2. The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor's overall responses, is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end. Deficiencies in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:

- Conducting more audit procedures as of the period end rather than at an interim date.
- Obtaining more extensive audit evidence from substantive procedures.
- Increasing the number of locations to be included in the audit scope.

A3. Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach).

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

The Nature, Timing and Extent of Further Audit Procedures (Ref: Para. 6)

A4. The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, (as appropriate and notwithstanding the requirements of this SA)[1], the auditor may determine that:

(a) Only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion;

(b) Performing only substantive procedures is appropriate for particular assertions and, therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing controls would be inefficient and therefore the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures; or

(c) A combined approach using both tests of controls and substantive procedures is an effective approach.

A5. The nature of an audit procedure refers to its purpose (i.e., test of controls or substantive procedure) and its type (i.e., inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure). The nature of the audit procedures is of most importance in responding to the assessed risks.

A6. Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies.

A7. 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.

A8. Designing and performing 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 provides a clear linkage between the auditors' further audit procedures and the risk assessment.

Responding to the Assessed Risks at the Assertion Level (Ref: Para. 7(a))

Nature

A9. The auditor's assessed risks may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.

A10. The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because of internal controls, and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those controls, as required by paragraph 8(a). This may be the case, for example, for a class of transactions of reasonably uniform, non-complex characteristics that are routinely processed and controlled by the entity's information system.

Timing

A11. The auditor may perform tests of controls or substantive procedures at an interim date or at the period end. The higher the risk of material misstatement, the more likely it is that the auditor may

[1] For example, as required by paragraph 18, irrespective of the approach selected, the auditor designs and performs substantive procedures for each significant class of transactions, account balance, and disclosure.

decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). This is particularly relevant when considering the response to the risks of fraud. For example, the auditor may conclude that, when the risks of intentional misstatement or manipulation have been identified, audit procedures to extend audit conclusions from interim date to the period end would not be effective.

A12. On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters.

A13. In addition, certain audit procedures can be performed only at or after the period end, for example:

- Agreeing the financial statements to the accounting records;
- Examining adjustments made during the course of preparing the financial statements; and
- Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalised.

A14. Further relevant factors that influence the auditor's consideration of when to perform audit procedures include the following:

- The control environment.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may wish to examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.

Extent

A15. The extent of an audit procedure judged necessary is determined after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. When a single purpose is met by a combination of procedures, the extent of each procedure is considered separately. In general, the extent of audit procedures increases as the risk of material misstatement increases. For example, in response to the assessed risk of material misstatement due to fraud, increasing sample sizes or performing substantive analytical procedures at a more detailed level may be appropriate. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk.

A16. The use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files, which may be useful when the auditor decides to modify the extent of testing, for example, in responding to the risks of material misstatement due to fraud. 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.

A17. In certain circumstances, the audit mandate and any other special auditing requirements may affect the auditor's consideration of the nature, timing and extent of further audit procedures.

Considerations specific to smaller entities

A18. In the case of very small entities, there may not be many control activities that could be identified by the auditor, or the extent to which their existence or operation have been documented by the entity may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures. In some rare cases, however, the absence of control activities or of other components of control may make it impossible to obtain sufficient appropriate audit evidence.

Higher Assessments of Risk (Ref: Para 7(b))

A19. 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, e.g., by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.

Tests of Controls

Designing and Performing Tests of Controls (Ref: Para. 8)

A20. Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in an assertion. If substantially different controls were used at different times during the period under audit, each is considered separately.

A21. Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.

A22. Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor's risk assessment procedures may have included:

- Inquiring about management's use of budgets.
- Observing management's comparison of monthly budgeted and actual expenses.
- Inspecting reports pertaining to the investigation of variances between budgeted and actual amounts.

These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented, but may also provide audit evidence about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses.

A23. In addition, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design, and evaluate the results of, a test to examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.

A24. In some cases, as discussed in SA 315, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level[2]. This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, paragraph 8(b) requires the auditor to perform tests of relevant controls.

[2] SA 315, paragraph 30.

Audit Evidence and Intended Reliance (Ref: Para. 9)

A25. 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 Tests of Controls

Other audit procedures in combination with inquiry (Ref: Para. 10(a))

A26. 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.

A27. 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. For other controls, however, documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed by a computer. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

Extent of tests of controls

A28. 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 tests 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.

SA 530, "Audit Sampling" contains further guidance on the extent of testing.

A29. Because of the inherent consistency of IT processing, it may not be necessary to increase the extent of testing of an automated control. An automated control can be expected to function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests might include determining that:

- Changes to the program are not made without being subject to the appropriate program change controls;
- The authorised version of the program is used for processing transactions; and
- Other relevant general controls are effective.

Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorised access has not occurred during the period.

Testing of indirect controls (Ref: Para. 10(b))

A30. In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls. For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is directly of relevance to the auditor. Controls over the accuracy of the information in the reports (for example, the general IT-controls) are described as "indirect" controls.

A31. Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated application control, when considered in combination with audit evidence about the operating effectiveness of the entity's general controls (in particular, change controls), may also provide substantial audit evidence about its operating effectiveness.

Timing of Tests of Controls

Intended period of reliance (Ref: Para. 11)

A32. 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 during an interim period (Ref: Para. 12)

A33. Relevant factors in determining what additional audit evidence to obtain about controls that were operating during the period remaining after an interim period, include:

- The significance of the assessed risks of material misstatement at the assertion level.
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes, and personnel.
- The degree to which audit evidence about the operating effectiveness of those controls was obtained.
- The length of the remaining period.
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls.
- The control environment.

A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the entity's monitoring of controls.

Using audit evidence obtained in previous audits (Ref: Para.13)

A35. In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor performs audit procedures to establish its continuing relevance. For example, in performing a previous audit, the auditor may have determined that an automated control was functioning as intended. The auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for example, inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

Controls that have changed from previous audits (Ref: Para. 14(a))

A36. Changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

Controls that have not changed from previous audits (Ref: Para. 14(b))

A37. The auditor's decision on whether to rely on audit evidence obtained in previous audits for controls that:

(a) Have not changed since they were last tested; and

(b) Are not controls that mitigate a significant risk;

is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment, but is required by paragraph 14 (b) to be at least once in every third year.

A38. In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control, or result in not relying on audit evidence obtained in previous audits at all, include the following:

- A deficient control environment.
- Deficient monitoring of controls.
- A significant manual element to the relevant controls.
- Personnel changes that significantly affect the application of the control.
- Changing circumstances that indicate the need for changes in the control.
- Deficient general IT-controls.

A39. When there are a number of controls for which the auditor intends to rely on audit evidence obtained in previous audits, testing some of those controls in each audit provides corroborating information about the continuing effectiveness of the control environment. This contributes to the auditor's decision about whether it is appropriate to rely on audit evidence obtained in previous audits.

Evaluating the Operating Effectiveness of Controls (Ref: Para.16-17)

A40. A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

A41. The concept of effectiveness of the operation of controls recognises that some deviations in the way controls are applied by the entity may occur. 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. The detected rate of deviation, in particular in comparison with the expected rate, may indicate that the control cannot be relied on to reduce risk at the assertion level to that assessed by the auditor.

Substantive Procedures (Ref: Para. 18)

A42. Paragraph 18 requires the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement. 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.

Nature and Extent of Substantive Procedures

A43. Depending on the circumstances, the auditor may determine that:

- 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 tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

A44. 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.

A45. 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.

A46. 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 tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

A47. 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. See SA 500[3].

Considering Whether External Confirmation Procedures Are to Be Performed (Ref: Para. 19)

A48. 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:

- Bank balances and other information relevant to banking relationships.
- Accounts receivable balances and terms.
- Inventories held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.

[3] SA 500, "Audit Evidence", paragraph 10.

- Accounts payable balances and terms.

A49. 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. For example, external confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence.

A50. The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters. 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.

A51. Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:

- 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.
- 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.
- 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 (Ref: Para. 20(b))

A52. 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 (Ref: Para. 21)

A53. Paragraph 21 of this SA 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. For 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.

Timing of Substantive Procedures (Ref: Para. 22-23)

A54. In most cases, audit evidence from a previous audit's substantive procedures provides little or no audit evidence for the current period. There are, however, exceptions, e.g., a legal opinion obtained in a previous audit related to the structure of a securitisation to which no changes have occurred, may be relevant in the current period. In such cases, it may be appropriate to use audit evidence from a previous audit's substantive procedures if that evidence and the related subject matter have not fundamentally changed, and audit procedures have been performed during the current period to establish its continuing relevance.

Using audit evidence obtained during an interim period (Ref: Para. 22)

A55. In some circumstances, the auditor may determine that it is effective to perform substantive procedures at an interim date, and to compare and reconcile information concerning the balance at the period end with the comparable information at the interim date to:

(a) Identify amounts that appear unusual;

(b) Investigate any such amounts; and

(c) Perform substantive analytical procedures or tests of details to test the intervening period.

A56. Performing substantive procedures at an interim date without undertaking additional procedures at a later date increases the risk that the auditor will not detect misstatements that may exist at the period end. This risk increases as the remaining period is lengthened. Factors such as the following may influence whether to perform substantive procedures at an interim date:

- The control environment and other relevant controls.
- The availability at a later date of information necessary for the auditor's procedures.
- The purpose of the substantive procedure.
- The assessed risk of material misstatement.
- The nature of the class of transactions or account balance and related assertions.
- The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period end will not be detected.

A57. Factors such as the following may influence whether to perform substantive analytical procedures with respect to the period between the interim date and the period end:

- Whether the period end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition.
- Whether the entity's procedures for analysing and adjusting such classes of transactions or account balances at interim dates and for establishing proper accounting cutoffs are appropriate.
- Whether the information system relevant to financial reporting will provide information concerning the balances at the period end and the transactions in the remaining period that is sufficient to permit investigation of:
  (a) Significant unusual transactions or entries (including those at or near the period end);
  (b) Other causes of significant fluctuations, or expected fluctuations that did not occur; and
  (c) Changes in the composition of the classes of transactions or account balances.

Misstatements detected at an interim date (Ref: Para. 23)

A58. When the auditor concludes that the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified as a result of unexpected misstatements detected at an interim date, such modification may include extending or repeating the procedures performed at the interim date at the period end.

Adequacy of Presentation and Disclosure (Ref: Para. 24)

A59. Evaluating the overall presentation of the financial statements, including the related disclosures, relates to whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information, and the form, arrangement, and content of the financial statements and their appended notes. This includes, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

Evaluating the Sufficiency and Appropriateness of Audit Evidence (Ref: Para. 25-27)

A60. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example,

- The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgment about the risk assessments and may indicate a significant deficiency in internal control.
- The auditor may become aware of discrepancies in accounting records, or conflicting or missing evidence.
- Analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognised risk of material misstatement.

In such circumstances, the auditor may need to re-evaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions. SA 315 contains further guidance on revising the auditor's risk assessment[4].

A61. The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate.

A62. The auditor's judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as the following:

- Significance of the potential misstatement in the assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
- Effectiveness of management's responses and controls to address the risks.
- Experience gained during previous audits with respect to similar potential misstatements.
- Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- Source and reliability of the available information.
- Persuasiveness of the audit evidence.

[4] SA 315, paragraph 31.

- Understanding of the entity and its environment, including the entity's internal control.

Documentation (Ref: Para. 28)

A63. The form and extent of audit documentation is a matter of professional judgment, and 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 audit.

Material Modifications to ISA 330, The Auditor's Responses to Assessed Risks

Deletion

1. Paragraph A17 of the Application Section of ISA 330 dealt with the application of the requirements of ISA 330 to the audits of public sector entities regarding the auditor's consideration of the nature, timing and extent of further audit procedures. 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 required to give special considerations regarding the nature, timing and extent as a result of the terms of appointment of the auditor or any other special reporting requirement under the statute or regulation under which the entity operates. Accordingly, the spirit of erstwhile A17, highlighting the fact that in some cases, the auditor's consideration of the nature, timing and extent of further audit procedures may be affected by the audit mandate or any other special auditing requirements, has been retained.

SA 402*
Audit Considerations relating to an Entity Using a Service Organisation

(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 user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations. Specifically, it expands on how the user auditor applies SA 315[1] and SA 330[2] in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.
2. Many entities outsource aspects of their business to organisations that provide services ranging from performing a specific task under the direction of an entity to replacing an entity's entire business units or functions, such as the tax compliance function. Many of the services provided by such organisations are integral to the entity's business operations; however, not all those services are relevant to the audit.
3. Services provided by a service organisation are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organisation are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets. A service organisation's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:
   (a) The classes of transactions in the user entity's operations that are significant to the user entity's financial statements;
   (b) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
   (c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements that are used to initiate, record, process and report the user entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger;
   (d) How the user entity's information system captures events and conditions, other than

* Published in August, 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".

transactions, that are significant to the financial statements;

(e) The financial reporting process used to prepare the user entity's financial statements, including significant accounting estimates and disclosures; and

(f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

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

5. This SA does not apply to services provided by financial institutions that are limited to processing, for an entity's account held at the financial institution, transactions that are specifically authorised by the entity, such as the processing of checking account transactions by a bank or the processing of securities transactions by a broker. In addition, this SA does not apply to the audit of transactions arising from proprietary financial interests in other entities, such as partnerships, corporations and joint ventures, when proprietary interests are accounted for and reported to interest holders.

Effective Date

6. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

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

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

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

Definitions

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

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

(b) *Report on the description and design of controls at a service organisation (referred to in this SA as a Type 1 report)* – A report that comprises:

(i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls that have been designed and implemented as at a specified date; and

(ii) 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 organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.

(c) *Report on the description, design, and operating effectiveness of controls at a service organisation (referred to in this SA as a Type 2 report)* – A report that comprises:

(i) A description, prepared by management of the service organisation, of the service organisation'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

(ii) A report by the service auditor with the objective of conveying reasonable assurance that includes:

a. The service auditor's opinion on the description of the service organisation'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

b. A description of the service auditor's tests of the controls and the results thereof.

(d) *Service auditor* – An auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation.

(e) *Service organisation* – A third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

(f) *Service organisation's system* – The policies and procedures designed, implemented and maintained by the service organisation to provide user entities with the services covered by the service auditor's report.

(g) *Subservice organisation* – A service organisation used by another service organisation to perform some of the services provided to user entities that are part of those user entities' information systems relevant to financial reporting.

(h) *User auditor* – An auditor who audits and reports on the financial statements of a user entity.

(i) *User entity* – An entity that uses a service organisation and whose financial statements are being audited.

Requirements

Obtaining an Understanding of the Services Provided by a Service Organisation, Including Internal Control

9. When obtaining an understanding of the user entity in accordance with SA 315,[3] the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including: (Ref: Para. A1-A2)

   (a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control; (Ref: Para. A3-A5)

   (b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation; (Ref: Para. A6)

   (c) The degree of interaction between the activities of the service organisation and those of the user entity; and (Ref: Para. A7)

   (d) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation. (Ref: Para. A8-A11)

10. When obtaining an understanding of internal control relevant to the audit in accordance with SA 315,[4]

[3] SA 315, paragraph 11.

[4] SA 315, paragraph 12.

the user auditor shall evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation, including those that are applied to the transactions processed by the service organisation. (Ref: Para. A12-A14)

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

12. If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures: (Ref: Para. A15-A20)

    (a) Obtaining a Type 1 or Type 2 report, if available;

    (b) Contacting the service organisation, through the user entity, to obtain specific information;

    (c) Visiting the service organisation and performing procedures that will provide the necessary information about the relevant controls at the service organisation; or

    (d) Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organisation.

Using a Type 1 or Type 2 Report to Support the User Auditor's Understanding of the Service Organisation

13. In determining the sufficiency and appropriateness of the audit evidence provided by a Type 1 or Type 2 report, the user auditor shall be satisfied as to: (Ref: Para. A21)

    (a) The service auditor's professional competence (except where the service auditor is a member of the Institute of Chartered Accountants of India) and independence from the service organisation; and

    (b) The adequacy of the standards under which the Type 1 or Type 2 report was issued.

14. If the user auditor plans to use a Type 1 or Type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organisation, the user auditor shall: (Ref: Para. A22-A23)

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

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

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

Responding to the Assessed Risks of Material Misstatement

15. In responding to assessed risks in accordance with SA 330 , the user auditor shall: (Ref: Para. A24-A28)

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

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

Tests of Controls

16. When the user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively, the user auditor shall obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures: (Ref: Para. A29-A30)

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

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

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

Using a Type 2 Report as Audit Evidence that Controls at the Service Organisation Are Operating Effectively

17. If, in accordance with paragraph 16(a), the user auditor plans to use a Type 2 report as audit evidence that controls at the service organisation are operating effectively, the user auditor shall determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by: (Ref: Para. A31-A39)

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

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

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

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

Type 1 and Type 2 Reports that Exclude the Services of a Subservice Organisation

18. If the user auditor plans to use a Type 1 or a Type 2 report that excludes the services provided by a subservice organisation and those services are relevant to the audit of the user entity's financial statements, the user auditor shall apply the requirements of this SA with respect to the services provided by the subservice organisation. (Ref: Para. A40)

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

19. The user auditor shall inquire of management of the user entity whether the service organisation has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, non-compliance with laws and regulations or uncorrected misstatements affecting the financial statements of the user entity. The user auditor shall evaluate how such matters affect the nature, timing and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report. (Ref: Para. A41)

Reporting by the User Auditor

20. The user auditor shall modify the opinion in the user auditor's report in accordance with SA 705[5] if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services

[5] SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 6.

provided by the service organisation relevant to the audit of the user entity's financial statements. (Ref: Para. A42)

21. The user auditor shall not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion. (Ref: Para. A43)

22. If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion, the user auditor's report shall indicate that such reference does not diminish the user auditor's responsibility for that opinion. (Ref: Para. A44)

Application and Other Explanatory Material

Obtaining an Understanding of the Services Provided by a Service Organisation, Including Internal Control

Sources of Information (Ref: Para. 9)

A1. Information on the nature of the services provided by a service organisation may be available from a wide variety of sources, such as:

- User manuals.
- System overviews.
- Technical manuals.
- The contract or service level agreement between the user entity and the service organisation.
- Reports by service organisations, internal auditors or regulatory authorities on controls at the service organisation.
- Reports by the service auditor, including management letters, if available.

A2. Knowledge obtained through the user auditor's experience with the service organisation, for example through experience with other audit engagements, may also be helpful in obtaining an understanding of the nature of the services provided by the service organisation. This may be particularly helpful if the services and controls at the service organisation over those services are highly standardised.

Nature of the Services Provided by the Service Organisation (Ref: Para. 9(a))

A3. A user entity may use a service organisation such as one that processes transactions and maintains related accountability, or records transactions and processes related data. Service organisations that provide such services include, for example, bank trust departments that invest and service assets for employee benefit plans or for others; mortgage bankers that service mortgages for others; and application service providers that provide packaged software applications and a technology environment that enables customers to process financial and operational transactions.

A4. Examples of service organisation services that are relevant to the audit include:

- Maintenance of the user entity's accounting records.
- Management of assets.
- Initiating, recording or processing transactions as agent of the user entity.

Considerations Specific to Smaller Entities

A5. Smaller entities may use external bookkeeping services ranging from the processing of certain transactions (e.g., payment of payroll taxes) and maintenance of their accounting records to the preparation of their financial statements. The use of such a service organisation for the preparation of its financial statements does not relieve management of the smaller entity and, where appropriate, those charged with governance of their responsibilities for the financial statements.[6]

Nature and Materiality of Transactions Processed by the Service Organisation (Ref: Para. 9(b))

A6. A service organisation may establish policies and procedures that affect the user entity's internal control. These policies and procedures are at least in part physically and operationally separate from the user entity. The significance of the controls of the service organisation to those of the user entity depends on the nature of the services provided by the service organisation, including the nature and materiality of the transactions it processes for the user entity. In certain situations, the transactions processed and the accounts affected by the service organisation may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.

The Degree of Interaction between the Activities of the Service Organisation and the User Entity (Ref: Para. 9(c))

A7. The significance of the controls of the service organisation to those of the user entity also depends on the degree of interaction between its activities and those of the user entity. The degree of interaction refers to the extent to which a user entity is able to and elects to implement effective controls over the processing performed by the service organisation. For example, a high degree of interaction exists between the activities of the user entity and those at the service organisation when the user entity authorises transactions and the service organisation processes and does the accounting for those transactions. In these circumstances, it may be practicable for the user entity to implement effective controls over those transactions. On the other hand, when the service organisation initiates or initially records, processes, and does the accounting for the user entity's transactions, there is a lower degree of interaction between the two organisations. In these circumstances, the user entity may be unable to, or may elect not to, implement effective controls over these transactions at the user entity and may rely on controls at the service organisation.

Nature of the Relationship between the User Entity and the Service Organisation (Ref: Para. 9(d))

A8. The contract or service level agreement between the user entity and the service organisation may provide for matters such as:

- The information to be provided to the user entity and responsibilities for initiating transactions relating to the activities undertaken by the service organisation;
- The application of requirements of regulatory bodies concerning the form of records to be maintained, or access to them;
- The indemnification, if any, to be provided to the user entity in the event of a performance failure;
- Whether the service organisation will provide a report on its controls and, if so, whether such report would be a Type 1 or Type 2 report;
- Whether the user auditor has rights of access to the accounting records of the user entity maintained by the service organisation and other information necessary for the conduct of the

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[6] SA 200, paragraph 4 and A2-A3.

audit; and

- Whether the agreement allows for direct communication between the user auditor and the service auditor.

A9. There is a direct relationship between the service organisation and the user entity and between the service organisation and the service auditor. These relationships do not necessarily create a direct relationship between the user auditor and the service auditor. When there is no direct relationship between the user auditor and the service auditor, communications between the user auditor and the service auditor are usually conducted through the user entity and the service organisation. A direct relationship may also be created between a user auditor and a service auditor, taking into account the relevant ethical and confidentiality considerations. A user auditor, for example, may use a service auditor to perform procedures on the user auditor's behalf, such as:

(a) Tests of controls at the service organisation; or

(b) Substantive procedures on the user entity's financial statement transactions and balances maintained by a service organisation.

A10. Auditors generally have broad rights of access established by legislation. However, there may be situations where such rights of access are not available, for example when the service organisation is located in a different jurisdiction. In such situations, the auditor may need to obtain an understanding of the legislation applicable in the different jurisdiction to determine whether appropriate access rights can be obtained. In such cases, the auditor may also obtain or ask the user entity to incorporate rights of access in any contractual arrangements between the user entity and the service organisation.

A11. In the above context, the auditors may also use another auditor to perform tests of controls or substantive procedures in relation to compliance with law, regulation or other authority.

Understanding the Controls relating to Services provided by the Service Organisation (Ref: Para. 10)

A12. The user entity may establish controls over the service organisation's services that may be tested by the user auditor and that may enable the user auditor to conclude that the user entity's controls are operating effectively for some or all of the related assertions, regardless of the controls in place at the service organisation. If a user entity, for example, uses a service organisation to process its payroll transactions, the user entity may establish controls over the submission and receipt of payroll information that could prevent or detect material misstatements. These controls may include:

- Comparing the data submitted to the service organisation with reports of information received from the service organisation after the data has been processed.
- Recomputing a sample of the payroll amounts for clerical accuracy and reviewing the total amount of the payroll for reasonableness.

A13. In this situation, the user auditor may perform tests of the user entity's controls over payroll processing that would provide a basis for the user auditor to conclude that the user entity's controls are operating effectively for the assertions related to payroll transactions.

A14. As noted in SA 315,7 in respect of some risks, the user 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 and account balances, the characteristics of which often permit highly automated

[7] SA 315, paragraph 30.

processing with little or no manual intervention. Such automated processing characteristics may be particularly present when the user entity uses service organisations. In such cases, the user entity's controls over such risks are relevant to the audit and the user auditor is required to obtain an understanding of, and to evaluate, such controls in accordance with paragraphs 9 and 10 of this SA.

Further Procedures When a Sufficient Understanding Cannot Be Obtained from the User Entity (Ref: Para. 12)

A15. The user auditor's decision as to which procedure, individually or in combination, in paragraph 12 to undertake, in order to obtain the information necessary to provide a basis for the identification and assessment of the risks of material misstatement in relation to the user entity's use of the service organisation, may be influenced by such matters as:

- The size of both the user entity and the service organisation;
- The complexity of the transactions at the user entity and the complexity of the services provided by the service organisation;
- The location of the service organisation (for example, the user auditor may decide to use another auditor to perform procedures at the service organisation on the user auditor's behalf if the service organisation is in a remote location);
- Whether the procedure(s) is expected to effectively provide the user auditor with sufficient appropriate audit evidence; and
- The nature of the relationship between the user entity and the service organisation.

A16. A service organisation may engage a service auditor to report on the description and design of its controls (Type 1 report) or on the description and design of its controls and their operating effectiveness (Type 2 report). Type 1 or Type 2 reports may be issued under Standard on Assurance Engagements (SAE) 3402[8] or under standards established by an authorised or recognised standards setting organisation (which may identify them by different names, such as Type A or Type B reports).

A17. The availability of a Type 1 or Type 2 report will generally depend on whether the contract between a service organisation and a user entity includes the provision of such a report by the service organisation. A service organisation may also elect, for practical reasons, to make a Type 1 or Type 2 report available to the user entities. However, in some cases, a Type 1 or Type 2 report may not be available to user entities.

A18. In some circumstances, a user entity may outsource one or more significant business units or functions, such as its entire tax planning and compliance functions, or finance and accounting or the controllership function to one or more service organisations. As a report on controls at the service organisation may not be available in these circumstances, visiting the service organisation may be the most effective procedure for the user auditor to gain an understanding of controls at the service organisation, as there is likely to be direct interaction of management of the user entity with management at the service organisation.

A19. Another auditor may be used to perform procedures that will provide the necessary information about the relevant controls at the service organisation. If a Type 1 or Type 2 report has been issued, the user auditor may use the service auditor to perform these procedures as the service

[8] SAE 3402, Assurance Reports on Controls at a Service Organisation.

auditor has an existing relationship with the service organisation. The user auditor using the work of another auditor may find the guidance in SA 600[9] useful as it relates to understanding another auditor (including that auditor's independence and professional competence[10]), involvement in the work of another auditor in planning the nature, extent and timing of such work, and in evaluating the sufficiency and appropriateness of the audit evidence obtained.

A20. A user entity may use a service organisation that in turn uses a sub-service organisation to provide some of the services provided to a user entity that are part of the user entity's information system relevant to financial reporting. The sub-service organisation may be a separate entity from the service organisation or may be related to the service organisation. A user auditor may need to consider controls at the sub-service organisation. In situations where one or more sub-service organisations are used, the interaction between the activities of the user entity and those of the service organisation is expanded to include the interaction between the user entity, the service organisation and the sub-service organisations. The degree of this interaction, as well as the nature and materiality of the transactions processed by the service organisation and the sub-service organisations are the most important factors for the user auditor to consider in determining the significance of the service organisation's and sub-service organisation's controls to the user entity's controls.

Using a Type 1 or Type 2 Report to Support the User Auditor's Understanding of the Service Organisation (Ref: Para. 13-14)

A21. The user auditor may make inquiries about the service auditor to the service auditor's professional organisation or other practitioners and inquire whether the service auditor is subject to regulatory oversight. The service auditor may be practicing in a jurisdiction where different standards are followed in respect of reports on controls at a service organisation, and the user auditor may obtain information about the standards used by the service auditor from the standard setting organisation.

A22. A Type 1 or Type 2 report, along with information about the user entity, may assist the user auditor in obtaining an understanding of:

(a) The aspects of controls at the service organisation that may affect the processing of the user entity's transactions, including the use of subservice organisations;

(b) The flow of significant transactions through the service organisation to determine the points in the transaction flow where material misstatements in the user entity's financial statements could occur;

(c) The control objectives at the service organisation that are relevant to the user entity's financial statement assertions; and

(d) Whether controls at the service organisation are suitably designed and implemented to prevent or detect processing errors that could result in material misstatements in the user entity's financial statements.

A Type 1 or Type 2 report may assist the user auditor in obtaining a sufficient understanding to identify and assess the risks of material misstatement. A type 1 report, however, does not provide any evidence of the operating effectiveness of the relevant controls.

A23. A Type 1 or Type 2 report that is as of a date or for a period that is outside of the reporting period

[9] SA 600, Using the Work of Another Auditor.

[10] Except where such other auditor is a member of the Institute of Chartered Accountants of India.

of a user entity may assist the user auditor in obtaining a preliminary understanding of the controls implemented at the service organisation if the report is supplemented by additional current information from other sources. If the service organisation's description of controls is as of a date or for a period that precedes the beginning of the period under audit, the user auditor may perform procedures to update the information in a Type 1 or Type 2 report, such as:

- Discussing the changes at the service organisation with user entity personnel who would be in a position to know of such changes;
- Reviewing current documentation and correspondence issued by the service organisation; or
- Discussing the changes with service organisation personnel.

Responding to the Assessed Risks of Material Misstatement (Ref: Para. 15)

A24. Whether the use of a service organisation increases a user entity's risk of material misstatement depends on the nature of the services provided and the controls over these services; in some cases, the use of a service organisation may decrease a user entity's risk of material misstatement, particularly if the user entity itself does not possess the expertise necessary to undertake particular activities, such as initiating, processing, and recording transactions, or does not have adequate resources (e.g., an IT system).

A25. When the service organisation maintains material elements of the accounting records of the user entity, direct access to those records may be necessary in order for the user auditor to obtain sufficient appropriate audit evidence relating to the operations of controls over those records or to substantiate transactions and balances recorded in them, or both. Such access may involve either physical inspection of records at the service organisation's premises or interrogation of records maintained electronically from the user entity or another location, or both. Where direct access is achieved electronically, the user auditor may thereby obtain evidence as to the adequacy of controls operated by the service organisation over the completeness and integrity of the user entity's data for which the service organisation is responsible.

A26. In determining the nature and extent of audit evidence to be obtained in relation to balances representing assets held or transactions undertaken by a service organisation on behalf of the user entity, the following procedures may be considered by the user auditor:

(a) Inspecting records and documents held by the user entity: the reliability of this source of evidence is determined by the nature and extent of the accounting records and supporting documentation retained by the user entity. In some cases, the user entity may not maintain independent detailed records or documentation of specific transactions undertaken on its behalf.

(b) Inspecting records and documents held by the service organisation: the user auditor's access to the records of the service organisation may be established as part of the contractual arrangements between the user entity and the service organisation. The user auditor may also use another auditor, on its behalf, to gain access to the user entity's records maintained by the service organisation.

(c) Obtaining confirmations of balances and transactions from the service organisation: where the user entity maintains independent records of balances and transactions, confirmation from the service organisation corroborating the user entity's records may constitute reliable audit evidence concerning the existence of the transactions and assets concerned. For example, when multiple service organisations are used, such as an investment manager and a custodian, and these service organisations maintain independent records, the user auditor may confirm balances with these organisations in order to compare this information with the independent records of the user entity.

If the user entity does not maintain independent records, information obtained in confirmations from the service organisation is merely a statement of what is reflected in the records maintained by the service organisation. Therefore, such confirmations do not, taken alone, constitute reliable audit evidence. In these circumstances, the user auditor may consider whether an alternative source of independent evidence can be identified.

(d) Performing analytical procedures on the records maintained by the user entity or on the reports received from the service organisation: the effectiveness of analytical procedures is likely to vary by assertion and will be affected by the extent and detail of information available.

A27. Another auditor may perform procedures that are substantive in nature for the benefit of user auditors. Such an engagement may involve the performance, by another auditor, of procedures agreed upon by the user entity and its user auditor and by the service organisation and its service auditor. The findings resulting from the procedures performed by another auditor are reviewed by the user auditor to determine whether they constitute sufficient appropriate audit evidence. In addition, there may be requirements imposed by governmental authorities or through contractual arrangements whereby a service auditor performs designated procedures that are substantive in nature. The results of the application of the required procedures to balances and transactions processed by the service organisation may be used by user auditors as part of the evidence necessary to support their audit opinions. In these circumstances, it may be useful for the user auditor and the service auditor to agree, prior to the performance of the procedures, to the audit documentation or access to audit documentation that will be provided to the user auditor.

A28. In certain circumstances, in particular when a user entity outsources some or all of its finance function to a service organisation, the user auditor may face a situation where a significant portion of the audit evidence resides at the service organisation. Substantive procedures may need to be performed at the service organisation by the user auditor or another auditor on its behalf. A service auditor may provide a Type 2 report and, in addition, may perform substantive procedures on behalf of the user auditor. The involvement of another auditor does not alter the user auditor's responsibility to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. Accordingly, the user auditor's consideration of whether sufficient appropriate audit evidence has been obtained and whether the user auditor needs to perform further substantive procedures includes the user auditor's involvement with, or evidence of, the direction, supervision and performance of the substantive procedures performed by another auditor.

Tests of Controls (Ref: Para. 16)

A29. The user auditor is required by SA 330[11] to design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls in certain circumstances. In the context of a service organisation, this requirement applies when:

(a) The user auditor's assessment of risks of material misstatement includes an expectation that the controls at the service organisation are operating effectively (i.e., the user auditor intends to rely on the operating effectiveness of controls at the service organisation in determining the nature, timing and extent of substantive procedures); or

(b) Substantive procedures alone, or in combination with tests of the operating effectiveness of controls at the user entity, cannot provide sufficient appropriate audit evidence at the assertion level.

A30. If a Type 2 report is not available, a user auditor may contact the service organisation, through the user

[11] SA 330, paragraph 8.

entity, to request that a service auditor be engaged to provide a Type 2 report that includes tests of the operating effectiveness of the relevant controls or the user auditor may use another auditor to perform procedures at the service organisation that test the operating effectiveness of those controls. A user auditor may also visit the service organisation and perform tests of relevant controls if the service organisation agrees to it. The user auditor's risk assessments are based on the combined evidence provided by the work of another auditor and the user auditor's own procedures.

Using a Type 2 Report as Audit Evidence that Controls at the Service Organisation Are Operating Effectively (Ref: Para. 17)

A31. A Type 2 report may be intended to satisfy the needs of several different user auditors; therefore tests of controls and results described in the service auditor's report may not be relevant to assertions that are significant in the user entity's financial statements. The relevant tests of controls and results are evaluated to determine that the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment. In doing so, the user auditor may consider the following factors:

(a) The time period covered by the tests of controls and the time elapsed since the performance of the tests of controls;

(b) The scope of the service auditor's work and the services and processes covered, the controls tested and tests that were performed, and the way in which tested controls relate to the user entity's controls; and

(c) The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

A32. For certain assertions, the shorter the period covered by a specific test and the longer the time elapsed since the performance of the test, the less audit evidence the test may provide. In comparing the period covered by the Type 2 report to the user entity's financial reporting period, the user auditor may conclude that the Type 2 report offers less audit evidence if there is little overlap between the period covered by the Type 2 report and the period for which the user auditor intends to rely on the report. When this is the case, a Type 2 report covering a preceding or subsequent period may provide additional audit evidence. In other cases, the user auditor may determine it is necessary to perform, or use another auditor to perform, tests of controls at the service organisation in order to obtain sufficient appropriate audit evidence about the operating effectiveness of those controls.

A33. It may also be necessary for the user auditor to obtain additional evidence about significant changes to the relevant controls at the service organisation outside of the period covered by the Type 2 report or determine additional audit procedures to be performed. Relevant factors in determining what additional audit evidence to obtain about controls at the service organisation that were operating outside of the period covered by the service auditor's report may include:

- The significance of the assessed risks of material misstatement at the assertion level;
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes, and personnel;
- The degree to which audit evidence about the operating effectiveness of those controls was obtained;
- The length of the remaining period;
- The extent to which the user auditor intends to reduce further substantive procedures based on the reliance on controls; and

- The effectiveness of the control environment and monitoring of controls at the user entity.

A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the user entity's monitoring of controls.

A35. If the service auditor's testing period is completely outside the user entity's financial reporting period, the user auditor will be unable to rely on such tests for the user auditor to conclude that the user entity's controls are operating effectively because they do not provide current audit period evidence of the effectiveness of the controls, unless other procedures are performed.

A36. In certain circumstances, a service provided by the service organisation may be designed with the assumption that certain controls will be implemented by the user entity. For example, the service may be designed with the assumption that the user entity will have controls in place for authorising transactions before they are sent to the service organisation for processing. In such a situation, the service organisation's description of controls may include a description of those complementary user entity controls. The user auditor considers whether those complementary user entity controls are relevant to the service provided to the user entity.

A37. If the user auditor believes that the service auditor's report may not provide sufficient appropriate audit evidence, for example, if a service auditor's report does not contain a description of the service auditor's tests of controls and results thereon, the user auditor may supplement the understanding of the service auditor's procedures and conclusions by contacting the service organisation, through the user entity, to request a discussion with the service auditor about the scope and results of the service auditor's work. Also, if the user auditor believes it is necessary, the user auditor may contact the service organisation, through the user entity, to request that the service auditor perform procedures at the service organisation. Alternatively, the user auditor, or another auditor at the request of the user auditor, may perform such procedures.

A38. The service auditor's Type 2 report identifies results of tests, including exceptions and other information that could affect the user auditor's conclusions. Exceptions noted by the service auditor or a modified opinion in the service auditor's Type 2 report do not automatically mean that the service auditor's Type 2 report will not be useful for the audit of the user entity's financial statements in assessing the risks of material misstatement. Rather, the exceptions and the matter giving rise to a modified opinion in the service auditor's Type 2 report are considered in the user auditor's assessment of the testing of controls performed by the service auditor. In considering the exceptions and matters giving rise to a modified opinion, the user auditor may discuss such matters with the service auditor. Such communication is dependent upon the user entity contacting the service organisation, and obtaining the service organisation's approval for the communication to take place.

Communication of Deficiencies in Internal Control identified during the Audit

A39. The user auditor is required to communicate in writing significant deficiencies identified during the audit to both management and those charged with governance on a timely basis.[12] The user auditor is also required to communicate to management at an appropriate level of responsibility on a timely basis other deficiencies in internal control identified during the audit that, in the user auditor's professional judgment, are of sufficient importance to merit management's attention.[13] Matters that the user auditor may identify during the audit and may communicate to management and those charged with governance of the user entity include:

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[12] SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", paragraph 9 and 10.

[13] SA 265, paragraph 9.

- Any monitoring of controls that could be implemented by the user entity, including those identified as a result of obtaining a Type 1 or Type 2 report;
- Instances where complementary user entity controls are noted in the Type 1 or Type 2 report and are not implemented at the user entity; and
- Controls that may be needed at the service organisation that do not appear to have been implemented or that are not specifically covered by a Type 2 report.

Type 1 and Type 2 Reports that Exclude the Services of a Subservice Organisation (Ref: Para. 18)

A40. If a service organisation uses a subservice organisation, the service auditor's report may either include or exclude the subservice organisation's relevant control objectives and related controls in the service organisation's description of its system and in the scope of the service auditor's engagement. These two methods of reporting are known as the inclusive method and the carve-out method, respectively. If the Type 1 or Type 2 report excludes the controls at a subservice organisation, and the services provided by the subservice organisation are relevant to the audit of the user entity's financial statements, the user auditor is required to apply the requirements of this SA in respect of the subservice organisation. The nature and extent of work to be performed by the user auditor regarding the services provided by a subservice organisation depend on the nature and significance of those services to the user entity and the relevance of those services to the audit. The application of the requirement in paragraph 9 assists the user auditor in determining the effect of the subservice organisation and the nature and extent of work to be performed.

Fraud, Non-Compliance with Laws and Regulations and Uncorrected Misstatements in Relation to Activities at the Service Organisation (Ref: Para. 19)

A41. A service organisation may be required under the terms of the contract with user entities to disclose to affected user entities any fraud, non-compliance with laws and regulations or uncorrected misstatements attributable to the service organisation's management or employees. As required by paragraph 19, the user auditor makes inquiries of the user entity management regarding whether the service organisation has reported any such matters and evaluates whether any matters reported by the service organisation affect the nature, timing and extent of the user auditor's further audit procedures. In certain circumstances, the user auditor may require additional information to perform this evaluation, and may request the user entity to contact the service organisation to obtain the necessary information.

Reporting by the User Auditor (Ref: Para. 20)

A42. When a user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements, a limitation on the scope of the audit exists. This may be the case when:

- The user auditor is unable to obtain a sufficient understanding of the services provided by the service organisation and does not have a basis for the identification and assessment of the risks of material misstatement;
- A user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively and the user auditor is unable to obtain sufficient appropriate audit evidence about the operating effectiveness of these controls; or
- Sufficient appropriate audit evidence is only available from records held at the service organisation, and the user auditor is unable to obtain direct access to these records.

Whether the user auditor expresses a qualified opinion or disclaims an opinion depends on the user auditor's conclusion as to whether the possible effects on the financial statements are material or pervasive.

Reference to the Work of a Service Auditor (Ref: Para. 21-22)

A43. In some cases, law or regulation may require a reference to the work of a service auditor in the user auditor's report, for example, for the purposes of transparency in the public sector. In such circumstances, the user auditor may need the consent of the service auditor before making such a reference.

A44. The fact that a user entity uses a service organisation does not alter the user auditor's responsibility under SAs to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. Therefore, the user auditor does not make reference to the service auditor's report as a basis, in part, for the user auditor's opinion on the user entity's financial statements. However, when the user auditor expresses a modified opinion because of a modified opinion in a service auditor's report, the user auditor is not precluded from referring to the service auditor's report if such reference assists in explaining the reason for the user auditor's modified opinion. In such circumstances, the user auditor may need the consent of the service auditor before making such a reference.

Material Modifications to ISA 402, "Audit Considerations Relating to an Entity Using a Service Organisation"

1. Paragraphs A10 and A11 of ISA 402 deal with the application of the requirements of ISA 402 to public sector auditors who have broad rights of access established by legislation. 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 the situation envisaged in paragraphs A10 and A11 may be possible even in case of auditors of non-public sector entities, the spirit of paragraphs A10 and A11 has been retained and made generic.

2. Paragraph 13 (a) and paragraph A19 of ISA 402 deal with assessment of the service auditor's professional competence and independence from the service organisation for obtaining sufficient and appropriate audit evidence and for reporting purposes. The corresponding paragraphs of SA 402 also require such assessment of professional competence except where the service auditor is also a member of the Institute of Chartered Accountants of India.

SA 450*

Evaluation of Misstatements Identified during the 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 evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. SA 700 (Revised)[1] deals with the auditor's responsibility, in forming an opinion on the financial statements, to conclude whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement. The auditor's conclusion required by SA 700 (Revised) takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with this SA. SA 320[2] deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing 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 evaluate:

   (a) The effect of identified misstatements on the audit; and

   (b) The effect of uncorrected misstatements, if any, on the financial statements.

Definitions

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

   (a) Misstatement – A difference between the amounts, 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. (Ref: Para. A1)

   When the auditor expresses an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material respects, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to give a true and fair view or present fairly, in all material respects.

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* Published in August, 2009 issue of the Journal.

[1] 700, "Forming an Opinion and Reporting on Financial Statements", paragraphs 10-11.

[2] SA 320, "Materiality in Planning and Performing an Audit".

(b) Uncorrected misstatements – Misstatements that the auditor has accumulated during the audit and that have not been corrected.

Requirements

Accumulation of Identified Misstatements

5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. (Ref: Para. A2-A3)

Consideration of Identified Misstatements as the Audit Progresses

6. The auditor shall determine whether the overall audit strategy and audit plan need to be revised if:

   (a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or (Ref: Para. A4)

   (b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320. (Ref: Para. A5)

7. If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain. (Ref: Para. A6)

Communication and Correction of Misstatements

8. The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation[3].The auditor shall request management to correct those misstatements .(Ref: Para. A7-A9)

9. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. (Ref: Para. A 10)

Evaluating the Effect of Uncorrected Misstatements

10. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with SA 320 to confirm whether it remains appropriate in the context of the entity's actual financial results. (Ref: Para. A11-A12)

11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

   (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and (Ref: Para. A13-A17, A19-A20)

   (b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. (Ref: Para. A18)

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[3] SA 260, "Communication with Those Charged with Governance", paragraph A4.

Communication with Those Charged with Governance

12. The auditor shall communicate with those charged with governance[4] uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A21-A23)

13. The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Written Representation

14. The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation. (Ref: Para. A24)

Documentation

15. The audit documentation shall include: (Ref: Para. A25)
    (a) The amount below which misstatements would be regarded as clearly trivial (paragraph 5);
    (b) All misstatements accumulated during the audit and whether they have been corrected (paragraphs 5,8 and 12); and
    (c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion. (paragraph 11)

Application and Other Explanatory Material

Misstatements (Ref: Para. 4(a))

A1. Misstatements may result from:
    (a) An inaccuracy in gathering or processing data from which the financial statements are prepared;
    (b) An omission of an amount or disclosure;
    (c) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts; and
    (d) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

    Examples of misstatements arising from fraud are provided in SA 240.[5]

Accumulation of Identified Misstatements (Ref: Para. 5)

A2. The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. "Clearly trivial" is not another

[4] In accordance with the paragraph 9 of SA 260, "Communication with Those Charged with Governance," if this matter has been communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matter need not be communicated again with those same person(s) in their governance role.

[5] SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraphs A1-A6.

expression for "not material". Matters that are "clearly trivial" will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with SA 320, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

A3. To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.

- Factual misstatements are misstatements about which there is no doubt.
- Judgmental misstatements are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.
- Projected misstatements are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in SA 530[6].

Consideration of Identified Misstatements as the Audit Progresses (Ref: Para. 6-7)

A4. A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.

A5. If the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320, there may be a greater than an acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed the materiality. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk.7

A6. The auditor may request management to examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor, perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to the financial statements. Such a request may be made, for example, based on the auditor's projection of misstatements identified in an audit sample to the entire population from which it was drawn.

Communication and Correction of Misstatements (Ref: Para. 8-9)

A7. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and to take the necessary action.

A8. Law or regulation may restrict the auditor's communication of certain misstatements to management, or others, within the entity. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of

[6] SA 530, "Audit Sampling", paragraphs 14-15.

[7] SA 530, paragraphs 5(c) and (d).

confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.

A9. The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

A10. SA 700 (Revised) requires the auditor to evaluate whether the financial statements are prepared and presented, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments[8], which may be affected by the auditor's understanding of management's reasons for not making the corrections.

Evaluating the Effect of Uncorrected Misstatements (Ref: Para. 10-11)

A11. The auditor's determination of the materiality in accordance with SA 320 is often based on estimates of the entity's financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with SA 320 based on the actual financial results.

A12. SA 320 explains that, as the audit progresses, the 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) is revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially[9]. Thus, any significant revision is likely to have been made before the auditor evaluates the effect of uncorrected misstatements. However, if the auditor's reassessment of materiality determined in accordance with SA 320 (see paragraph 10 of this SA) gives rise to a lower amount (or amounts), then performance materiality and the appropriateness of the nature, timing and extent of the further audit procedures, are reconsidered so as to obtain sufficient appropriate audit evidence on which to base the audit opinion.

A13. Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.

A14. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate[10].

A15. Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as the effect of the classification misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals, or the effect on key ratios. There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels

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[8] Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 12.

[9] SA 320, paragraph 12.

[10] The identification of a number of immaterial misstatements within the same account balance or class of transactions may require the auditor to re-assess the risk of material misstatement for that account balance or class of transactions.

applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.

A16. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than the materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which the misstatement:

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
- Makes a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is significant having regard to the auditor's understanding of known previous communications to users, for example in relation to forecast earnings;
- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity; or
- Affects other information that will be communicated in documents containing the audited financial statements (for example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to influence the economic decisions of the users of the financial statements. SA 720[11] deals with the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

These circumstances are only examples; not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

[11] SA 720, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements".

A17. SA 240[12], explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements.

A18. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. There are different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements. Using the same evaluation approach provides consistency from period to period.

A19. In the case of an audit of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the evaluation whether a misstatement is material may also be affected by legislation or regulation and additional responsibilities for the auditor to report other matters, including, for example, fraud.

A20. Furthermore, issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, may affect the assessment whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with regulation, legislation or other authority.

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

A21. If uncorrected misstatements have been communicated with person(s) with management responsibilities and those person(s) also have governance responsibilities, they need not be communicated again with those same person(s) in their governance role. The auditor nonetheless has to be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.[13]

A22. Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.

A23. SA 260 requires the auditor to communicate with those charged with governance the written representations the auditor is requesting (see paragraph 14 of this SA).[14] The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, and possible implications in relation to future financial statements.

Written Representation (Ref: Para. 14)

A24. Because management and, where appropriate, those charged with governance are responsible for adjusting the financial statements to correct material misstatements, the auditor is required to request them to provide a written representation about uncorrected misstatements. In some circumstances, management and, where appropriate, those charged with governance may not believe that certain uncorrected misstatements are misstatements. For that reason, they may want to add to their written representation words such as: "We do not agree that items ………and …………… constitute misstatements because [*description of reasons*]." Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

Documentation (Ref: Para. 15)

A25. The auditor's documentation of uncorrected misstatements may take into account:

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[12] SA 240, paragraph 35.

[13] SA 260, paragraph 9.

[14] SA 260, paragraph 12(c)(iii).

(a) The consideration of the aggregate effect of uncorrected misstatements;

(b) The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and

(c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

Material Modifications to ISA 450, "Evaluation of Misstatements Identified during the Audit"

Deletions

Paragraph A19 of ISA 450 states that in the case of an audit of public sector entities, the evaluation whether a misstatement is material may also be affected by legislation or regulation and additional responsibilities for the auditor to report other matters, including, for example, fraud. 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 erstwhile A19, highlighting such fact, has been retained though a specific reference to public sector entities has been deleted.

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 315[1]), the audit evidence to be obtained in relation to a particular topic (for example, SA 570[2]), specific procedures to obtain audit evidence (for example, SA 520[3]), and the evaluation of whether sufficient appropriate audit evidence has been obtained (SA 200 and SA 330[4]).

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

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[*] 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".

opinion is based. Audit evidence includes both information contained in the accounting records 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.

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[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 relevance[8].

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.

[8] SA 330, paragraph A35.

A16. 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

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. Reperformance 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.

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[11] SA 580, "Written Representations".

Reliability

A31. 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.

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

[12] SA 520, paragraph 5 (a).

[13] SA 240,"The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph 13.

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 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 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.

[14] SA 620, "Using the Work of an Auditor's Expert", paragraph 7.

- 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 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)

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.

[15] SA 530, "Audit Sampling".

[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 330[1], SA 500[2] 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.

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* 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 705[3]. (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 620[4] 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

[4] SA 620, "Using the Work of an Auditor's Expert".

either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory 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 date[5].

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 200[6], 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 limitation[7].

Inventory under the Custody and Control of a Third Party

Confirmation (Ref: Para. 8(a))

A15. SA 505[8] 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

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[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".

procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures 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 540[9] 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

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

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 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 700[10], 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 330[1] and SA 500[2]. It does not address inquiries regarding litigation and claims. SA 501[3] 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 obtained[4]. That SA also includes the following generalisations applicable to audit evidence [5]:

- 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 level[6]. In addition, SA 330 requires that,

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* 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 procedures[7].

- SA 330 requires that the auditor obtain more persuasive audit evidence the higher the auditor's assessment of risk[8]. 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 error[9].
- 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 level[10].
- 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 management[11].

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.

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[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 260[12]. The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705[13].

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)

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[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 315[14]. 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 240[15].

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 reliability[16]. 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 evidence[17]. 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

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[14] SA 315, paragraph 31.

[15] SA 240, paragraph 24.

[16] SA 500, paragraph A31.

[17] SA 500, paragraph 11.

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.

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 315[18]. For example, an unreliable response may indicate a fraud risk factor that requires evaluation in accordance with SA 240[19].

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 315[20]. 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 240[21].

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 fraud[22]. Exceptions may provide a guide to the

[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.

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)

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 330[23].

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 710[1] also apply. SA 300[2] 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.

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* 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 Loss[3];

(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 450[4].

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]

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[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".

Audit Conclusions and Reporting

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

[6] SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

misstatements in opening balances is indicated.

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

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* Profit & Loss Account.

* Balance Sheet.

to the current period or, when appropriate, have been restated. 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.

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*

<u>Illustration 1</u>:

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 Statements[8]

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 presentation[10] 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.

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[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)
(Designation[12])
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.**

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[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 Statements[14]

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[15] 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 presentation[16] 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.

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[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)
(Designation[18])
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 315[1]. 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 procedures[2].

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 330[3], the auditor shall: (Ref: Para. A4-A5)

(a) Determine the suitability of particular substantive analytical procedures for given assertions, taking

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*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 Reponses 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 entity[4];

(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 procedures[5].

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 date[6].

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

[4] SA 500, "Audit Evidence", paragraph A31.

[5] SA 500, paragraph 10.

[6] SA 330, paragraphs 22-23.

period to another than in comparing discretionary expenses, such as research or advertising.

- 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 materiality[7] 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 risk[8]. Accordingly, as the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence[9].

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 accordingly[10].

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.

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[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.

Appendix

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 500[1], 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.

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* 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 320[2], 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.

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[2] SA 320, "Materiality in Planning and Performing an Audit", paragraph 9.

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 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 330[3] 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

[3] SA 330, "The Auditor's Responses to Assessed Risks", paragraphs 17 and A41.

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.

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 a 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 50^{th} 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 540*

Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

(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 regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315[1] and SA 330[2] and other relevant SAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

Nature of Accounting Estimates

2. Some financial statement items cannot be measured precisely, but can only be estimated. For purposes of this SA, such financial statement items are referred to as accounting estimates. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias. *(Ref: Para. A1-A11)*

3. The measurement objective of accounting estimates can vary depending on the applicable financial reporting framework and the financial item being reported. The measurement objective for some accounting estimates is to forecast the outcome of one or more transactions, events or conditions giving rise to the need for the accounting estimate. For other accounting estimates, including many fair value accounting estimates, the measurement objective is different, and is expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability. For example, the applicable financial reporting framework may require fair value measurement based on an assumed hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as "marketplace participants" or equivalent) in an arm's length transaction, rather than the settlement of a transaction at some past or future date.[3]

4. A difference between the outcome of an accounting estimate and the amount originally recognised or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is

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* Published in February, 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] Different definitions of fair value may exist among financial reporting frameworks.

invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

Effective Date

5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective

6. The objective of the auditor is to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework:

(a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and

(b) related disclosures in the financial statements are adequate.

Definitions

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

(a) ***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 this SA addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used.

(b) ***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.

(c) ***Estimation uncertainty*** – The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

(d) ***Management bias*** – A lack of neutrality by management in the preparation and presentation of information.

(e) ***Management's point estimate*** – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

(f) ***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.

Requirements

Risk Assessment Procedures and Related Activities

8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by SA 315,[4] the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates: *(Ref: Para. A12)*

(a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures. *(Ref: Para. A13-A15)*

(b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that

[4] SA 315, paragraphs 5-6 and 11-12.

may give rise to new, or the need to revise existing, accounting estimates. *(Ref: Para. A16-A21)*

(c) How management makes the accounting estimates, and an understanding of the data on which they are based, including: *(Ref: Para. A22-A23)*

(i) The method, including where applicable the model, used in making the accounting estimate; *(Ref: Para. A24-A26)*

(ii) Relevant controls; *(Ref: Para. A27-A28)*

(iii) Whether management has used an expert; *(Ref: Para. A29-A30)*

(iv) The assumptions underlying the accounting estimates; *(Ref: Para. A31-A36)*

(v) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and *(Ref: Para. A37)*

(vi) Whether and, if so, how management has assessed the effect of estimation uncertainty. *(Ref: Para. A38)*

9. The auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time. *(Ref: Para. A39-A44)*

Identifying and Assessing the Risks of Material Misstatement

10. In identifying and assessing the risks of material misstatement, as required by SA 315,[5] the auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate. *(Ref: Para. A45-A46)*

11. The auditor shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks. *(Ref: Para. A47-A51)*

Responses to the Assessed Risks of Material Misstatement

12. Based on the assessed risks of material misstatement, the auditor shall determine: *(Ref: Para. A52)*

(a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and *(Ref: Para. A53-A56)*

(b) Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances. *(Ref: Para. A57-A58)*

13. In responding to the assessed risks of material misstatement, as required by SA 330,[6] the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate: *(Ref: Para. A59- A61)*

(a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate. *(Ref: Para. A62-A67)*

(b) Test how management made the accounting estimate and the data on which it is based. In doing so,

[5] SA 315, paragraph 25.

[6] SA 330, paragraph 5.

the auditor shall evaluate whether: *(Ref: Para. A68-A70)*

(i) The method of measurement used is appropriate in the circumstances; and *(Ref: Para. A71-A76)*

(ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework. *(Ref: Para. A77-A83)*

(c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures. (Ref: Para. A84- A86)

(d) Develop a point estimate or a range to evaluate management's point estimate. For this purpose: (Ref: Para. A87-A91)

(i) When the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. *(Ref: Para. A92)*

(ii) When the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. *(Ref: Para. A93-A95)*

14. In determining the matters identified in paragraph 12 or in responding to the assessed risks of material misstatement in accordance with paragraph 13, the auditor shall consider whether specialised skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence. *(Ref: Para. A96-A101)*

Further Substantive Procedures to Respond to Significant Risks

Estimation Uncertainty

15. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of SA 330,[7] the auditor shall evaluate the following: *(Ref: Para. A102)*

(a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate. *(Ref: Para. A103-A106)*

(b) Whether the significant assumptions used by management are reasonable. *(Ref: Para A107-A109)*

(c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so. *(Ref: Para. A110)*

16. If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate. *(Ref: Para. A111-A112)*

Recognition and Measurement Criteria

17. For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence whether the following are in accordance with the requirements of the applicable financial reporting framework:

(a) management's decision to recognise, or to not recognise, the accounting estimates in the financial

[7] SA 330, paragraph 18.

statements; and *(Ref: Para. A113-A114)*

(b) the selected measurement basis for the accounting estimates. *(Ref: Para. A115)*

Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements

18. The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated. *(Ref: Para. A116-A119)*

Disclosures Related to Accounting Estimates

19. The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. *(Ref: Para. A120-A121)*

20. For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework. *(Ref: Para. A122-A123)*

Indicators of Possible Management Bias

21. The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates. *(Ref: Para. A124-A125)*

Written Representations

22. The auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable. *(Ref: Para. A126-A127)*

Documentation

23. The audit documentation shall include:

(a) The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and

(b) Indicators of possible management bias, if any. *(Ref: Para. A128)*

Application and Other Explanatory Material

Nature of Accounting Estimates (Ref: Para. 2)

A1. Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific. The Appendix to this SA discusses fair value measurements and disclosures under different financial reporting frameworks.

A2. Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.

- Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as "observable" in the context of a fair value accounting estimate.
- Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.
- Fair value accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.

A3. For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.
- Fair value accounting estimates for which a highly specialised entity-developed model is used or for which there are assumptions or inputs that cannot be observed in the marketplace.

A4. The degree of estimation uncertainty varies based on the nature of the accounting estimate, the extent to which there is a generally accepted method or model used to make the accounting estimate, and the subjectivity of the assumptions used to make the accounting estimate. In some cases, estimation uncertainty associated with an accounting estimate may be so great that the recognition criteria in the applicable financial reporting framework are not met and the accounting estimate cannot be made.

A5. Not all financial statement items requiring measurement at fair value, involve estimation uncertainty. For example, this may be the case for some financial statement items where there is an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur, in which case the existence of published price quotations ordinarily is the best audit evidence of fair value. However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant in relation to the market or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.

A6. Additional examples of situations where accounting estimates, other than fair value accounting estimates, may be required include:

- Allowance for doubtful accounts.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
- Outcome of long term contracts.
- Financial Obligations / Costs arising from litigation settlements and judgments.

A7. Additional examples of situations where fair value accounting estimates may be required include:

- Complex financial instruments, which are not traded in an active and open market.
- Share-based payments.

- Property or equipment held for disposal.
- Certain assets or liabilities acquired in a business combination, including goodwill and intangible assets.
- Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration, for example, a non-monetary exchange of plant facilities in different lines of business.

A8. Estimation involves judgments based on information available when the financial statements are prepared. For many accounting estimates, these include making assumptions about matters that are uncertain at the time of estimation. The auditor is not responsible for predicting future conditions, transactions or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management.

Management Bias

A9. Financial reporting frameworks often call for neutrality, that is, freedom from bias. Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired result). The susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

A10. Management bias can be difficult to detect at an account level. It may only be identified when considered in the aggregate of groups of accounting estimates or all accounting estimates, or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, in making such judgments there may be no intention by management to mislead the users of financial statements. Where, however, there is intention to mislead, management bias is fraudulent in nature.

A11. Certain entities such as, Central/State governments and related government entities (for example, agencies, boards, commissions) may have significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement at fair value or other current value bases, or a combination of both. Often specialised assets held do not generate cash flows and do not have an active market. Measurement at fair value therefore ordinarily requires estimation and may be complex, and in some rare cases may not be possible at all.

Risk Assessment Procedures and Related Activities (Ref: Para. 8)

A12. The risk assessment procedures and related activities required by paragraph 8 of this SA assist the auditor in developing an expectation of the nature and type of accounting estimates that an entity may have. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to identify and assess the risks of material misstatement in relation to accounting estimates, and to plan the nature, timing and extent of further audit procedures.

Obtaining an Understanding of the Requirements of the Applicable Financial Reporting Framework (Ref: Para. 8(a))

A13. Obtaining an understanding of the requirements of the applicable financial reporting framework assists the auditor in determining whether it, for example:

- Prescribes certain conditions for the recognition,8 or methods for the measurement, of accounting estimates.
- Specifies certain conditions that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability.
- Specifies required or permitted disclosures.

Obtaining this understanding also provides the auditor with a basis for discussion with management about how management has applied those requirements relevant to the accounting estimate, and the auditor's determination of whether they have been applied appropriately.

A14. Financial reporting frameworks may provide guidance for management on determining point estimates where alternatives exist. Some financial reporting frameworks, for example, require that the point estimate selected be the alternative that reflects management's judgment of the most likely outcome.[9] Others may require, for example, use of a discounted probability-weighted expected value. In some cases, management may be able to make a point estimate directly. In other cases, management may be able to make a reliable point estimate only after considering alternative assumptions or outcomes from which it is able to determine a point estimate.

A15. Financial reporting frameworks may require the disclosure of information concerning the significant assumptions to which the accounting estimate is particularly sensitive. Furthermore, where there is a high degree of estimation uncertainty, some financial reporting frameworks do not permit an accounting estimate to be recognised in the financial statements, but certain disclosures may be required in the notes to the financial statements.

Obtaining an Understanding of How Management Identifies the Need for Accounting Estimates (Ref: Para. 8(b))

A16. In preparing the financial statements, management has the responsibility to determine whether a transaction, event or condition gives rise to the need to make an accounting estimate, and that all necessary accounting estimates have been recognised, measured and disclosed in the financial statements in accordance with the applicable financial reporting framework.

A17. Management's identification of transactions, events and conditions that give rise to the need for accounting estimates is likely to be based on:

- Management's knowledge of the entity's business and the industry in which it operates.
- Management's knowledge of the implementation of business strategies in the current period.
- Where applicable, management's cumulative experience of preparing the entity's financial statements in prior periods.

In such cases, the auditor may obtain an understanding of how management identifies the need for accounting estimates primarily through inquiry of management. In other cases, where management's process is more structured, for example, when management has a formal risk management function, the auditor may perform risk assessment procedures directed at the methods and practices followed by management for periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting

[8] Most financial reporting frameworks require incorporation in the balance sheet or income statement of items that satisfy their criteria for recognition. Disclosure of accounting policies or adding notes to the financial statements does not rectify a failure to recognise such items, including accounting estimates.

[9] Different financial reporting frameworks may use different terminology to describe point estimates determined in this way.

estimates as necessary. The completeness of accounting estimates is often an important consideration for the auditor particularly accounting estimates relating to liabilities.

A18. The auditor's understanding of the entity and its environment obtained during the performance of risk assessment procedures, together with other audit evidence obtained during the course of the audit, assist the auditor in identifying circumstances, or changes in circumstances, that may give rise to the need for an accounting estimate.

A19. Inquiries of management about changes in circumstances may include, for example, inquiries about whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- Terms of transactions that gave rise to accounting estimates have changed.
- Accounting policies relating to accounting estimates have changed, as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

A20. During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. SA 315 deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to the entity's risk assessment processes.[10]

Considerations Specific to Smaller Entities

A21. Obtaining this understanding for smaller entities is often less complex as their business activities are often limited and transactions are less complex. Further, often a single person, for example the owner-manager, identifies the need to make an accounting estimate and the auditor may focus inquiries accordingly.

Obtaining an Understanding of How Management Makes the Accounting Estimates (Ref: Para. 8(c))

A22. Management is responsible for establishing financial reporting processes for making accounting estimates, including adequate internal control. Such processes include the following:

- Selecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation methods, including, where applicable, models.
- Developing or identifying relevant data and assumptions that affect accounting estimates.
- Periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary.

A23. Matters that the auditor may consider in obtaining an understanding of how management makes the accounting estimates include, for example:

- The types of accounts or transactions to which the accounting estimates relate (for example, whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions).

[10] SA 315, paragraph 16.

- Whether and, if so, how management has used recognised measurement techniques for making particular accounting estimates.
- Whether the accounting estimates were made based on data available at an interim date and, if so, whether and how management has taken into account the effect of events, transactions and changes in circumstances occurring between that date and the period end.

Method of Measurement, Including the Use of Models (Ref: Para. 8(c)(i))

A24. In some cases, the applicable financial reporting framework may prescribe the method of measurement for an accounting estimate, for example, a particular model that is to be used in measuring a fair value estimate. In many cases, however, the applicable financial reporting framework does not prescribe the method of measurement, or may specify alternative methods for measurement.

A25. When the applicable financial reporting framework does not prescribe a particular method to be used in the circumstances, matters that the auditor may consider in obtaining an understanding of the method or, where applicable the model, used to make accounting estimates include, for example:

- How management selects a particular method considering the nature of the asset or liability being estimated.
- Whether the entity operates in a particular business, industry or environment in which there are methods commonly used to make the particular type of accounting estimate.

A26. There may be greater risks of material misstatement, for example, in cases when management has internally developed a model to be used to make the accounting estimate or is departing from a method commonly used in a particular industry or environment.

Relevant Controls (Ref: Para. 8(c)(ii))

A27. Matters that the auditor may consider in obtaining an understanding of relevant controls include, for example, the experience and competence of those who make the accounting estimates, and controls related to:

- How management determines the completeness, relevance and accuracy of the data used to develop accounting estimates.
- The review and approval of accounting estimates, including the assumptions or inputs used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
- The segregation of duties between those committing the entity to the underlying transactions and those responsible for making the accounting estimates, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services (for example, in the case of a large financial institution, relevant segregation of duties may include an independent function responsible for estimation and validation of fair value pricing of the entity's proprietary financial products staffed by individuals whose remuneration is not tied to such products).

A28. Other controls may be relevant to making the accounting estimates depending on the circumstances. For example, if the entity uses specific models for making accounting estimates, management may put into place specific policies and procedures around such models. Relevant controls may include, for example, those established over:

- The design and development, or selection, of a particular model for a particular purpose.
- The use of the model.
- The maintenance and periodic validation of the integrity of the model.

Management's Use of Experts (Ref: Para. 8(c)(iii))

A29. Management may have, or the entity may employ individuals with, the experience and competence necessary to make the required point estimates. In some cases, however, management may need to engage an expert to make, or assist in making, them. This need may arise because of, for example:

- The specialised nature of the matter requiring estimation, for example, the measurement of mineral or hydrocarbon reserves in extractive industries.
- The technical nature of the models required to meet the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements at fair value.
- The unusual or infrequent nature of the condition, transaction or event requiring an accounting estimate.

Considerations Specific to Smaller Entities

A30. In smaller entities, the circumstances requiring an accounting estimate often are such that the owner-manager is capable of making the required point estimate. In some cases, however, an expert will be needed. Discussion with the owner-manager early in the audit process about the nature of any accounting estimates, the completeness of the required accounting estimates, and the adequacy of the estimating process may assist the owner manager in determining the need to use an expert.

Assumptions (Ref: Para. 8(c)(iv))

A31. Assumptions are integral components of accounting estimates. Matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates include, for example:

- The nature of the assumptions, including which of the assumptions are likely to be significant assumptions.
- How management assesses whether the assumptions are relevant and complete (that is, that all relevant variables have been taken into account).
- Where applicable, how management determines that the assumptions used are internally consistent.
- Whether the assumptions relate to matters within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life), and how they conform to the entity's business plans and the external environment, or to matters that are outside its control (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).
- The nature and extent of documentation, if any, supporting the assumptions.

Assumptions may be made or identified by an expert to assist management in making the accounting estimates. Such assumptions, when used by management, become management's assumptions.

A32. In some cases, assumptions may be referred to as inputs, for example, where management uses a model to make an accounting estimate, though the term inputs may also be used to refer to the underlying data to which specific assumptions are applied.

A33. Management may support assumptions with different types of information drawn from internal and external sources, the relevance and reliability of which will vary. In some cases, an assumption may be reliably based on applicable information from either external sources (for example, published interest rate or other statistical data) or internal sources (for example, historical information or previous conditions experienced by the entity). In other cases, an assumption may be more subjective, for example, where the entity has no experience or external sources from which to draw.

A34. In the case of fair value accounting estimates, assumptions reflect, or are consistent with, what knowledgeable, willing arm's length parties (sometimes referred to as "marketplace participants" or equivalent) would use in determining fair value when exchanging an asset or settling a liability. Specific assumptions will also vary with the characteristics of the asset or liability being valued, the valuation method used (for example, a market approach, or an income approach) and the requirements of the applicable financial reporting framework.

A35. With respect to fair value accounting estimates, assumptions or inputs vary in terms of their source and bases, as follows:

(a) Those that reflect what marketplace participants would use in pricing an asset or liability developed based on market data obtained from sources independent of the reporting entity (sometimes referred to as "observable inputs" or equivalent).

(b) Those that reflect the entity's own judgments about what assumptions marketplace participants would use in pricing the asset or liability developed based on the best information available in the circumstances (sometimes referred to as "unobservable inputs" or equivalent). In practice, however, the distinction between (a) and (b) is not always apparent. Further, it may be necessary for management to select from a number of different assumptions used by different marketplace participants.

A36. The extent of subjectivity, such as whether an assumption or input is observable, influences the degree of estimation uncertainty and thereby the auditor's assessment of the risks of material misstatement for a particular accounting estimate.

Changes in Methods for making Accounting Estimates (Ref: Para. 8(c)(v))

A37. In evaluating how management makes the accounting estimates, the auditor is required to understand whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates. A specific estimation method may need to be changed in response to changes in the environment or circumstances affecting the entity or in the requirements of the applicable financial reporting framework. If management has changed the method for making an accounting estimate, it is important that management can demonstrate that the new method is more appropriate, or is itself a response to such changes. For example, if management changes the basis of making an accounting estimate from a mark-to-market approach to using a model, the auditor challenges whether management's assumptions about the marketplace are reasonable in light of economic circumstances.

Estimation Uncertainty (Ref: Para. 8(c)(vi))

A38. Matters that the auditor may consider in obtaining an understanding of whether and, if so, how management has assessed the effect of estimation uncertainty include, for example:

- Whether and, if so, how management has considered alternative assumptions or outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the assumptions on an accounting estimate.
- How management determines the accounting estimate when analysis indicates a number of outcome scenarios.
- Whether management monitors the outcome of accounting estimates made in the prior period, and whether management has appropriately responded to the outcome of that monitoring procedure.

Reviewing Prior Period Accounting Estimates (Ref: Para. 9)

A39. The outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

A40. The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

A41. A retrospective review of management judgments and assumptions related to significant accounting estimates is also required by SA 240.[11] That review is conducted as part of the requirement for the auditor to design and perform procedures to review accounting estimates for biases that could represent a risk of material misstatement due to fraud, in response to the risks of management override of controls. As a practical matter, the auditor's review of prior period accounting estimates as a risk assessment procedure in accordance with this SA may be carried out in conjunction with the review required by SA 240.

A42. The auditor may judge that a more detailed review is required for those accounting estimates that were identified during the prior period audit as having high estimation uncertainty, or for those accounting estimates that have changed significantly from the prior period. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A43. For fair value accounting estimates and other accounting estimates based on current conditions at the measurement date, more variation may exist between the fair value amount recognised in the prior period financial statements and the outcome or the amount re-estimated for the purpose of the current period. This is because the measurement objective for such accounting estimates deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that would be relevant to identifying and assessing risks of material misstatement. For example, in some cases obtaining an understanding of changes in marketplace participant assumptions which affected the outcome of a prior period fair value accounting estimate may be unlikely to provide relevant information for audit purposes. If so, then the auditor's consideration of the outcome of prior period fair value accounting estimates may be directed more towards understanding the effectiveness of management's prior estimation process, that is, management's track record, from which the auditor can judge the likely effectiveness of management's current process.

A44. A difference between the outcome of an accounting estimate and the amount recognised in the prior period financial statements does not necessarily represent a misstatement of the prior period financial statements. However, it may do so if, for example, the difference arises from information that was available to management when the prior period's financial statements were finalised, or that could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed.

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[11] SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph 32(b)(ii).

Identifying and Assessing the Risks of Material Misstatement

Estimation Uncertainty (Ref: Para. 10)

A45. The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:

- The extent to which the accounting estimate depends on judgment.
- The sensitivity of the accounting estimate to changes in assumptions.
- The existence of recognised measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may nevertheless give rise to estimation uncertainty).
- The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
- The availability of reliable data from external sources.
- The extent to which the accounting estimate is based on observable or unobservable inputs.

The degree of estimation uncertainty associated with an accounting estimate may influence the estimate's susceptibility to bias.

A46. Matters that the auditor considers in assessing the risks of material misstatement may also include:

- The actual or expected magnitude of an accounting estimate.
- The recorded amount of the accounting estimate (that is, management's point estimate) in relation to the amount expected by the auditor to be recorded.
- Whether management has used an expert in making the accounting estimate.
- The outcome of the review of prior period accounting estimates.

High Estimation Uncertainty and Significant Risks (Ref: Para. 11)

A47. Examples of accounting estimates that may have high estimation uncertainty include the following:

- Accounting estimates that are highly dependent upon judgment, for example, judgments about the outcome of pending litigation or the amount and timing of future cash flows dependent on uncertain events many years in the future.
- Accounting estimates that are not calculated using recognised measurement techniques.
- Accounting estimates where the results of the auditor's review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.
- Fair value accounting estimates for which a highly specialised entity-developed model is used or for which there are no observable inputs.

A48. A seemingly immaterial accounting estimate may have the potential to result in a material misstatement due to the estimation uncertainty associated with the estimation; that is, the size of the amount recognised or disclosed in the financial statements for an accounting estimate may not be an indicator of its estimation uncertainty.

A49. In some circumstances, the estimation uncertainty is so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may, therefore, preclude recognition of the item in the financial statements, or its measurement at fair value. In such cases, the significant risks relate not only to whether an accounting estimate should be recognised, or whether it should be measured at fair value, but also to the adequacy of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the high estimation uncertainty associated with them (see paragraphs A120-A123).

A50. Where the auditor determines that an accounting estimate gives rise to a significant risk, the auditor is required to obtain an understanding of the entity's controls, including control activities.[12]

A51. In some cases, the estimation uncertainty of an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. SA 570 [13] establishes requirements and provides guidance in such circumstances.

Responses to the Assessed Risks of Material Misstatement (Ref: Para. 12)

A52. SA 330 requires the auditor to design and perform audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement in relation to accounting estimates at both the financial statement and assertion levels.[14] Paragraphs A53-A115 focus on specific responses at the assertion level only.

Application of the Requirements of the Applicable Financial Reporting Framework (Ref: Para. 12(a))

A53. Many financial reporting frameworks prescribe certain conditions for the recognition of accounting estimates and specify the methods for making them and required disclosures. Such requirements may be complex and require the application of judgment. Based on the understanding obtained in performing risk assessment procedures, the requirements of the applicable financial reporting framework that may be susceptible to misapplication or differing interpretations become the focus of the auditor's attention.

A54. Determining whether management has appropriately applied the requirements of the applicable financial reporting framework is based, in part, on the auditor's understanding of the entity and its environment. For example, the measurement of the fair value of some items, such as intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations.

A55. In some situations, additional audit procedures, such as the inspection by the auditor of the current physical condition of an asset, may be necessary to determine whether management has appropriately applied the requirements of the applicable financial reporting framework.

A56. The application of the requirements of the applicable financial reporting framework requires management to consider changes in the environment or circumstances that affect the entity. For example, the introduction of an active market for a particular class of asset or liability may indicate that the use of discounted cash flows to estimate the fair value of such asset or liability is no longer appropriate.

Consistency in Methods and Basis for Changes (Ref: Para. 12(b))

A57. The auditor's consideration of a change in an accounting estimate, or in the method for making it from the prior period, is important because a change that is not based on a change in circumstances or new information is considered arbitrary. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to a financial statement misstatement or be an indicator of possible management bias.

A58. Management often is able to demonstrate good reason for a change in an accounting estimate or the method for making an accounting estimate from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management's contention that there has been

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[12] SA 315, paragraph 29.
[13] SA 570, "Going Concern".
[14] SA 330, paragraphs 5-6.

a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, are matters of judgment.

Responses to the Assessed Risks of Material Misstatements (Ref: Para. 13)

A59. The auditor's decision as to which response, individually or in combination, in paragraph 13 to undertake to respond to the risks of material misstatement may be influenced by such matters as:

- The nature of the accounting estimate, including whether it arises from routine or non-routine transactions.
- Whether the procedure(s) is expected to effectively provide the auditor with sufficient appropriate audit evidence.
- The assessed risk of material misstatement, including whether the assessed risk is a significant risk.

A60. For example, when evaluating the reasonableness of the allowance for doubtful accounts, an effective procedure for the auditor may be to review subsequent cash collections in combination with other procedures. Where the estimation uncertainty associated with an accounting estimate is high, for example, an accounting estimate based on a proprietary model for which there are unobservable inputs, it may be that a combination of the responses to assessed risks in paragraph 13 is necessary in order to obtain sufficient appropriate audit evidence.

A61. Additional guidance explaining the circumstances in which each of the responses may be appropriate is provided in paragraphs A62-A95.

Events Occurring Up to the Date of the Auditor's Report (Ref: Para. 13(a))

A62. Determining whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate may be an appropriate response when such events are expected to:

- Occur; and
- Provide audit evidence that confirms or contradicts the accounting estimate.

A63. Events occurring up to the date of the auditor's report may sometimes provide sufficient appropriate audit evidence about an accounting estimate. For example, sale of the complete inventory of a superseded product shortly after the period end may provide audit evidence relating to the estimate of its net realisable value. In such cases, there may be no need to perform additional audit procedures on the accounting estimate, provided that sufficient appropriate evidence about the events is obtained.

A64. For some accounting estimates, events occurring up to the date of the auditor's report are unlikely to provide audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period-end may not reflect the events or conditions existing at the balance sheet date and therefore may not be relevant to the measurement of the fair value accounting estimate. Paragraph 13 identifies other responses to the risks of material misstatement that the auditor may undertake.

A65. In some cases, events that contradict the accounting estimate may indicate that management has ineffective processes for making accounting estimates, or that there is management bias in the making of accounting estimates.

A66. Even though the auditor may decide not to undertake this approach in respect of specific accounting estimates, the auditor is required to comply with SA 560[15]. The auditor is required to perform audit

[15] Standard on Auditing (SA) 560, "Subsequent Events".

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[16] and appropriately reflected in the financial statements.[17] Because the measurement of many accounting estimates, other than fair value accounting estimates, usually depends on the outcome of future conditions, transactions or events, the auditor's work under SA 560 is particularly relevant.

Considerations Specific to Smaller Entities

A67. When there is a longer period between the balance sheet date and the date of the auditor's report, the auditor's review of events in this period may be an effective response for accounting estimates other than fair value accounting estimates. This may particularly be the case in some smaller owner-managed entities, especially when management does not have formalised control procedures over accounting estimates.

Testing how Management made the Accounting Estimate (Ref: Para. 13(b))

A68. Testing how management made the accounting estimate and the data on which it is based may be an appropriate response when the accounting estimate is a fair value accounting estimate developed on a model that uses observable and unobservable inputs. It may also be appropriate when, for example:

- The accounting estimate is derived from the routine processing of data by the entity's accounting system.
- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is likely to be effective.
- The accounting estimate is based on a large population of items of a similar nature that individually are not significant.

A69. Testing how management made the accounting estimate may involve, for example:

- Testing the extent to which data on which the accounting estimate is based is accurate, complete and relevant, and whether the accounting estimate has been properly determined using such data and management assumptions.
- Considering the source, relevance and reliability of external data or information, including that received from external experts engaged by management to assist in making an accounting estimate.
- Re-calculating the accounting estimate, and reviewing information about an accounting estimate for internal consistency.
- Considering management's review and approval processes.

Considerations Specific to Smaller Entities

A70. In smaller entities, the process for making accounting estimates is likely to be less structured than in larger entities. Smaller entities with active management involvement may not have extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Even if the entity has no formal established process, it does not mean that management is not able to provide a basis upon which the auditor can test the accounting estimate.

Evaluating the Method of Measurement (Ref: Para. 13(b)(i))

A71. When the applicable financial reporting framework does not prescribe the method of measurement, evaluating whether the method used, including any applicable model, is appropriate in the circumstances is a

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[16] SA 560, paragraph 6.
[17] SA 560, paragraph 7.

matter of professional judgment.

A72. For this purpose, matters that the auditor may consider include, for example, whether:

- Management's rationale for the method selected is reasonable.
- Management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method.
- The method is appropriate in the circumstances given the nature of the asset or liability being estimated and the requirements of the applicable financial reporting framework relevant to accounting estimates.
- The method is appropriate in relation to the business, industry and environment in which the entity operates.

A73. In some cases, management may have determined that different methods result in a range of significantly different estimates. In such cases, obtaining an understanding of how the entity has investigated the reasons for these differences may assist the auditor in evaluating the appropriateness of the method selected.

Evaluating the use of Models

A74. In some cases, particularly when making fair value accounting estimates, management may use a model. Whether the model used is appropriate in the circumstances may depend on a number of factors, such as the nature of the entity and its environment, including the industry in which it operates, and the specific asset or liability being measured.

A75. The extent to which the following considerations are relevant depends on the circumstances, including whether the model is one that is commercially available for use in a particular sector or industry, or a proprietary model. In some cases, an entity may use an expert to develop and test a model.

A76. Depending on the circumstances, matters that the auditor may also consider in testing the model include, for example, whether:

- The model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:
  - The model's theoretical soundness and mathematical integrity, including the appropriateness of model parameters.
  - The consistency and completeness of the model's inputs with market practices.
  - The model's output as compared to actual transactions.
- Appropriate change control policies and procedures exist.
- The model is periodically calibrated and tested for validity, particularly when inputs are subjective.
- Adjustments are made to the output of the model, including in the case of fair value accounting estimates, whether such adjustments reflect the assumptions marketplace participants would use in similar circumstances.
- The model is adequately documented; including the model's intended applications and limitations and its key parameters, required inputs, and results of any validation analysis performed.

Assumptions Used by Management (Ref: Para. 13(b)(ii))

A77. The auditor's evaluation of the assumptions used by management is based only on information available to the auditor at the time of the audit. Audit procedures dealing with management assumptions are performed in the context of the audit of the entity's financial statements, and not for the purpose of providing an opinion on assumptions themselves.

A78. Matters that the auditor may consider in evaluating the reasonableness of the assumptions used by management include, for example:

- Whether individual assumptions appear reasonable.
- Whether the assumptions are interdependent and internally consistent.
- Whether the assumptions appear reasonable when considered collectively or in conjunction with other assumptions, either for that accounting estimate or for other accounting estimates.
- In the case of fair value accounting estimates, whether the assumptions appropriately reflect observable marketplace assumptions.

A79. The assumptions on which accounting estimates are based may reflect what management expects will be the outcome of specific objectives and strategies. In such cases, the auditor may perform audit procedures to evaluate the reasonableness of such assumptions by considering, for example, whether the assumptions are consistent with:

- The general economic environment and the entity's economic circumstances.
- The plans of the entity.
- Assumptions made in prior periods, if relevant.
- Experience of, or previous conditions experienced by, the entity, to the extent this historical information may be considered representative of future conditions or events.
- Other assumptions used by management relating to the financial statements.

A80. The reasonableness of the assumptions used may depend on management's intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the financial reporting framework may require it to do so. Although the extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgment, the auditor's procedures may include the following:

- Review of management's history of carrying out its stated intentions.
- Review of written plans and other documentation, including, where applicable, formally approved budgets, authorisations or minutes.
- Inquiry of management about its reasons for a particular course of action.
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor's report.
- Evaluation of the entity's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments.

Certain financial reporting frameworks, however, may not permit management's intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that assumptions reflect those used by marketplace participants.

A81. Matters that the auditor may consider in evaluating the reasonableness of assumptions used by management underlying fair value accounting estimates, in addition to those discussed above where applicable, may include, for example:

- Where relevant, whether and, if so, how management has incorporated market specific inputs into the development of assumptions.

- Whether the assumptions are consistent with observable market conditions, and the characteristics of the asset or liability being measured at fair value.
- Whether the sources of market-participant assumptions are relevant and reliable, and how management has selected the assumptions to use when a number of different market participant assumptions exist.
- Where appropriate, whether and, if so, how management considered assumptions used in, or information about, comparable transactions, assets or liabilities.

A82. Further, fair value accounting estimates may comprise observable inputs as well as unobservable inputs. Where fair value accounting estimates are based on unobservable inputs, matters that the auditor may consider include, for example, how management supports the following:

- The identification of the characteristics of marketplace participants relevant to the accounting estimate.
- Modifications it has made to its own assumptions to reflect its view of assumptions marketplace participants would use.
- Whether it has incorporated the best information available in the circumstances.
- Where applicable, how its assumptions take account of comparable transactions, assets or liabilities.

If there are unobservable inputs, it is more likely that the auditor's evaluation of the assumptions will need to be combined with other responses to assessed risks in paragraph 13 in order to obtain sufficient appropriate audit evidence. In such cases, it may be necessary for the auditor to perform other audit procedures, for example, examining documentation supporting the review and approval of the accounting estimate by appropriate levels of management and, where appropriate, by those charged with governance.

A83. In evaluating the reasonableness of the assumptions supporting an accounting estimate, the auditor may identify one or more significant assumptions. If so, it may indicate that the accounting estimate has high estimation uncertainty and may, therefore, give rise to a significant risk. Additional responses to significant risks are described in paragraphs A102- A115.

Testing the Operating Effectiveness of Controls (Ref: Para. 13(c))

A84. Testing the operating effectiveness of the controls over how management made the accounting estimate may be an appropriate response when management's process has been well-designed, implemented and maintained, for example:

- Controls exist for the review and approval of the accounting estimates by appropriate levels of management and, where appropriate, by those charged with governance.
- The accounting estimate is derived from the routine processing of data by the entity's accounting system.

A85. Testing the operating effectiveness of the controls is required when:

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls over the process are operating effectively; or

(b) Substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.[18]

Considerations Specific to Smaller Entities

A86. Controls over the process to make an accounting estimate may exist in smaller entities, but the

[18] SA 330, paragraph 8.

formality with which they operate varies. Further, smaller entities may determine that certain types of controls are not necessary because of active management involvement in the financial reporting process. In the case of very small entities, however, there may not be many controls that the auditor can identify. For this reason, the auditor's response to the assessed risks is likely to be substantive in nature, with the auditor performing one or more of the other responses in paragraph 13.

Developing a Point Estimate or Range (Ref: Para. 13(d))

A87. Developing a point estimate or a range to evaluate management's point estimate may be an appropriate response when, for example:

- An accounting estimate is not derived from the routine processing of data by the accounting system.
- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is unlikely to be effective.
- The entity's controls within and over management's processes for determining accounting estimates are not well designed or properly implemented.
- Events or transactions between the period end and the date of the auditor's report contradict management's point estimate.
- There are alternative sources of relevant data available to the auditor which can be used in making a point estimate or a range.

A88. Even when the entity's controls are well designed and properly implemented, developing a point estimate or a range may be an effective or efficient response to the assessed risks. In other situations, the auditor may consider this approach as part of determining whether further procedures are necessary and, if so, their nature and extent.

A89. The approach taken by the auditor in developing either a point estimate or a range may vary based on what is considered most effective in the circumstances. For example, the auditor may initially develop a preliminary point estimate, and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management's point estimate. Alternatively, the auditor may begin by developing a range for purposes of determining, where possible, a point estimate.

A90. The ability of the auditor to make a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value).

A91. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a model, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.
- Further developing management's consideration of alternative assumptions or outcomes, for example, by introducing a different set of assumptions.
- Employing or engaging a person with specialised expertise to develop or execute the model, or to provide relevant assumptions.
- Making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

Understanding Management's Assumptions or Method (Ref: Para. 13(d)(i))

A92. When the auditor makes a point estimate or a range and uses assumptions or a method different from those used by management, paragraph 13(d)(i) requires the auditor to obtain a sufficient understanding of the assumptions or method used by management in making the accounting estimate. This understanding provides the auditor with information that may be relevant to the auditor's development of an appropriate point estimate or range. Further, it assists the auditor to understand and evaluate any significant differences from management's point estimate. For example, a difference may arise because the auditor used different, but equally valid, assumptions as compared with those used by management. This may reveal that the accounting estimate is highly sensitive to certain assumptions and therefore subject to high estimation uncertainty, indicating that the accounting estimate may be a significant risk. Alternatively, a difference may arise as a result of a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate.

Narrowing a Range (Ref: Para. 13(d)(ii))

A93. When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management's point estimate (the auditor's range), paragraph 13(d)(ii) requires that range to encompass all "reasonable outcomes" rather than all possible outcomes. The range cannot be one that comprises all possible outcomes if it is to be useful, as such a range would be too wide to be effective for purposes of the audit. The auditor's range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is misstated.

A94. Ordinarily, a range that has been narrowed to be equal to or less than performance materiality is adequate for the purposes of evaluating the reasonableness of management's point estimate. However, particularly in certain industries, it may not be possible to narrow the range to below such an amount. This does not necessarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk. Additional responses to significant risks are described in paragraphs A102-A115.

A95. Narrowing the range to a position where all outcomes within the range are considered reasonable may be achieved by:

(a) Eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur; and

(b) Continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate.

Considering whether Specialised Skills or Knowledge are Required (Ref: Para. 14)

A96. In planning the audit, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the audit engagement[19]. This may include, as necessary, the involvement of those with specialised skills or knowledge. In addition, SA 220 requires the engagement partner to be satisfied that the engagement team, and any auditor's external experts, collectively have the appropriate capabilities, competence and time to perform the audit engagement.[20] During the course of the audit of accounting estimates the auditor may identify, in light of the experience of the auditor and the circumstances of the engagement, the need for specialised skills or knowledge to be applied in relation to one or more aspects of

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[19] SA 300, "Planning an Audit of Financial Statements", paragraph 7(e).

[20] SA 220, "Quality Control for and Audit of Financial Statements", paragraph 14.

the accounting estimates.

A97. Matters that may affect the auditor's consideration of whether specialised skills or knowledge is required include, for example:

- The nature of the underlying asset, liability or component of equity in a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments).
- A high degree of estimation uncertainty.
- Complex calculations or specialised models are involved, for example, when estimating fair values when there is no observable market.
- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice is inconsistent or developing.
- The procedures the auditor intends to undertake in responding to assessed risks.

A98. For the majority of accounting estimates, even when there is estimation uncertainty, it is unlikely that specialised skills or knowledge will be required. For example, it is unlikely that specialised skills or knowledge would be necessary for an auditor to evaluate an allowance for doubtful accounts.

A99. However, the auditor may not possess the specialised skills or knowledge required when the matter involved is in a field other than accounting or auditing and may need to obtain it from an auditor's expert. SA 620[21] establishes requirements and provides guidance in determining the need to employ or engage an auditor's expert and the auditor's responsibilities when using the work of an auditor's expert.

A100. Further, in some cases, the auditor may conclude that it is necessary to obtain specialised skills or knowledge related to specific areas of accounting or auditing. Individuals with such skills or knowledge may be employed by the auditor's firm or engaged from an external organisation outside of the auditor's firm. When such individuals perform audit procedures on the engagement, they are part of the engagement team and accordingly, they are subject to the requirements in SA 220.

A101. Depending on the auditor's understanding and experience of working with the auditor's expert or those other individuals with specialised skills or knowledge, the auditor may consider it appropriate to discuss matters such as the requirements of the applicable financial reporting framework with the individuals involved to establish that their work is relevant for audit purposes.

Further Substantive Procedures to Respond to Significant Risks (Ref: Para. 15)

A102. In auditing accounting estimates that give rise to significant risks, the auditor's further substantive procedures are focused on the evaluation of:

(a) How management has assessed the effect of estimation uncertainty on the accounting estimate, and the effect such uncertainty may have on the appropriateness of the recognition of the accounting estimate in the financial statements; and

(b) The adequacy of related disclosures.

Estimation Uncertainty

Management's Consideration of Estimation Uncertainty (Ref: Para. 15(a))

A103. Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. One possible method used by management is to undertake a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies

[21] SA 620, "Using the Work of an Auditor's Expert".

with different assumptions. Even for accounting estimates measured at fair value there can be variation because different market participants will use different assumptions. A sensitivity analysis could lead to the development of a number of outcome scenarios, sometimes characterised as a range of outcomes by management, such as "pessimistic" and "optimistic" scenarios.

A104. A sensitivity analysis may demonstrate that an accounting estimate is not sensitive to changes in particular assumptions. Alternatively, it may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor's attention.

A105. This is not intended to suggest that one particular method of addressing estimation uncertainty (such as sensitivity analysis) is more suitable than another, or that management's consideration of alternative assumptions or outcomes needs to be conducted through a detailed process supported by extensive documentation. Rather, it is whether management has assessed how estimation uncertainty may affect the accounting estimate that is important, not the specific manner in which it is done. Accordingly, where management has not considered alternative assumptions or outcomes, it may be necessary for the auditor to discuss with management, and request support for, how it has addressed the effects of estimation uncertainty on the accounting estimate.

Considerations Specific to Smaller Entities

A106. Smaller entities may use simple means to assess the estimation uncertainty. In addition to the auditor's review of available documentation, the auditor may obtain other audit evidence of management consideration of alternative assumptions or outcomes by inquiry of management. In addition, management may not have the expertise to consider alternative outcomes or otherwise address the estimation uncertainty of the accounting estimate. In such cases, the auditor may explain to management the process or the different methods available for doing so, and the documentation thereof. This would not, however, change the responsibilities of management for the preparation and presentation of the financial statements.

Significant Assumptions (Ref: Para. 15(b))

A107. An assumption used in making an accounting estimate may be deemed to be significant if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate.

A108. Support for significant assumptions derived from management's knowledge may be obtained from management's continuing processes of strategic analysis and risk management. Even without formal established processes, such as may be the case in smaller entities, the auditor may be able to evaluate the assumptions through inquiries of and discussions with management, along with other audit procedures in order to obtain sufficient appropriate audit evidence.

A109. The auditor's considerations in evaluating assumptions made by management are described in paragraphs A77-A83.

Management Intent and Ability (Ref: Para. 15(c))

A110. The auditor's considerations in relation to assumptions made by management and management's intent and ability are described in paragraphs A13 and A80.

Development of a Range (Ref: Para. 16)

A111. In preparing the financial statements, management may be satisfied that it has adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks. In some circumstances, however, the auditor may view the efforts of management as inadequate. This may be the case, for example, where, in the auditor's judgment:

- Sufficient appropriate audit evidence could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.
- It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate, for example, where the auditor is aware of wide variation in outcomes for similar accounting estimates in similar circumstances.
- It is unlikely that other audit evidence can be obtained, for example, through the review of events occurring up to the date of the auditor's report.
- Indicators of management bias in the making of accounting estimates may exist.

A112. The auditor's considerations in determining a range for this purpose are described in paragraphs A87-A95.

Recognition and Measurement Criteria

Recognition of the Accounting Estimates in the Financial Statements (Ref: Para. 17(a))

A113. Where management has recognised an accounting estimate in the financial statements, the focus of the auditor's evaluation is on whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable financial reporting framework.

A114. With respect to accounting estimates that have not been recognised, the focus of the auditor's evaluation is on whether the recognition criteria of the applicable financial reporting framework have in fact been met. Even where an accounting estimate has not been recognised, and the auditor concludes that this treatment is appropriate, there may be a need for disclosure of the circumstances in the notes to the financial statements. The auditor may also determine that there is a need to draw the reader's attention to a significant uncertainty by adding an Emphasis of Matter paragraph to the auditor's report. SA 706[22] establishes requirements and provides guidance concerning such paragraphs.

Measurement Basis for the Accounting Estimates (Ref: Para. 17(b))

A115. With respect to fair value accounting estimates, some financial reporting frameworks presume that fair value can be measured reliably as a prerequisite to either requiring or permitting fair value measurements and disclosures. In some cases, this presumption may be overcome when, for example, there is no appropriate method or basis for measurement. In such cases, the focus of the auditor's evaluation is on whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.

Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements (Ref: Para. 18)

A116. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an accounting estimate that differs from management's point estimate. Where the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. Where the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range.

A117. Where management has changed an accounting estimate, or the method in making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude based on the audit evidence that the accounting estimate is misstated as a result of an arbitrary change by management, or may regard it as an indicator of possible management bias (see paragraphs A124-A125).

[22] SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report".

A118.SA 450[23] provides guidance on distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of:

- Misstatements about which there is no doubt (factual misstatements).
- Differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements).
- The auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn (projected misstatements).

In some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making separate identification difficult or impossible.

A119.Evaluating the reasonableness of accounting estimates and related disclosures included in the notes to the financial statements, whether required by the applicable financial reporting framework or disclosed voluntarily, involves essentially the same types of considerations applied when auditing an accounting estimate recognised in the financial statements.

Disclosures Related to Accounting Estimates

Disclosures in accordance with the Applicable Financial Reporting Framework (Ref: Para. 19)

A120.The presentation of financial statements in accordance with the applicable financial reporting framework includes adequate disclosure of material matters. The applicable financial reporting framework may permit, or prescribe, disclosures related to accounting estimates, and some entities may disclose voluntarily additional information in the notes to the financial statements. These disclosures may include, for example:

- The assumptions used.
- The method of estimation used, including any applicable model.
- The basis for the selection of the method of estimation.
- The effect of any changes to the method of estimation from the prior period.
- The sources and implications of estimation uncertainty.

Such disclosures are relevant to users in understanding the accounting estimates recognised or disclosed in the financial statements, and sufficient appropriate audit evidence needs to be obtained about whether the disclosures are in accordance with the requirements of the applicable financial reporting framework.

A121.In some cases, the applicable financial reporting framework may require specific disclosures regarding uncertainties. For example, some financial reporting frameworks prescribe:

- The disclosure of key assumptions and other sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities. Such requirements may be described using terms such as "Key Sources of Estimation Uncertainty" or "Critical Accounting Estimates".
- The disclosure of the range of possible outcomes, and the assumptions used in determining the range.
- The disclosure of information regarding the significance of fair value accounting estimates to the

[23] SA 450, "Evaluation of Misstatements Identified during the Audit".

entity's financial position and performance.

- Qualitative disclosures such as the exposures to risk and how they arise, the entity's objectives, policies and procedures for managing the risk and the methods used to measure the risk and any changes from the previous period of these qualitative concepts.
- Quantitative disclosures such as the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel, including credit risk, liquidity risk and market risk.

Disclosures of Estimation Uncertainty for Accounting Estimates that give Rise to Significant Risks (Ref: Para. 20)

A122. In relation to accounting estimates having significant risk, even where the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved. The auditor's evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality (see related discussion in paragraph A95 & A94).

A123. In some cases, the auditor may consider it appropriate to encourage management to describe, in the notes to the financial statements, the circumstances relating to the estimation uncertainty. SA 705[24] provides guidance on the implications for the auditor's report when the auditor believes that management's disclosure of estimation uncertainty in the financial statements is inadequate or misleading.

Indicators of Possible Management Bias (Ref: Para. 21)

A124. During the audit, the auditor may become aware of judgments and decisions made by management which give rise to indicators of possible management bias. Such indicators may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate, and the auditor may need to consider the implications for the rest of the audit. Further, they may affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement, as discussed in Revised SA 700[25]

A125. Examples of indicators of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.
- Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
- Selection or construction of significant assumptions that yield a point estimate favourable for management objectives.
- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

Written Representations (Ref: Para. 22)

A126. SA 580[26] discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognised or disclosed in the financial statements may include representations:

- About the appropriateness of the measurement processes, including related assumptions and models,

[24] SA 705, "Modifications to the Opinion in the Independent Auditor's Report".
[25] Revised SA 700, "Forming An Opinion and Reporting on Financial Statements".
[26] Standard on Auditing (SA) 580, "Written Representations".

used by management in determining accounting estimates in the context of the applicable financial reporting framework, and the consistency in application of the processes.

- That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
- That disclosure related to accounting estimates are complete and appropriate under the applicable financial reporting framework.
- That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.

A127. For those accounting estimates not recognised or disclosed in the financial statements, written representations may also include representations about:

- The appropriateness of the basis used by management for determining that the recognition or disclosure criteria of the applicable financial reporting framework have not been met (see paragraph A114).
- The appropriateness of the basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's applicable financial reporting framework, for those accounting estimates not measured or disclosed at fair value (see paragraph A115).

Documentation (Ref: Para. 23)

A128. Documentation of indicators of possible management bias identified during the audit assists the auditor in concluding whether the auditor's risk assessment and related responses remain appropriate, and in evaluating whether the financial statements as a whole are free from material misstatement. See paragraph A125 for examples of indicators of possible management bias.

Material Modifications *vis a vis* ISA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"

Deletions

1. Paragraph A11 of the Application Section of ISA 540 deals with the application of the requirements of ISA 540 to the audits of public sector entities regarding significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement at fair value or other current value bases, or a combination of both. 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 non-public sector entities, may have significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement. Accordingly, the spirit of erstwhile A11, highlighting the fact that in case of certain entities, there may be a requirement of estimation at fair value in case of specialised assets, has been retained.

Appendix

(Ref: Para. A1)

Fair Value Measurements and Disclosures Under Different Financial Reporting Frameworks

The purpose of this appendix is only to provide a general discussion of fair value measurements and disclosures under different financial reporting frameworks, for background and context.

1. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry-specific measurement and disclosure practices for fair values also exist.

2. Definitions of fair value may differ among financial reporting frameworks, or for different assets, liabilities or disclosures within a particular framework. For example, Accounting Standard (AS) 30[27] defines fair value as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction". The concept of fair value ordinarily assumes a current transaction, rather than settlement at some past or future date. Accordingly, the process of measuring fair value would be a search for the estimated price at which that transaction would occur. Additionally, different financial reporting frameworks may use such terms as "entity-specific value," "value in use," or similar terms, but may still fall within the concept of fair value in this SA.

3. Financial reporting frameworks may treat changes in fair value measurements that occur over time in different ways. For example, a particular financial reporting framework may require that changes in fair value measurements of certain assets or liabilities be reflected directly in equity, while such changes might be reflected in income under another framework. In some frameworks, the determination of whether to use fair value accounting or how it is applied is influenced by management's intent to carry out certain courses of action with respect to the specific asset or liability.

4. Different financial reporting frameworks may require certain specific fair value measurements and disclosures in financial statements and prescribe or permit them in varying degrees. The financial reporting frameworks may:

- Prescribe measurement, presentation and disclosure requirements for certain information included in the financial statements or for information disclosed in notes to financial statements or presented as supplementary information;
- Permit certain measurements using fair values at the option of an entity or only when certain criteria have been met;
- Prescribe a specific method for determining fair value, for example, through the use of an independent appraisal or specified ways of using discounted cash flows;
- Permit a choice of method for determining fair value from among several alternative methods (the criteria for selection may or may not be provided by the financial reporting framework); or
- Provide no guidance on the fair value measurements or disclosures of fair value other than their use being evident through custom or practice, for example, an industry practice.

[27] AS 30, "Financial Instruments: Recognition and Measurement".

5. Some financial reporting frameworks presume that fair value can be measured reliably for assets or liabilities as a prerequisite to either requiring or permitting fair value measurements or disclosures. In some cases, this presumption may be overcome when an asset or liability does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable. Some financial reporting frameworks may specify a fair value hierarchy that distinguishes inputs for use in arriving at fair values ranging from those that involve clearly "observable inputs" based on quoted prices and active markets and those "unobservable inputs" that involve an entity's own judgments about assumptions that marketplace participants would use.

6. Some financial reporting frameworks require certain specified adjustments or modifications to valuation information, or other considerations unique to a particular asset or liability. For example, accounting for investment properties may require adjustments to be made to an appraised market value, such as adjustments for estimated closing costs on sale, adjustments related to the property's condition and location, and other matters. Similarly, if the market for a particular asset is not an active market, published price quotations may have to be adjusted or modified to arrive at a more suitable measure of fair value. For example, quoted market prices may not be indicative of fair value if there is infrequent activity in the market, the market is not well established, or small volumes of units are traded relative to the aggregate number of trading units in existence. Accordingly, such market prices may have to be adjusted or modified. Alternative sources of market information may be needed to make such adjustments or modifications. Further, in some cases, collateral assigned (for example, when collateral is assigned for certain types of investment in debt) may need to be considered in determining the fair value or possible impairment of an asset or liability.

7. In most financial reporting frameworks, underlying the concept of fair value measurements is a presumption that the entity is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Therefore, in this case, fair value would not be the amount that an entity would receive or pay in a forced transaction, involuntary liquidation, or distress sale. On the other hand, general economic conditions or economic conditions specific to certain industries may cause illiquidity in the marketplace and require fair values to be predicated upon depressed prices, potentially significantly depressed prices. An entity, however, may need to take its current economic or operating situation into account in determining the fair values of its assets and liabilities if prescribed or permitted to do so by its financial reporting framework and such framework may or may not specify how that is done. For example, management's plan to dispose of an asset on an accelerated basis to meet specific business objectives may be relevant to the determination of the fair value of that asset.

Prevalence of Fair Value Measurements

8. Measurements and disclosures based on fair value are becoming increasingly prevalent in financial reporting frameworks. Fair values may occur in, and affect the determination of, financial statements in a number of ways, including the measurement at fair value of the following:

- Specific assets or liabilities, such as marketable securities or liabilities to settle an obligation under a financial instrument, routinely or periodically "marked-to-market".
- Specific components of equity, for example when accounting for the recognition, measurement and presentation of certain financial instruments with equity features, such as a bond convertible by the holder into common shares of the issuer.
- Specific assets or liabilities acquired in a business combination. For example, the initial determination of goodwill arising on the purchase of an entity in a business combination usually is based on the fair value measurement of the identifiable assets and liabilities acquired and the fair value of the consideration given.
- Specific assets or liabilities adjusted to fair value on a one-time basis. Some financial reporting

frameworks may require the use of a fair value measurement to quantify an adjustment to an asset or a group of assets as part of an asset impairment determination, for example, a test of impairment of goodwill acquired in a business combination based on the fair value of a defined operating entity or reporting unit, the value of which is then allocated among the entity's or unit's group of assets and liabilities in order to derive an implied goodwill for comparison to the recorded goodwill.

- Aggregations of assets and liabilities. In some circumstances, the measurement of a class or group of assets or liabilities calls for an aggregation of fair values of some of the individual assets or liabilities in such class or group. For example, under an entity's applicable financial reporting framework, the measurement of a diversified loan portfolio might be determined based on the fair value of some categories of loans comprising the portfolio.
- Information disclosed in notes to financial statements or presented as supplementary information, but not recognised in the financial statements.

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 315[1], SA 330[2] and SA 240[3] 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

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* 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".

they are affected by 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 240[4] 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 SAs[5]. 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 200[6] 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

[4] SA 240, paragraph 24.
[5] SA 200, paragraph A52.
[6] SA 200, paragraph 15.

in accordance with the framework.

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 framework[7]; 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 require[9] 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

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[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.

(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 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

[10] SA 315, paragraph 25.

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 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

[11] SA 330, paragraphs 5-6.
[12] SA 240, paragraph 32(c).

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

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 entity[14], 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 230[15] 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.

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[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 210[17] the auditor determined that the framework is acceptable[18].

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).

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[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.

(d) Being a close family member of any person referred to in subparagraph (c).

(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 entity[19] 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.

[19] SA 315, paragraphs A26-A27, provides guidance regarding the nature of a special-purpose entity.

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:

- 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 aware[20]. 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

[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.

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 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.

[21] SA 200, paragraph A2.
[22] SA 315, paragraph 14.

- 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-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 705[23], 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

[23] SA 705, "Modifications to the Opinion in the Independent Auditor's Report".
[24] SA 240, paragraphs 31 and A4.

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 (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:

[25] SA 240, Appendix 1.

- 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 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

[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.

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.
- 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

[27] SA 330, paragraph 8(b).

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 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:
  - Is overly complex (e.g., it may involve multiple related parties within a consolidated group).
  - Has unusual terms of trade, such as unusual prices, interest rates, guarantees and repayment terms.
  - Lacks an apparent logical business reason for its occurrence.
  - Involves previously unidentified related parties.
  - 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

[28] SA 500, "Audit Evidence", paragraph 11.

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 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 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 audit[30] 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.

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[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.

[30] SA 230, "Audit Documentation", paragraph A8 provides further guidance on the nature of significant matters arising during the audit.

- 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"

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 frameworks[1] 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 authority have asserted that they have taken responsibility for those financial statements. *(Ref: Para. A2)*

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* 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.

(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) paragraph[3] 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 705[4] 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.

(b) Determine whether the financial statements need amendment and, if so,

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[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".

(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 governance[5] 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 and the entity follows its own procedures in preparing and finalising its financial statements in view

[5] SA 260, paragraph 12(c).

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 procedures may take the form of inspection of available books and records,

[6] SA 700, paragraph 41.

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.

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[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, 2009)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility in the audit of financial statements with respect to management's use of the going concern assumption in the preparation and presentation of the financial statements.

Going Concern Assumption

2. Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, 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[1] may or may not be prepared in accordance with a financial reporting framework[2] for which the going concern basis is relevant. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. *(Ref: Para. A1)*

Responsibilities of Management

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 financial reporting framework may require the management to make an assessment of the entity's ability to continue as a going concern and prepare the financial statements on a going concern basis unless the management intends to liquidate the entity or cease operations, or has no realistic alternative but to do so. In case the financial statements have not been prepared on a going concern basis, the fact would need to be appropriately disclosed, together with the basis on which the financial statements

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* Published in December, 2008 issue of the Journal.

1 Financial Statements prepared and presented in accordance with a financial reporting framework designed to meet the financial information needs of specific users are referred to as special purpose financial statements. Examples of special purpose financial statements include:

(i) financial statements which are prepared in addition to general purpose financial statements;
(ii) financial statements prepared in compliance with requirements of any agreement or statute or regulation; or
(iii) financial information given in special purpose formats or schedules.

2 SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph 13 (a).

are prepared and the reason why the entity is not regarded as a going concern[3].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, since the going concern assumption is a fundamental principle in the preparation of financial statements as discussed in paragraph 2, management's responsibility for the preparation and presentation of the financial statements includes a responsibility 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, financial reporting frameworks normally 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 responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. This responsibility exists 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, 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

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[3] In India, Section 217(2AA) of the Companies Act, 1956 *inter alia* requires the directors to make a specific assertion in their Directors' Responsibility Statement under this section that "the directors had prepared the annual accounts on a going concern basis". Further, paragraph 9 of the Accounting Standard (AS) 1, "*Disclosure of Accounting Policies",* states as follows:

> "**Fundamental Accounting Assumptions**
>
> 9. Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed".
>
> Further, paragraph 10 of AS 1 states as follows:
>
> "The following have been generally accepted as fundamental accounting assumptions:-
>
> a. *Going Concern*
>
> The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations…."

absence of any reference to going concern uncertainty 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, 2009.

Objectives

9. The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation 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 determine the implications for the auditor's report.

Requirements

Risk Assessment Procedures and Related Activities

10. When performing risk assessment procedures as required by SA 315,[4] the auditor shall consider whether there are events or conditions 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. A2-A5)*

(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

(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 assumption, 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. A6)*

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. A7-A9; A11-A12)*

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,[5] the auditor shall request management to extend its assessment period to at least twelve months from that date. *(Ref: Para. A10-A12)*

14. In evaluating management's assessment, the auditor shall consider whether management's

[4] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 5.

[5] SA 560, "Subsequent Events", paragraph 5(a).

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. A13-A14)*

Additional Audit Procedures When Events or Conditions Are Identified

16. When 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 through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include: *(Ref: Para. A15)*

(a) When 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. A16)*

(c) When 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 action: *(Ref: Para. A17-A18)*

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

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

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

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

Audit Conclusions and Reporting

17. 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:

(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. *(Ref: Para. A19)*

Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists

18. When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

(a) Adequately describe 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 realise its assets and discharge its liabilities in the normal course of business. *(Ref: Para. A20)*

19. If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph in the auditor's report to:

(a) Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and to

(b) Draw attention to the note in the financial statements that discloses the matters set out in paragraph 18. (See SA 706[6]) *(Ref: Para. A21-A22)*

20. If adequate disclosure is not made in the financial statements, the auditor shall express a qualified or adverse opinion, as appropriate (See SA 705 [7]). The auditor shall state in the auditor's report that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern. *(Ref: Para. A23-A24)*

Use of Going Concern Assumption Inappropriate

21. If the financial statements have been prepared on a going concern basis but, in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate, the auditor shall express an adverse opinion. *(Ref: Para. A25-A26)*

Management Unwilling to Make or Extend Its Assessment

22. 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. A27)*

Communication with Those Charged with Governance

23. Unless all those charged with governance are involved in managing the entity[8], 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 the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements; and

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

Significant Delay in the Approval of Financial Statements

24. When 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. When 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 17.

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[6] SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report".

[7] SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

[8] SA 260, paragraph 12(c).

Application and Other Explanatory Material

Introduction

Going Concern Assumption (Ref: Para. 2)

A1. In some enterprises, for example, those where the funding arrangements are guaranteed by the Central Government, going concern risks may arise, but are not limited to, situations where such type of entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatisation. Events or conditions that may cast significant doubt on an entity's ability to continue as a going concern may include situations where such type of entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by such an entity.

Risk Assessment Procedures and Related Activities

Events or Conditions That May Cast Doubt about Going Concern Assumption (Ref: Para. 10)

A2. The following are examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. 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).
- Labour difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other

- Non-compliance with capital or other statutory requirements.
- 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.

A3. The risk assessment procedures required by paragraph 10 help the auditor to determine whether management's use of the going concern assumption 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

A4. 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.

A5. 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)

A6. 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.[9] 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 330[10] 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)

A7. 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 assumption.

A8. 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 assumption is appropriate in the circumstances. For example, when there is a history of profitable operations and a ready

[9] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 31.

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

access to financial resources, management may make its assessment without detailed analysis. In this case, the auditor's evaluation of the appropriateness of management's assessment may be made without performing detailed evaluation procedures if the auditor's other audit procedures are sufficient to enable the auditor to conclude whether management's use of the going concern assumption in the preparation of the financial statements is appropriate in the circumstances.

A9. 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)

A10. 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)

A11. 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.

A12. 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 favour 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)

A13. 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 assumption 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.

A14. 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)

A15. Audit procedures that are relevant to the requirement in paragraph 16 may include the following:

- Analysing and discussing cash flow, profit and other relevant forecasts with management.
- Analysing 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))

A16. 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))

A17. 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.

A18. 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.

Audit Conclusions and Reporting (Ref: Para. 17)

A19. 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.

Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists

Adequacy of Disclosure of Material Uncertainty (Ref: Para. 18)

A20. The determination of the adequacy of the financial statement disclosure may involve determining whether the information explicitly draws the reader's attention to the possibility that the entity may be unable to continue realising its assets and discharging its liabilities in the normal course of business.

Audit Reporting When Disclosure of Material Uncertainty Is Adequate (Ref: Para. 19)

A21. The following is an illustration of an Emphasis of Matter paragraph when the auditor is satisfied as to the adequacy of the note disclosure:

Emphasis of Matter

Without qualifying our opinion, we draw attention to Note X in the financial statements which indicates that the Company incurred a net loss of ZZZ during the year ended March 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

A22. In situations involving multiple material 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 adding an Emphasis of Matter paragraph. SA 705 provides guidance on this issue.

Audit Reporting When Disclosure of Material Uncertainty Is Inadequate (Ref: Para. 20)

A23. The following is an illustration of the relevant paragraphs when a qualified opinion is to be expressed:

Basis for Qualified Opinion

The Company's financing arrangements expire and amounts outstanding are payable on May 19, 20X1. The Company has been unable to re-negotiate or obtain replacement financing. This situation indicates the existence of a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore the Company may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not fully disclose this fact.

Qualified Opinion

In our opinion, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion paragraph, the financial statements give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of the company as at March 31, 20X1;

(b) in the case of the Profit and Loss Account, of the profit/ loss for the year ended on that date; and

(c) in the case of the cash flow statement, of the cash flows for the year ended on that date.

A24. The following is an illustration of the relevant paragraphs when an adverse opinion is to be expressed:

Basis for Adverse Opinion

The Company's financing arrangements expired and the amount outstanding was payable on March 31, 20X0. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore it may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not give the information required by the Companies Act, 1956, in the manner so required and also do not give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of the company as at March 31, 20X0; and

(b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date; and

(c) in the case of the cash flow statement, of the cash flows for the year ended on that date.

Use of Going Concern Assumption Inappropriate (Ref: Para. 21)

A25. If the financial statements have been prepared on a going concern basis but, in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate, the requirement of 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 assumption.

A26. If the entity's management is required, or elects, to prepare financial statements when the use of the going concern assumption is not appropriate in the circumstances, the financial statements are prepared on an alternative 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 alternative basis is an acceptable financial reporting framework in the circumstances. The auditor may be able to express an unmodified opinion on those financial statements, provided there is adequate disclosure therein but may consider it appropriate or necessary to include an Emphasis of Matter paragraph in the auditor's report to draw the user's attention to that alternative basis and the reasons for its use.

Management Unwilling to Make or Extend Its Assessment (Ref: Para. 22)

A27. 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 the use of the going concern assumption 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.

Material Modifications to ISA 570, "Going Concern"

Addition

In Paragraph 3, the responsibilities of management to make an assessment of the entity's ability to continue as a going concern have been made more country specific.

Deletion

Paragraph A1 of the Application Section of ISA 570 deals with the application of the requirements of ISA 570 to the audits of public sector entities in the context of going concern risks that 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 privatisation. 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 situation may arise in the case of non-public sector enterprise. Accordingly, the spirit of erstwhile A1, highlighting the appropriateness of the going concern assumption in the preparation of the financial statements where the funding arrangements are guaranteed by the Central Government has been retained.

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:

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* 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)*

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[2] SA 210, "Agreeing the Terms of Audit Engagements," paragraph 6(b)(i)

[8] SA 210, "Agreeing the Terms of Audit Engagements," paragraph 6(b)(iii).

Form of Written Representations

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 705[4], 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:
    (a) Discuss the matter with management;
    (b) 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
    (c) 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)*
    (a) 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
    (b) 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

[4] SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

significant issues may exist. Further, a request for written, rather than oral, representations in many cases 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:
    - Plans or intentions that may affect the carrying value or classification of assets and liabilities;
    - Liabilities, both actual and contingent;
    - Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral; and
    - 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.

[5] SA 210, "Agreeing the Terms of Audit Engagements," paragraph 6(b).

Written Representations about Specific Assertions

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 450[6] 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

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[6] SA 450, "Evaluation of Misstatements Identified during the Audit", paragraph 5.

requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

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 260[7] 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 230[8] 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

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[7] SA 260, "Communication with Those Charged with Governance", paragraph 12(c)(ii).

[8] SA 230, "Audit Documentation", refer paragraph 8 and 10.

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 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 570[10] 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, 20XX[11] 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".

- 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;
- Additional information that you have requested from us for the purpose of the audit; and
- 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:
    - Management;
    - Employees who have significant roles in internal control; or
    - 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 600
Using the Work of Another Auditor

(Effective for all audits relating to accounting periods beginning on or after April 1, 2002)

Introduction

1. The Standard on Auditing (SA) 200, "Basic Principles Governing an Audit", states (paragraph 9):

   "When the auditor delegates work to assistants or uses work performed by other auditors 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. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 1956 the auditor's report should expressly state the fact of such reliance."

2. The purpose of this Standard on Auditing (SA) is to establish standards to be applied in situations where an auditor (referred to herein as the 'principal auditor'), reporting on the financial information of an entity, uses the work of another auditor (referred to herein as the 'other auditor') with respect to the financial information of one or more components included in the financial information of the entity. This Standard also discusses the principal auditor's responsibility in relation to his use of the work of the other auditor. In this Standard, the term 'financial information' encompasses 'financial statements'.

3. This Standard does not deal with those instances where two or more auditors are appointed as joint auditors[1] nor does it deal with the auditor's relationship with a predecessor auditor.

4. When the principal auditor concludes that the financial information of a component is immaterial, the procedures outlined in this Statement do not apply. When several components, immaterial in themselves, are together material in relation to the financial information of the entity as a whole, the procedures outlined in this Statement should be considered.

5. **When the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit.**

6. "Principal auditor" means the auditor with responsibility for reporting on the financial information of an entity when that financial information includes the financial information of one or more components audited by another auditor.

7. "Other auditor" means an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component which is included in the financial information audited by the principal auditor.

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[1] Standard on Auditing (SA) 299, "Responsibility of Joint Auditors", deals with the audit procedures to be employed where two or more auditors are appointed as joint auditors.

8. "Component" means a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.

Acceptance as Principal Auditor

9. **The auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor.** For this purpose the auditor would consider:

(a) the materiality of the portion of the financial information which the principal auditor audits;

(b) the principal auditor's degree of knowledge regarding the business of the components;

(c) the risk of material misstatements in the financial information of the components audited by the other auditor; and

(d) the performance of additional procedures as set out in this SA regarding the components audited by other auditor resulting in the principal auditor having significant participation in such audit.

The Principal Auditor's Procedures

10. 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.

11. **When planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.**

12. **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 areas 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.

13. 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. The principal auditor may conclude that it is not necessary to apply procedures such as those described in paragraph 13 because sufficient appropriate audit evidence previously obtained that acceptable quality control policies and procedures are complied with in the conduct of other auditor's practice.

15. **The principal auditor should consider the significant findings of the other auditor.**

16. The principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the components. He may also decide that supplemental tests of the records or the financial statements of the component are necessary. Such tests may, depending upon the circumstances, be performed by the principal auditor or the other auditor.

17. In certain circumstances, the other auditor may happen to be a person other than a professionally qualified auditor. This may happen, for instance, where a component is situated in a foreign country and the applicable laws permit a person other than a professionally qualified auditor to audit the financial statements of such component. In such circumstances, the procedures outlined in paragraphs 10 to 16 assume added importance.

18. The principal auditor should document in his working papers the components whose financial information was audited by other auditors; their significance to the financial information of the entity as a whole; the names of the other auditors; and any conclusions reached that individual components are not material. The principal auditor should also document the procedures performed and the conclusions reached. For example, the auditor would document the results of discussions with the other auditor and review of the written summary of the other auditor's procedures. However, the principal auditor need not document the reasons for limiting the procedures in the circumstances described at 14 above, provided those reasons are summarised elsewhere in the documentation maintained by the principal auditor. Where the other auditor's report is other than unmodified[2], the principal auditor should also document how he has dealt with the qualifications or adverse remarks contained in the other auditor's report in framing his own report.

Co-ordination Between Auditors

19. **There should be sufficient liaison between the principal auditor and the other auditor.** For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

20. **The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor.** For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

21. When considered necessary by him, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties. The other auditor should respond to such questionnaire on a timely basis.

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[2] Standard on Auditing (SA) 700, "The Auditor's Report on Financial Statements", deals with the concept of "modified audit report". An auditor's report is considered to be modified when it includes:

"Matters that do not affect the auditor 's opinion

(a) emphasis of matter

Matters that do affect the auditor 's opinion

(a) qualified opinion,

(b) disclaimer of opinion, or

(c) adverse opinion".

Reporting Considerations

22. **When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.**

23. In all circumstances, if the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting that it requires a modification of the principal auditor's report.

Division of Responsibility

24. The principal auditor would not be responsible in respect of the work entrusted to the other auditors, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the other auditors.

25. **When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components 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.**

Effective Date

26. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 2002.

Compatibility with International Standard on Auditing (ISA) 600

The auditing standards established in this Standard on Auditing (SA) are generally consistent, in all material respects, with those set out in ISA 600 "Using the Work of Another Auditor".

SA 610*
Using the Work of Internal Auditors
(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 external auditor's responsibilities regarding the work of internal auditors when the external auditor has determined, in accordance with SA 315,[1] that the internal audit function is likely to be relevant to the audit. (Ref: Para. A1-A2)

2. This SA does not deal with instances when individual internal auditors provide direct assistance to the external auditor in carrying out audit procedures or where, in terms of the applicable legal and regulatory framework, it is not permissible for the internal auditor to provide access to his working papers to the third parties.

Relationship between the Internal Audit Function and the External Auditor

3. The role and objectives of the internal audit function are determined by management and, where applicable, those charged with governance. While the objectives of the internal audit function and the external auditor are different, some of the ways in which the internal audit function and the external auditor achieve their respective objectives may be similar. (Ref: Para. A3)

4. Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the entity as is required of the external auditor when expressing an opinion on financial statements. 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 auditors.

Effective Date

5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

6. The objectives of the external auditor, where the entity has an internal audit function that the external auditor has determined is likely to be relevant to the audit, are to determine:

(a) Whether, and to what extent, to use specific work of the internal auditors; and

(b) If so, whether such work is adequate for the purposes of the audit.

Definitions

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

(a) 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

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* Published in August, 2009 issue of the Journal.

[1] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," paragraph 23.

effectiveness of internal control. The Preface to the Standards on Internal Audit, issued by the Institute of Chartered Accountants of India, issued in November 2004 describes internal audit as "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. Internal audit, therefore, provides assurance that there is transparency in reporting, as a part of good governance."

(b) 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.

Requirements

Determining Whether and to What Extent to Use the Work of the Internal Auditors

8. The external auditor shall determine:

(a) Whether the work of the internal auditors is likely to be adequate for purposes of the audit; and

(b) If so, the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures.

9. In determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, the external auditor shall evaluate:

(a) The objectivity of the internal audit function;

(b) The technical competence of the internal auditors;

(c) Whether the work of the internal auditors is likely to be carried out with due professional care; and

(d) Whether there is likely to be effective communication between the internal auditors and the external auditor. (Ref: Para. A4)

10. In determining the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures, the external auditor shall consider:

(a) The nature and scope of specific work performed, or to be performed, by the internal auditors;

(b) The assessed risks of material misstatement at the assertion level for particular classes of transactions, account balances, and disclosures; and

(c) The degree of subjectivity involved in the evaluation of the audit evidence gathered by the internal auditors in support of the relevant assertions. (Ref: Para. A5)

Using Specific Work of the Internal Auditors

11. In order for the external auditor to use specific work of the internal auditors, the external auditor shall evaluate and perform audit procedures on that work to determine its adequacy for the external auditor's purposes. (Ref: Para. A6)

12. To determine the adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether:

(a) The work was performed by internal auditors having adequate technical training and proficiency;

(b) The work was properly supervised, reviewed and documented;

(c) Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;

(d) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and

(e) Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

Documentation

13. When the external auditor uses specific work of the internal auditors, the external auditor shall document conclusions regarding the evaluation of the adequacy of the work of the internal auditors, and the audit procedures performed by the external auditor on that work, in accordance with paragraph 11.

Application and Other Explanatory Material

Scope of this SA (Ref: Para. 1)

A1. As described in SA 315[2], 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.

A2. Carrying out procedures in accordance with this SA may cause the external auditor to re-evaluate the external auditor's assessment of the risks of material misstatement. Consequently, this may affect the external auditor's determination of the relevance of the internal audit function to the audit. Similarly, the external auditor may decide not to otherwise use the work of the internal auditors to affect the nature, timing or extent of the external auditor's procedures. In such circumstances, the external auditor's further application of this SA may not be necessary.

Scope and Objectives of the Internal Audit Function (Ref: Para. 3)

A3. 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 activities of the internal audit function may include one or more of the following:

- Monitoring of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, monitoring their operation and recommending improvements thereto.
- Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, 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.
- Risk management. The internal audit function may assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.
- Governance. The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

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[2] SA 315, paragraph A101.

Determining Whether and to What Extent to Use the Work of the Internal Auditors

Whether the Work of the Internal Auditors Is Likely to Be Adequate for Purposes of the Audit (Ref: Para. 9)

A4. Factors that may affect the external auditor's determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include:

Objectivity

- The status of the internal audit function within the entity and the effect such status has on the ability of the internal auditors to be objective.
- Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal auditors have direct access to those charged with governance.
- Whether the internal auditors are free of any conflicting responsibilities.
- Whether those charged with governance oversee employment decisions related to the internal audit function.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance.
- Whether, and to what extent, management acts on the recommendations of the internal audit function, and how such action is evidenced.

Technical competence

- Whether the internal auditors are members of relevant professional bodies.
- Whether the internal auditors have adequate technical training and proficiency as internal auditors.
- Compliance with the mandatory/ recommendatory Standards on Internal Audit (SIAs) issued by Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI).
- Whether there are established policies for hiring and training internal auditors.

Due professional care

- Whether activities of the internal audit function are properly planned, supervised, reviewed and documented.
- The existence and adequacy of audit manuals or other similar documents, work programs and internal audit documentation.

Communication

Communication between the external auditor and the internal auditors may be most effective when the internal auditors are free to communicate openly with the external auditors, and:

- Meetings are held at appropriate intervals throughout the period;
- The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal auditors when such matters may affect the work of the external auditor; and
- The external auditor informs the internal auditors of any significant matters that may affect the internal audit function.

Planned Effect of the Work of the Internal Auditors on the Nature, Timing or Extent of the External Auditor's Procedures (Ref: Para. 10)

A5. Where the work of the internal auditors is to be a factor in determining the nature, timing or extent of the external auditor's procedures, it may be useful to agree in advance the following matters with the internal auditors:

- The timing of such work;
- 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;
- Documentation of the work performed; and
- Review and reporting procedures.

Using Specific Work of the Internal Auditors (Ref: Para. 11)

A6. The nature, timing and extent of the audit procedures performed on specific work of the internal auditors will depend on the external auditor's assessment of the risk of material misstatement, the evaluation of the internal audit function, and the evaluation of the specific work of the internal auditors. Such audit procedures may include:

- Examination of items already examined by the internal auditors;
- Examination of other similar items; and
- Observation of procedures performed by the internal auditors.

Material Modifications to ISA 610, "Using the Work of Internal Auditors"

Addition

Paragraph 2 of ISA 610 deals with the situations where this ISA would not be applicable. 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 situation, "where, in terms of the applicable legal and regulatory framework, it is not permissible for the internal auditor to provide access to his working papers to the third parties" has been added.

SA 620*
Using the Work of an Auditor's Expert
(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 regarding the use of an individual or organisation's work in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.

2. This SA does not deal with:

(a) Situations where the engagement team includes a member with expertise in specialised area of accounting or auditing, which is dealt with in SA 220[1]; or

(b) The auditor's use of the work of 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(a management's expert), which is dealt with in SA 500[2].

The Auditor's Responsibility for the Audit Opinion

3. The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert. Nonetheless, if the auditor using the work of an auditor's expert, having followed this SA, concludes that the work of that expert is adequate for the auditor's purposes, the auditor may accept that expert's findings or conclusions in the expert's field as appropriate audit evidence.

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

5. The objectives of the auditor are:

(a) To determine whether to use the work of an auditor's expert; and

(b) If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes.

Definitions

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

(a) Auditor'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 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

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* Published in March, 2010 issue of the Journal.

1 SA 220, "Quality Control for an Audit of Financial Statements", paragraph A20.

2 SA 500, "Audit Evidence", paragraphs A34-A48.

partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert. (Ref: Para. A1-A3)

(b) Expertise – Skills, knowledge and experience in a particular field.

(c) 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.

Requirements

Determining the Need for an Auditor's Expert

7. If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert. (Ref: Para. A4-A9)

Nature, Timing and Extent of Audit Procedures

8. The nature, timing and extent of the auditor's procedures with respect to the requirements in paragraphs 9-13 of this SA will vary depending on the circumstances. In determining the nature, timing and extent of those procedures, the auditor shall consider matters including: (Ref: Para. A10)

(a) The nature of the matter to which that expert's work relates;

(b) The risks of material misstatement in the matter to which that expert's work relates;

(c) The significance of that expert's work in the context of the audit;

(d) The auditor's knowledge of and experience with previous work performed by that expert; and

(e) Whether that expert is subject to the auditor's firm's quality control policies and procedures. (Ref: Para. A11-A13)

The Competence, Capabilities and Objectivity of the Auditor's Expert

9. The auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity. (Ref: Para. A14-A20)

Obtaining an Understanding of the Field of Expertise of the Auditor's Expert

10. The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to: (Ref: Para. A21-A22)

(a) Determine the nature, scope and objectives of that expert's work for the auditor's purposes; and

(b) Evaluate the adequacy of that work for the auditor's purposes.

Agreement with the Auditor's Expert

11. The auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert: (Ref: Para. A23-A26)

(a) The nature, scope and objectives of that expert's work; (Ref: Para. A27)

(b) The respective roles and responsibilities of the auditor and that expert; (Ref: Para. A28-A29)

(c) The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert; and (Ref: Para. A30)

(d) The need for the auditor's expert to observe confidentiality requirements. (Ref: Para. A31)

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Evaluating the Adequacy of the Auditor's Expert's Work

12. The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including: (Ref: Para. A32)

(a) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence; (Ref: Para. A33-A34)

(b) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and (Ref: Para. A35-A37)

(c) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data. (Ref: Para. A38-A39)

13. If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall: (Ref: Para. A40)

(a) Agree with that expert on the nature and extent of further work to be performed by that expert; or

(b) Perform further audit procedures appropriate to the circumstances.

Reference to the Auditor's Expert in the Auditor's Report

14. The auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the auditor shall indicate in the auditor's report that the reference does not reduce the auditor's responsibility for the audit opinion. (Ref: Para. A41)

15. If the auditor makes reference to the work of an auditor's expert in the auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion. (Ref: Para. A42)

Application and Other Explanatory Material

Definitions

Auditor's Expert (Ref: Para. 6(a))

A1. Expertise in a field other than accounting or auditing may include expertise in relation to such matters as:

- The valuation of complex financial instruments, land and buildings, plant and machinery, jewelry, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.
- The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.
- The estimation of oil and gas reserves.
- The valuation of environmental liabilities, and site clean-up costs.
- The interpretation of contracts, laws and regulations.
- The analysis of complex or unusual tax compliance issues.

A2. In many cases, distinguishing between expertise in accounting or auditing, and expertise in another field, will be straightforward, even where this involves a specialised area of accounting or auditing. For example, an individual with expertise in applying methods of accounting for deferred income tax can often be easily distinguished from an expert in taxation law. The former is not an expert for the purposes of this SA as this constitutes accounting expertise; the latter is an expert for the purposes of this SA as this constitutes legal expertise. Similar distinctions may also be able to be made in other areas, for example, between expertise in methods of accounting for financial instruments, and expertise in complex modeling for the purpose of valuing financial instruments. In some cases, however, particularly those involving an emerging area of accounting or auditing expertise, distinguishing between specialised areas of accounting or auditing, and expertise in another field, will be a matter of professional judgment. Applicable professional rules and standards regarding education and competency requirements for accountants and auditors may assist the auditor in exercising that judgment.

A3. It is necessary to apply judgment when considering how the requirements of this SA are affected by the fact that an auditor's expert may be either an individual or an organisation. For example, when evaluating the competence, capabilities and objectivity of an auditor's expert, it may be that the expert is an organisation the auditor has previously used, but the auditor has no prior experience of the individual expert assigned by the organisation for the particular engagement; or it may be the reverse, that is, the auditor may be familiar with the work of an individual expert but not with the organisation that expert has joined. In either case, both the personal attributes of the individual and the managerial attributes of the organisation (such as systems of quality control the organisation implements) may be relevant to the auditor's evaluation.

Determining the Need for an Auditor's Expert (Ref: Para. 7)

A4. An auditor's expert may be needed to assist the auditor in one or more of the following:

- Obtaining an understanding of the entity and its environment, including its internal control.
- Identifying and assessing the risks of material misstatement.
- Determining and implementing overall responses to assessed risks at the financial statement level.
- Designing and performing further audit procedures to respond to assessed risks at the assertion level, comprising tests of controls or substantive procedures.
- Evaluating the sufficiency and appropriateness of audit evidence obtained in forming an opinion on the financial statements.

A5. The risks of material misstatement may increase when expertise in a field other than accounting is needed for management to prepare the financial statements, for example, because this may indicate some complexity, or because management may not possess knowledge of the field of expertise. If in preparing the financial statements management does not possess the necessary expertise, a management's expert may be used in addressing those risks. Relevant controls, including controls that relate to the work of a management's expert, if any, may also reduce the risks of material misstatement.

A6. If the preparation of the financial statements involves the use of expertise in a field other than accounting, the auditor, who is skilled in accounting and auditing, may not possess the necessary expertise to audit those financial statements. The engagement partner is required to 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 perform the audit engagement[3]. Further, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the engagement[4]. The auditor's determination of whether to use the work of an auditor's expert, and if so when and to what extent, assists the auditor in meeting these requirements. As the audit progresses, or as circumstances change, the auditor may need to revise earlier decisions about using the work of an auditor's expert.

A7. An auditor who is not an expert in a relevant field other than accounting or auditing may nevertheless

[3] SA 220, paragraph 14.

[4] SA 300, "Planning an Audit of Financial Statements", paragraph 7(e).

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be able to obtain a sufficient understanding of that field to perform the audit without an auditor's expert. This understanding may be obtained through, for example:

- Experience in auditing entities that require such expertise in the preparation of their financial statements.
- Education or professional development in the particular field. This may include formal courses, or discussion with individuals possessing expertise in the relevant field for the purpose of enhancing the auditor's own capacity to deal with matters in that field. Such discussion differs from consultation with an auditor's expert regarding a specific set of circumstances encountered on the engagement where that expert is given all the relevant facts that will enable the expert to provide informed advice about the particular matter[5].
- Discussion with auditors who have performed similar engagements.

A8. In other cases, however, the auditor may determine that it is necessary, or may choose, to use an auditor's expert to assist in obtaining sufficient appropriate audit evidence. Considerations when deciding whether to use an auditor's expert may include:

- Whether management has used a management's expert in preparing the financial statements (see paragraph A9).
- The nature and significance of the matter, including its complexity.
- The risks of material misstatement in the matter.
- The expected nature of procedures to respond to identified risks, including the auditor's knowledge of and experience with the work of experts in relation to such matters; and the availability of alternative sources of audit evidence.

A9. When management has used a management's expert in preparing the financial statements, the auditor's decision on whether to use an auditor's expert may also be influenced by such factors as:

- 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.
- The management's expert's competence and capabilities.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- Any controls within the entity over the management's expert's work.

SA 500[6] includes requirements and guidance regarding the effect of the competence, capabilities and objectivity of management's experts on the reliability of audit evidence.

Nature, Timing and Extent of Audit Procedures (Ref: Para. 8)

A10. The nature, timing and extent of audit procedures with respect to the requirements in paragraphs 9-13 of this SA will vary depending on the circumstances. For example, the following factors may suggest the

[5] SA 220, paragraph A21.

[6] SA 500, paragraphs 8 and A34-A48.

need for different or more extensive procedures than would otherwise be the case:

- The work of the auditor's expert relates to a significant matter that involves subjective and complex judgments.
- The auditor has not previously used the work of the auditor's expert, and has no prior knowledge of that expert's competence, capabilities and objectivity.
- The auditor's expert is performing procedures that are integral to the audit, rather than being consulted to provide advice on an individual matter.
- The expert is an auditor's external expert and is not, therefore, subject to the firm's quality control policies and procedures.

The Auditor's Firm's Quality Control Policies and Procedures *(Ref: Para. 8(e))*

A11. An auditor's internal expert may be a partner or staff, including temporary staff, of the auditor's firm, and therefore subject to the quality control policies and procedures of that firm in accordance with SQC 1[7]. Alternatively, an auditor's internal expert may be a partner or staff, including temporary staff, of a network firm, which may share common quality control policies and procedures with the auditor's firm.

A12. An auditor's external expert is not a member of the engagement team and is not subject to quality control policies and procedures in accordance with SQC 1[8]. Some law(s) or regulation(s), however, may require that an auditor's external expert be treated as a member of the engagement team, and may therefore be subject to relevant ethical and other professional requirements, including those relating to independence, as determined by such law(s) or regulation(s)[9].

A13. 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[10]. The extent of that reliance will vary with the circumstances, and may affect the nature, timing and extent of the auditor's procedures with respect to such matters as:

- Competence and capabilities, through recruitment and training programs.
- Objectivity. Auditor's internal experts are subject to relevant ethical requirements, including those pertaining to independence.
- The auditor's evaluation of the adequacy of the auditor's expert's work. For example, the firm's training programs may provide auditor's internal experts with an appropriate understanding of the interrelationship of their expertise with the audit process. Reliance on such training and other firm processes, such as protocols for scoping the work of auditor's internal experts, may affect the nature, timing and extent of the auditor's procedures to evaluate the adequacy of the auditor's expert's work.
- Adherence to regulatory and legal requirements, through monitoring processes.
- Agreement with the auditor's expert.

Such reliance does not reduce the auditor's responsibility to meet the requirements of this SA.

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7 SQC 1, paragraph 6(e).

8 SQC 1, paragraph 6(e).

9 Relevant ethical requirements ordinarily comprise the Code of Ethics of the Institute of Chartered Accountants of India related to an audit of financial statements.

10 SA 220, paragraph 4.

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The Competence, Capabilities and Objectivity of the Auditor's Expert (Ref: Para. 9)

A14. The competence, capabilities and objectivity of an auditor's expert are factors that significantly affect whether the work of the auditor's expert will be adequate for the auditor's purposes. Competence relates to the nature and level of expertise of the auditor's expert. Capability relates to the ability of the auditor's expert to exercise that competence in the circumstances of the engagement. 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 auditor's expert.

A15. Information regarding the competence, capabilities and objectivity of an auditor'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 other auditors or 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.
- The auditor's firm's quality control policies and procedures (see paragraphs A11-A13)

A16. Matters relevant to evaluating the competence, capabilities and objectivity of the auditor'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.

A17. Other matters that may be relevant include:

- The relevance of the auditor'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 auditor's expert's competence with respect to relevant accounting and auditing 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 auditor's expert as the audit progresses.

A18. 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 eliminate or reduce such threats, and may be created by external structures (for example, the auditor's expert's profession, legislation or regulation), or by the auditor's expert's work environment (for example, quality control policies and procedures). There may also be safeguards specific to the audit engagement.

A19. The evaluation of the significance of threats to objectivity and of whether there is a need for safeguards may depend upon the role of the auditor's expert and the significance of the expert's work in the context of the audit. There may be some circumstances in which safeguards cannot reduce threats to an acceptable level, for example, if a proposed auditor's expert is an individual who has played a significant role in preparing the information that is being audited, that is, if the auditor's expert is a management's expert.

A20. When evaluating the objectivity of an auditor's external expert, it may be relevant to:

(a) Inquire of the entity about any known interests or relationships that the entity has with the auditor's external expert that may affect that expert's objectivity.

(b) Discuss with that expert any applicable safeguards, including any professional requirements that apply to that expert; and evaluate whether the safeguards are adequate to reduce threats to an acceptable level. Interests and relationships that may be relevant to discuss with the auditor's expert include:

- Financial interests.
- Business and personal relationships.
- Provision of other services by the expert, including by the organisation in the case of an external expert that is an organisation.
- In some cases, it may also be appropriate for the auditor to obtain a written representation from the auditor's external expert about any interests or relationships with the entity of which that expert is aware.

Obtaining an Understanding of the Field of Expertise of the Auditor's Expert (Ref: Para. 10)

A21. The auditor may obtain an understanding of the auditor's expert's field of expertise through the means described in paragraph A7, or through discussion with that expert.

A22. Aspects of the auditor'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 (see paragraph A17).
- Whether any professional or other standards, and regulatory or legal requirements apply.
- What assumptions and methods, including models where applicable, are used by the auditor'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.

Agreement with the Auditor's Expert (Ref: Para. 11)

A23. The nature, scope and objectives of the auditor's expert's work may vary considerably with the circumstances, as may the respective roles and responsibilities of the auditor and the auditor's expert, and the nature, timing and extent of communication between the auditor and the auditor's expert. It is therefore required that these matters are agreed between the auditor and the auditor's expert regardless of whether the expert is an auditor's external expert or an auditor's internal expert.

A24. The matters noted in paragraph 8 may affect the level of detail and formality of the agreement between the auditor and the auditor's expert, including whether it is appropriate that the agreement be in writing. For example, the following factors may suggest the need for more a detailed agreement than would otherwise be the case, or for the agreement to be set out in writing:

- The auditor's expert will have access to sensitive or confidential entity information.
- The respective roles or responsibilities of the auditor and the auditor's expert are different from those normally expected.
- Multi-jurisdictional legal or regulatory requirements apply.

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- The matter to which the auditor's expert's work relates is highly complex.
- The auditor has not previously used work performed by that expert.
- The greater the extent of the auditor's expert's work, and its significance in the context of the audit.

A25. The agreement between the auditor and an auditor's external expert is often in the form of an engagement letter. The Appendix lists matters that the auditor may consider for inclusion in such an engagement letter, or in any other form of agreement with an auditor's external expert.

A26. When there is no written agreement between the auditor and the auditor's expert, evidence of the agreement may be included in, for example:

- Planning memoranda, or related working papers such as the audit program.
- The policies and procedures of the auditor's firm. In the case of an auditor's internal expert, the established policies and procedures to which that expert is subject may include particular policies and procedures in relation to that expert's work. The extent of documentation in the auditor's working papers depends on the nature of such policies and procedures. For example, no documentation may be required in the auditor's working papers if the auditor's firm has detailed protocols covering the circumstances in which the work of such an expert is used.

Nature, Scope and Objectives of Work (Ref: Para. 11(a))

A27. It may often be relevant when agreeing on the nature, scope and objectives of the auditor's expert's work to include discussion of any relevant technical performance standards or other professional or industry requirements that the expert will follow.

Respective Roles and Responsibilities (Ref: Para. 11(b))

A28. Agreement on the respective roles and responsibilities of the auditor and the auditor's expert may include:

- Whether the auditor or the auditor's expert will perform detailed testing of source data.
- Consent for the auditor to discuss the auditor's expert's findings or conclusions with the entity and others, and to include details of that expert's findings or conclusions in a modified auditor's report, if necessary (see paragraph A42).
- Any agreement to inform the auditor's expert of the auditor's conclusions concerning that expert's work.

Working Papers

A29. Agreement on the respective roles and responsibilities of the auditor and the auditor's expert may also include agreement about access to, and retention of, each other's working papers. When the auditor's expert is a member of the engagement team, that expert's working papers form part of the audit documentation. Subject to any agreement to the contrary, auditor's external experts' working papers are their own and do not form part of the audit documentation.

Communication (Ref: Para. 11(c))

A30. Effective two-way communication facilitates the proper integration of the nature, timing and extent of the auditor's expert's procedures with other work on the audit, and appropriate modification of the auditor's expert's objectives during the course of the audit. For example, when the work of the auditor's expert relates to the auditor's conclusions regarding a significant risk, both a formal written report at the conclusion of that expert's work, and oral reports as the work progresses, may be appropriate. Identification of specific partners or staff who will liaise with the auditor's expert, and procedures for communication between that expert and the entity, assists timely and effective communication, particularly on larger engagements.

Confidentiality (Ref: Para. 11(d))

A31. It is necessary for the confidentiality provisions of relevant ethical requirements that apply to the auditor also to apply to the auditor's expert. Additional requirements may be imposed by law or regulation. The entity may also have requested that specific confidentiality provisions be agreed with auditor's external experts.

Evaluating the Adequacy of the Auditor's Expert's Work (Ref: Para. 12)

A32. The auditor's evaluation of the auditor's expert's competence, capabilities and objectivity, the auditor's familiarity with the auditor's expert's field of expertise, and the nature of the work performed by the auditor's expert affect the nature, timing and extent of audit procedures to evaluate the adequacy of that expert's work for the auditor's purposes.

The Findings and Conclusions of the Auditor's Expert (Ref: Para. 12(a))

A33. Specific procedures to evaluate the adequacy of the auditor's expert's work for the auditor's purposes may include:

- Inquiries of the auditor's expert.
- Reviewing the auditor's expert's working papers and reports.
- Corroborative procedures, such as:
  - Observing the auditor's expert's work;
  - Examining published data, such as statistical reports from reputable, authoritative sources;
  - Confirming relevant matters with third parties;
  - Performing detailed analytical procedures; and
  - Re-performing calculations.
- Discussion with another expert with relevant expertise when, for example, the findings or conclusions of the auditor's expert are not consistent with other audit evidence.
- Discussing the auditor's expert's report with management.

A34. Relevant factors when evaluating the relevance and reasonableness of the findings or conclusions of the auditor's expert, whether in a report or other form, may include whether they are:

- Presented in a manner that is consistent with any standards of the auditor's expert's profession or industry;
- Clearly expressed, including reference to the objectives agreed with the auditor, the scope of the work performed and standards applied;
- Based on an appropriate period and take into account subsequent events, where relevant;
- Subject to any reservation, limitation or restriction on use, and if so, whether this has implications for the auditor; and
- Based on appropriate consideration of errors or deviations encountered by the auditor's expert.

Assumptions, Methods and Source Data

Assumptions and Methods (Ref: Para. 12(b))

A35. When the auditor's expert's work is to evaluate underlying assumptions and methods, including models where applicable, used by management in developing an accounting estimate, the auditor's procedures are likely to be primarily directed to evaluating whether the auditor's expert has adequately reviewed those assumptions and methods. When the auditor's expert's work is to develop an auditor's point estimate or an

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auditor's range for comparison with management's point estimate, the auditor's procedures may be primarily directed to evaluating the assumptions and methods, including models where appropriate, used by the auditor's expert.

A36. SA 540[11] discusses the assumptions and methods used by management in making accounting estimates, including the use in some cases of highly specialised, entity-developed models. Although that discussion is written in the context of the auditor obtaining sufficient appropriate audit evidence regarding management's assumptions and methods, it may also assist the auditor when evaluating an auditor's expert's assumptions and methods.

A37. When an auditor's expert's work involves the use of significant assumptions and methods, factors relevant to the auditor's evaluation of those assumptions and methods include whether they are:

- Generally accepted within the auditor's expert's field;
- Consistent with the requirements of the applicable financial reporting framework;
- Dependent on the use of specialised models; and
- Consistent with those of management, and if not, the reason for, and effects of, the differences.

Source Data Used by the Auditor's Expert (Ref: Para. 12(c))

A38. When an auditor's expert's work involves the use of source data that is significant to that expert's work, procedures such as the following may be used to test that data:

- Verifying the origin of the data, including obtaining an understanding of, and where applicable testing, the internal controls over the data and, where relevant, its transmission to the expert.
- Reviewing the data for completeness and internal consistency.

A39. In many cases, the auditor may test source data. However, in other cases, when the nature of the source data used by an auditor's expert is highly technical in relation to the expert's field, that expert may test the source data. If the auditor's expert has tested the source data, inquiry of that expert by the auditor, or supervision or review of that expert's tests may be an appropriate way for the auditor to evaluate that data's relevance, completeness, and accuracy.

Inadequate Work (Ref: Para. 13)

A40. If the auditor concludes that the work of the auditor's expert is not adequate for the auditor's purposes and the auditor cannot resolve the matter through the additional audit procedures required by paragraph 13, which may involve further work being performed by both the expert and the auditor, or include employing or engaging another expert, it may be necessary to express a modified opinion in the auditor's report in accordance with SA 705 because the auditor has not obtained sufficient appropriate audit evidence[12].

Reference to the Auditor's Expert in the Auditor's Report (Ref: Para. 14-15)

A41. In some cases, law or regulation may require a reference to the work of an auditor's expert, for example, for the purposes of transparency in the public sector.

A42. It may be appropriate in some circumstances to refer to the auditor's expert in an auditor's report containing a modified opinion, to explain the nature of the modification. In such circumstances, the auditor may need the permission of the auditor's expert before making such a reference.

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[11] SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", paragraphs 8, 13 and 15.

[12] SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 6(b).

Modifications *vis-a-vis* ISA 620, "Using the Work of an Auditor's Expert"

SA 620, "Using the Work of an Auditor's Expert" does not contain any modifications *vis-à-vis* ISA 620.

Appendix

(Ref: Para. A25)

Considerations for Agreement between the Auditor and an Auditor's External Expert

This Appendix lists matters that the auditor may consider for inclusion in any agreement with an auditor's external expert. The following list is illustrative and is not exhaustive; it is intended only to be a guide that may be used in conjunction with the considerations outlined in this SA. Whether to include particular matters in the agreement depends on the circumstances of the engagement. The list may also be of assistance in considering the matters to be included in an agreement with an auditor's internal expert.

Nature, Scope and Objectives of the Auditor's External Expert's Work

- The nature and scope of the procedures to be performed by the auditor's external expert.
- The objectives of the auditor's external expert's work in the context of materiality and risk considerations concerning the matter to which the auditor's external expert's work relates, and, when relevant, the applicable financial reporting framework.
- Any relevant technical performance standards or other professional or industry requirements the auditor's external expert will follow.
- The assumptions and methods, including models where applicable, the auditor's external expert will use, and their authority.
- The effective date of, or when applicable the testing period for, the subject matter of the auditor's external expert's work, and requirements regarding subsequent events.

The Respective Roles and Responsibilities of the Auditor and the Auditor's External Expert

- Relevant auditing and accounting standards, and relevant regulatory or legal requirements.
- The auditor's external expert's consent to the auditor's intended use of that expert's report, including any reference to it, or disclosure of it, to others, for example reference to it in a modified auditor's report, if necessary, or disclosure of it to management or an audit committee.
- The nature and extent of the auditor's review of the auditor's external expert's work.
- Whether the auditor or the auditor's external expert will test source data.
- The auditor's external expert's access to the entity's records, files, personnel and to experts engaged by the entity.
- Procedures for communication between the auditor's external expert and the entity.
- The auditor's and the auditor's external expert's access to each other's working papers.
- Ownership and control of working papers during and after the engagement, including any file retention requirements.
- The auditor's external expert's responsibility to perform work with due skill and care.
- The auditor's external expert's competence and capability to perform the work.

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- The expectation that the auditor's external expert will use all knowledge that expert has that is relevant to the audit or, if not, will inform the auditor.
- Any restriction on the auditor's external expert's association with the auditor's report.
- Any agreement to inform the auditor's external expert of the auditor's conclusions concerning that expert's work.

Communications and Reporting

- Methods and frequency of communications, including:
  - How the auditor's external expert's findings or conclusions will be reported (written report, oral report, ongoing input to the engagement team, etc.).
  - Identification of specific persons within the engagement team who will liaise with the auditor's external expert.
- When the auditor's external expert will complete the work and report findings or conclusions to the auditor.
- The auditor's external expert's responsibility to communicate promptly any potential delay in completing the work, and any potential reservation or limitation on that expert's findings or conclusions.
- The auditor's external expert's responsibility to communicate promptly instances in which the entity restricts that expert's access to records, files, personnel or experts engaged by the entity.
- The auditor's external expert's responsibility to communicate to the auditor all information that expert believes may be relevant to the audit, including any changes in circumstances previously communicated.
- The auditor's external expert's responsibility to communicate circumstances that may create threats to that expert's objectivity, and any relevant safeguards that may eliminate or reduce such threats to an acceptable level.

Confidentiality

- The need for the auditor's expert to observe confidentiality requirements, including:
  - The confidentiality provisions of relevant ethical requirements that apply to the auditor.
  - Additional requirements that may be imposed by law or regulation, if any.
  - Specific confidentiality provisions requested by the entity, if any.

SA 700*
Forming an Opinion and Reporting on Financial Statements

(Effective for all audits relating to accounting periods beginning on or after April 1, 2011[1])

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 705[2] and SA 706[3] 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.

3. This SA is written in the context of a complete set of general purpose financial statements. SA 800[4] deals with special considerations when financial statements are prepared in accordance with a special purpose framework. SA 805[5] 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.

4. This SA promotes consistency in the auditor's report. 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 recognised 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, 2011.

Objectives

6. The objectives of the auditor are to:

(a) Form an opinion on the financial statements based on an evaluation of the conclusions drawn from the

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*Published in February, 2010 issue of the Journal.

[1] 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 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).

[2] SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

[3] SA 706, "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".

audit evidence obtained; and

(b) Express clearly that opinion through a written report that also describes the basis for the opinion.

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[6].

(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[7].

(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[8].

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. 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 "Financial Reporting Standards" in this SA 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 Institute of Chartered Accountants of India, as may be applicable.

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[6] Paragraph 3.4 of the Revised Preface to the Statements of Accounting Standards issued by the Institute of Chartered Accountants of India in 2004 states as follows:

"*The term "General Purpose Financial Statements" includes balance sheet, statement of profit and loss, a cash flow statement (wherever applicable) and statements and explanatory notes which form part thereof, issued for the use of various stakeholders, Governments and their agencies and the public………".*

[7] SA 200, Paragraph 13(a).

[8] 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.

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.

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.

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[9] SA 200, paragraph 11.

[10] 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.

[11] SA 330, "The Auditor's Responses to Assessed Risks", paragraph 26.

[12] SA 450, "Evaluation of Misstatements Identified during the Audit", paragraph 11.

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.

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. (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 required by the circumstances of the engagement. (Ref: Para. A16)

Introductory Paragraph

23. The introductory paragraph in the auditor's report shall: (Ref: Para. A17-A19)

(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 that comprises the financial statements;

(d) Refer to the summary of significant accounting policies and other explanatory information; and

(e) Specify the date or period covered by each financial statement comprising the financial statements.

Management's Responsibility for the Financial Statements

24. This section of the auditor's report describes the responsibilities of those in the organisation that are

responsible for the preparation of the financial statements. The auditor's report need not refer specifically to "management", but shall use the term that is appropriate in the context of the legal and/or regulatory framework applicable to the entity. In case of some entities, the appropriate reference may be to those charged with governance*.

25. The auditor's report shall include a section with the heading "*Management's [or other appropriate term] Responsibility for the Financial Statements*".

26. The auditor's report shall describe management's responsibility for the preparation of the financial statements in the manner in which that responsibility is described in the terms of the audit engagement. The description shall include an explanation that management is responsible for the preparation of the financial statements in accordance with the applicable financial reporting framework; this responsibility includes the design, implementation and maintenance of internal control relevant to the preparation of financial statements that are free from material misstatement, whether due to fraud or error. (Ref: Para. A20-A22)

27. Where the financial statements are prepared in accordance with a fair presentation framework, the explanation of management's responsibility 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 Responsibility

28. The auditor's report shall include a section with the heading "*Auditor's Responsibility*".

29. The auditor's report shall state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit. (Ref: Para. A23)

30. The auditor's report shall state that the audit was conducted in accordance with Standards on Auditing issued by the Institute of Chartered Accountants of India. The auditor's report shall also explain that those Standards require that the auditor comply with ethical requirements and that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. (Ref: Para. A24-A25)

31. The auditor's report shall describe an audit by stating that:

(a) An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements;

(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

(c) An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of accounting estimates made by management, as well as the overall presentation of the financial statements.

32. Where the financial statements are prepared in accordance with a fair presentation framework, the description of the audit in the auditor's report shall refer to "the entity's preparation and fair presentation of

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* For example, the Board of Directors under the Companies Act, 1956.

the financial statements" or "the entity's preparation of financial statements that give a true and fair view", as appropriate in the circumstances.

33. The auditor's report shall state 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.

Auditor's Opinion

34. The auditor's report shall include a section with the heading "*Opinion*".

35. 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: (Ref: Para. A26-A32)

(a) The financial statements present fairly, in all material respects, in accordance with [the applicable financial reporting framework]; or

(b) The financial statements give a true and fair view of in accordance with [the applicable financial reporting framework].

36. When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor's opinion shall be that the financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework]. (Ref: Para. A26, A28-A32)

37. If the reference to the applicable financial reporting framework, in the auditor's opinion, is not to 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 Institute of Chartered Accountants of India, as may be applicable, the auditor's opinion shall identify the jurisdiction of origin of the framework.

Other Reporting Responsibilities

38. If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibility under the SAs to report on the financial statements, these other reporting responsibilities shall be addressed in a separate section in the auditor's report that shall be sub-titled "*Report on Other Legal and Regulatory Requirements,*" or otherwise as appropriate to the content of the section. (Ref: Para. A33-A34)

39. If the auditor's report contains a separate section on other reporting responsibilities, the headings, statements and explanations referred to in paragraphs 23-37 shall be under the sub-title "*Report on the Financial Statements*." The "*Report on Other Legal and Regulatory Requirements*" shall follow the "*Report on the Financial Statements*." (Ref: Para. A35)

Signature of the Auditor

40. The auditor's report shall be signed. (Ref: Para. A36)

Date of the Auditor's Report

41. 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. A37-A40)

(a) All the statements that comprise the financial statements, including the related notes, have been prepared; and

(b) Those with the recognised authority have asserted that they have taken responsibility for those financial statements.

Place of Signature

42. The auditor's report shall name specific location, which is ordinarily the city where the audit report is signed.

Auditor's Report Prescribed by Law or Regulation

43. If the auditor is required by any 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: (Ref: Para. A41)

(a) A title;

(b) An addressee, as required by the circumstances of the engagement;

(c) An introductory paragraph that identifies the financial statements audited;

(d) A description of the responsibility of management (or other appropriate term, see paragraph 24) for the preparation of the financial statements;

(e) A description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit, that includes:

- A reference to Standards on Auditing and the law or regulation; and
- A description of an audit in accordance with those Standards;

(f) An opinion paragraph containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements (including identifying the jurisdiction of origin of the financial reporting framework, see paragraph 37);

(g) The auditor's signature;

(h) The date of the auditor's report; and

(i) The place of signature.

Auditor's Report for Audits Conducted in Accordance with Both Auditing Standards issued by the Institute of Chartered Accountants of India and International Standards on Auditing

44. An auditor may be required to conduct an audit in accordance with the auditing Standards issued by the Institute of Chartered Accountants of India (the "national auditing standards"), but may additionally have complied with the International Standards on Auditing (ISAs) in the conduct of the audit. If this is the case, the auditor's report may refer to International Standards on Auditing in addition to the national auditing standards, but the auditor shall do so only if: (Ref: Para. A42-A43)

(a) There is no conflict between the requirements in the national auditing standards and those in ISAs that would lead the auditor (i) to form a different opinion, or (ii) not to include an Emphasis of Matter paragraph that, in the particular circumstances, is required by ISAs; and

(b) The auditor's report includes, at a minimum, each of the elements set out in paragraph 43(a)-(i) when the auditor uses the layout or wording specified by the national auditing standards. Reference to law or regulation in paragraph 43(e) shall be read as reference to the national auditing standards. The auditor's report shall thereby identify such national auditing standards.

45. When the auditor's report refers to both the national auditing standards and International Standards on Auditing, the auditor's report shall identify the national auditing standards being the Standards on Auditing issued by the Institute of Chartered Accountants of India.

Supplementary Information Presented with the Financial Statements (Ref: Para. A44-A50)

46. 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 such supplementary information is clearly differentiated from the audited financial statements. If such supplementary information is not clearly differentiated from the audited financial statements, the auditor shall ask management to change how the unaudited supplementary information is presented. If management refuses to do so, the auditor shall explain in the auditor's report that such supplementary information has not been audited.

47. Supplementary information that is not required by the applicable financial reporting framework but is nevertheless an integral part of the financial statements because it cannot be clearly differentiated from the audited financial statements due to its nature and how it is presented shall be covered by the auditor's opinion.

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 contains a discussion of the qualitative aspects of accounting practices[13]. 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[14]. 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.

Disclosure 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 Balance Sheet, Statement of Profit and Loss and Cash Flow Statement. 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 state of affairs, results of operations and cash flows.

Description of the Applicable Financial Reporting Framework (Ref: Para. 15)

A5. As explained in SA 200, management and, where appropriate, those charged with governance

[13] SA 260, "Communication with Those Charged with Governance", Appendix.

[14] SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", paragraph 21.

have responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework and for an adequate description of that framework in the financial statements15. That description is important because it 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 Financial Reporting Standards[16]") is not an adequate description of that framework as it may mislead users of the financial statements.

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., the national framework and International Financial Reporting Standards). 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 jurisdiction has adopted the other framework (e.g., International Financial Reporting Standards) as its own national framework, 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 national framework that also describe the extent to which they comply with International Financial Reporting Standards). Such description is supplementary financial information and, as discussed in paragraph 47, is considered an integral part of the financial statements and, accordingly, is covered by the auditor's opinion.

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.

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[15] SA 200, paragraphs A2-A3.

[16] 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.

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[17].

Auditor's Report (Ref: Para. 20)

A13. A written report encompasses reports issued in hard copy format and those using an electronic medium.

A14. The Appendix contains illustrations of auditors' reports on financial statements, incorporating the elements set forth in paragraphs 21-42.

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 Report", affirms that the auditor has met all of the relevant ethical requirements regarding independence and, therefore, distinguishes the independent auditor's report from reports issued by others.

Addressee (Ref: Para. 22)

A16. The law or regulation applicable to the entity often specifies 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.

Introductory Paragraph (Ref: Para. 23)

A17. The introductory paragraph states, for example, that the auditor has audited the accompanying 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 referring to the summary of significant accounting policies and other explanatory information.

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.

A19. 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 include: a Balance Sheet, Statement of Profit and Loss, a Cash Flow Statement, and a summary of significant accounting policies and other explanatory information. In case of some entities, additional information might also be considered to be an integral part of the financial statements.

Management's Responsibility for the Financial Statements (Ref: Para. 26)

A20. 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[18]. Management and, where appropriate, those charged with governance are responsible for the preparation of the financial statements in accordance with the applicable financial reporting framework.

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[17] SA 210, "Agreeing the Terms of Audit Engagements", paragraph 6(a).

[18] SA 200, paragraph 13(j).

For example, in the case of many general purpose frameworks, management is responsible for the preparation of financial statements that fairly present the financial position, financial performance and cash flows of the entity in accordance with those frameworks. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation of financial statements that are free from material misstatement, whether due to fraud or error. In some cases, 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 315[19]) no specific reference is made to them in paragraph 26 for the description of management's responsibilities.

A21. There may be circumstances when it is appropriate for the auditor to add to the description of management's responsibility in paragraph 26 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.

A22. SA 210 explains 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 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. For those that are not prescribed by law or regulation such that their effect is equivalent, the engagement letter or other suitable form of written agreement reflects the description in SA 210[20].

Auditor's Responsibility (Ref: Para. 29-30)

A23. The auditor's report states that the auditor's responsibility is to express an opinion on the financial statements based on the audit in order to contrast it to management's responsibility for the preparation of the financial statements.

A24. 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.

A25. In accordance with SA 200, the auditor does not represent compliance with SAs in the auditor's report unless the auditor has complied with the requirements of the SA 200 and all other SAs relevant to the audit[21].

Auditor's Opinion (Ref: Para. 35-37)

Wording of the auditor's opinion prescribed by law or regulation

A26. SA 210 explains that, in some cases, law or regulation prescribes the wording of the auditor's report (which in particular includes the auditor's opinion) in terms that are significantly different from the requirements of SAs. 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

[19] SA 315, "Identifying and Assessing the Risks of Material Misstatements Through Understanding the Entity and Its Environment", paragraph 4(c).

[20] SA 210, paragraph 6(b).

[21] SA 200, paragraph 20.

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[22].

"Present fairly, in all material respects" or "give a true and fair view"

A27. 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.

Description of information that the financial statements present

A28. 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 information that the financial statements are designed to present, for example, in the case of many general purpose frameworks, the financial position of the entity as at the end of the period and the entity's financial performance and cash flows for the period then ended.

Description of the applicable financial reporting framework and how it may affect the auditor's opinion

A29. 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 International Financial Reporting Standards" or

"… in accordance with accounting principles generally accepted in India…"

A30. When the applicable financial reporting framework encompasses financial reporting standards and legal or regulatory requirements, the framework is identified in such terms as "………..the information required by the Companies Act, 1956, in the manner so required and (give a true and fair view) in conformity with the accounting principles generally accepted in India". SA 210 deals with circumstances where there are conflicts between the financial reporting standards and the legislative or regulatory requirements[23].

A31. 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 35-36 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., the national framework) and an opinion that the financial statements are prepared in accordance with the other applicable financial reporting framework (e.g., International Financial Reporting Standards). These opinions may be expressed

[22] SA 210, paragraph 21.

[23] SA 210, paragraph 18.

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 International Financial Reporting Standards).

(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., the national framework) but a modified opinion given with regard to the other framework (e.g., International Financial Reporting Standards) in accordance with SA 705.

A32. 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. As explained in paragraph A45, such supplementary information is covered by the auditor's opinion as it cannot be clearly differentiated from the financial statements.

(a) If the disclosure as to the compliance with the other framework is misleading, a modified opinion is expressed in accordance with SA 705.

(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, drawing attention to the disclosure.

A32a. There can be situations where an entity or a class of entities obtains written permission from the Central Government of India or a regulator or by order of a court of law having jurisdiction to make such an order, to prepare its financial statements without meeting specific recognition, measurement, presentation or disclosure requirements of the applicable financial reporting framework. Such a change shall be treated as a modification of the financial reporting framework and not as inability of the auditor to obtain sufficient appropriate audit evidence. If the effect of this is material, the auditor shall describe in sufficient detail the resultant deviation from the financial reporting framework in an Emphasis of Matter paragraph in accordance with the SA 706.

Other Reporting Responsibilities (Ref: Para. 38-39)

A33. In case of some entities, the auditor may have additional responsibilities to report on other matters that are supplementary to the auditor's responsibility under the SAs to report on the financial statements. 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. Auditing standards often provide guidance on the auditor's responsibilities with respect to specific additional reporting responsibilities in such situations.

A34. In some cases, the relevant law or regulation may require or permit the auditor to report on these other responsibilities within the 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.

A35. These other reporting responsibilities are addressed in a separate section of the auditor's report in order to clearly distinguish them from the auditor's responsibility under the SAs to report on the financial statements. Where relevant, this section may contain sub- heading(s) that describe(s) the content of the other reporting responsibility paragraph(s).

Signature of the Auditor (Ref: Para. 40)

A36. The report is signed by the auditor 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[24].

Date of the Auditor's Report (Ref: Para. 41)

A37. 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[25].

A38. Since the auditor's opinion is provided on the financial statements and the financial statements are the 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.

A39. In 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 other entities, however, the approval process is not prescribed in law or regulation. In such cases, the procedures the entity follows in preparing and finalising its financial statements in view of its management and governance structures is 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.

A40. In some entities, final approval of the financial statements by shareholders is required before the financial statements are issued publicly. In these entities, 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 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 them.

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[24] 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 of/ 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. 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.

[25] SA 560, "Subsequent Events," paragraphs 10-17.

Auditor's Report Prescribed by Law or Regulation (Ref: Para. 43)

A41. SA 200 explains that the auditor may be required to comply with legal or regulatory requirements in addition to SAs[26]. Where this is the case, the auditor may be obliged to use a layout or wording in the auditor's report that differs from that described in this SA. As explained in paragraph 4, 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 recognised standards. When the differences between the legal or regulatory requirements and SAs relate only to the layout and wording of the auditor's report and, at a minimum, each of the elements identified in paragraph 43(a)-(i) are included in the auditor's report, the auditor's report may refer to Standards on Auditing. Accordingly, in such circumstances the auditor is considered to have complied with the requirements of SAs, even when the layout and wording used in the auditor's report are specified by legal or regulatory reporting requirements. Where specific requirements in a particular law or regulation do not conflict with SAs, adoption of the layout and wording used in this SA assists users of the auditor's report more readily to recognise the auditor's report as a report on an audit conducted in accordance with SAs. (SA 210 deals with circumstances where law or regulation prescribes the layout or wording of the auditor's report in terms that are significantly different from the requirements of SAs).

Auditor's Report for Audits Conducted in Accordance with Both Auditing Standards issued by the Institute of Chartered Accountants of India (national auditing standards) and International Standards on Auditing (Ref: Para. 44)

A42. The auditor may refer in the auditor's report to the audit having been conducted in accordance with both International Standards on Auditing as well as the national auditing standards, i.e., the Standards on Auditing issued by the Institute of Chartered Accountants of India when, in addition to complying with the national auditing standards, the auditor complies with each of the ISAs relevant to the audit.

A43. A reference to both International Standards on Auditing and the national auditing standards is not appropriate if there is a conflict between the requirements in ISAs and those in the national auditing standards that would lead the auditor to form a different opinion or not to include an Emphasis of Matter paragraph that, in the particular circumstances, is required by ISAs. In such a case, the auditor's report refers only to the auditing standards (either International Standards on Auditing or the national auditing standards) in accordance with which the auditor's report has been prepared.

Supplementary Information Presented with the Financial Statements (Ref: Para. 46-47)

A44. 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.

A45. The auditor's opinion covers supplementary information that cannot be clearly differentiated from the financial statements because of its nature and how it is presented. For example, this would be the case when the notes to the financial statements include an explanation of the extent to which the financial statements comply with another financial reporting framework. The auditor's opinion would also cover notes or supplementary schedules that are cross-referenced from the financial statements.

[26] SA 200, paragraph A55.

A46. Supplementary information that is covered by the auditor's opinion does not need to be specifically referred to in the introductory paragraph of the auditor's report when the reference to the notes in the description of the statements that comprise the financial statements in the introductory paragraph is sufficient.

A47. The law or regulation applicable to the entity may not require that the supplementary information be audited, and management may decide not to ask the auditor to include the supplementary information within the scope of the audit of the financial statements.

A48. 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".

A49. 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, place the unaudited notes together at the end of the required notes to the financial statements and clearly label them as unaudited. Unaudited notes that are intermingled with the audited notes can be misinterpreted as being audited.

A50. The fact that supplementary information is unaudited does not relieve the auditor of the responsibility to read that information to identify material inconsistencies with the audited financial statements. The auditor's responsibilities with respect to unaudited supplementary information are consistent with those described in SA 720[27].

Material Modifications *vis-a-vis* ISA 700, "Forming an Opinion and Reporting on Financial Statements"

Additions

1. Paragraph 9 of ISA 700 explains what constitutes the International Financial Reporting Standards (IFRS) for the ISA 700. Since in India, financial reporting standards, used for the preparation and presentation of financial statements, can be 'Accounting Standards promulgated by the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India or Accounting Standards, notified by the Central Government by publishing the same as Companies (Accounting Standards) Rules, 2006' or 'Accounting Standards for Local Bodies promulgated by the Committee on Accounting Standards for Local Bodies (CASLB) of the Institute of Chartered Accountants of India (ICAI)', the paragraph 9 has accordingly been changed. Corresponding changes have also been made at the relevant places of the Standard.
2. Paragraph 42 of ISA 700 states that the auditor's report shall name the location in the jurisdiction where the auditor practices. Since the practices prevailing in India requires the auditor to mention the "Place of Signature" instead of the "Auditor's Address" in the auditor's report, the requirement of mentioning the auditor's address has been replaced with the place of signature, which is the

[27] SA 720, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements".

name of specific location, which is ordinarily the city where the audit report is signed. Corresponding changes have also been made at the relevant places of the Standard.

3. Paragraph A36 of ISA 700 explains who is eligible for signing the auditor's report in the different situations. Since in India, audit report may be signed by the auditor in his personal name in case of sole practitioner and where the firm is appointed as the auditor, the report may be signed in the personal name of the auditor and in the name of the audit firm, the paragraph has accordingly been changed. Since as per the Indian practice, the partner/proprietor signing the audit report also needs to mention the firm registration number, wherever applicable, and the membership number assigned by the Institute of Chartered Accountants of India, the said requirement has also been incorporated in the paragraph A36 of SA 700 (Revised).

Appendix

(Ref: Para. A14)

Illustrative Formats of Auditors' Reports on Financial Statements

Illustration 1:

Circumstances include the following:

- **Audit of a complete set of separate general purpose financial statements of a company prepared under the Companies Act, 1956 financial reporting framework, which is a fair presentation framework.**
- **The terms of the audit engagement reflect description of management's responsibility for the financial statements in SA 210.**
- **The report is unmodified and does not include either an Emphasis of Matter paragraph or an Other Matter(s) paragraph.**
- **In addition to the audit of financial statements, the auditor has other reporting responsibilities required under the Companies Act, 1956 and/or other regulatory requirements.**

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements

We have audited the accompanying 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 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 of these financial statements that give a true and fair view of the financial position, financial performance 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 presentation of the financial statements that give a true and fair view and 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. 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 Company'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[28]. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the 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.

Opinion

In our opinion and to the best of our information and according to the explanations given to us, the 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:

(a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the Profit and Loss Account, of the profit/ loss for the year ended on that date; and

(c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.

2. As required by section 227(3) of the Act, we report that:

a. we have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;

b. in our opinion proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us][29];

c. 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[30];

d. the Balance Sheet, Statement of Profit and Loss, and Cash Flow Statement dealt with by this Report

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[28] 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.

[29] To be included if relevant.

[30] 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.

are in agreement with the books of account [and with the returns received from branches not visited by us][31];

e. in our opinion, the Balance Sheet, Statement of Profit and Loss, and Cash Flow Statement comply with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956;

f. on the basis of written representations received from the directors as on March 31, 20XX, and taken on record by the Board of Directors, none of the directors is disqualified as on March 31, 20XX, from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956.

g. Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the Company.[32]

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[33])
Membership Number

Place of Signature

Date

<u>Illustration 2:</u>

Circumstances include the following:

- **Audit of a complete set of consolidated general purpose financial statements of a parent company prepared under accounting principles generally accepted in India, as required for compliance with SEBI's regulatory requirement, which is a fair presentation framework.**
- **The terms of the group audit engagement reflect description of management's responsibility for the financial statements in SA 210.**
- **The report is unmodified and does not include either an Emphasis of Matter paragraph or an Other Matter(s) paragraph.**

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[31] To be included if relevant.

[32] Attention of the readers is invited to the Announcement issued by the Council of the ICAI (pursuant to a decision taken in this regard at its 312th meeting held in December, 2011) regarding the auditor's reporting responsibilities pursuant to clause 4(ix)(a) of the Companies (Auditor's Report) Order, 2003 and section 227(3)(g) of the Companies Act, 1956 wrt the cess payable under Section 441A of the Companies Act, 1956. Pursuant to the said Announcement, since the operative date of section 227 (3)(g) has not yet been notified by the Central Government, the statutory auditor's report need not contain any comment on section 227 (3)(g) of the Companies Act, 1956. 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.

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

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of ABC Company Limited

We[34] have audited the accompanying consolidated financial statements of ABC Company Limited ("the Company") and its subsidiaries, which comprise the consolidated Balance Sheet as at March 31, 20XX, and the consolidated Statement of Profit and Loss and the consolidated Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation of these consolidated financial statements that give a true and fair view of the consolidated financial position, consolidated financial performance and consolidated cash flows of the Company in accordance with accounting principles generally accepted in India. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the consolidated financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated 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. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and presentation of the consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, <u>but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control[35].</u> An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion and to the best of our information and according to the explanations given to us, the consolidated financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the consolidated Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the consolidated Profit and Loss Account, of the profit/ loss for the year ended on that date; and

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[34] As there is no reporting on 'Other Legal and Regulatory Requirements', there is no necessity of including the heading 'Report on the Financial Statements' above the introductory paragraph.

[35] 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.

(c) in the case of the consolidated Cash Flow Statement, of the cash flows for the year ended on that date.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[36])
Membership Number

Place of Signature
Date

Illustration 3:

Circumstances include the following:

- **Audit of a complete set of separate general purpose financial statements of an entity prepared in accordance with the requirements of XYZ Law of India under a compliance framework.**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.**
- **The report is unmodified and does not include either an Emphasis of Matter paragraph or an Other Matter(s) paragraph.**

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We[37] have audited the accompanying financial statements of ABC and Associates, which comprise the Balance Sheet as at March 31, 20XX, and the Profit and Loss Account[38] 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 of these financial statements in accordance with XYZ Law of India. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation of the 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. 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.

[36] Partner or Proprietor, as the case may be.

[37] As there is no reporting on 'Other Legal and Regulatory Requirements', there is no necessity of including the heading 'Report on the Financial Statements' above the introductory paragraph.

[38] Provide titles of all financial statements that comprise a full set of financial statements required by XYZ Law of India.

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 judgement, 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 Company'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[39]. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the 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.

Opinion[40]

In our opinion and to the best of our information and according to the explanations given to us, the financial statements of ABC and Associates for the year ended March 31, 20XX are prepared, in all material respects, in accordance with XYZ Law of India.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[41])
Membership Number

Place of Signature

Date

Illustration 4:

The following illustrative format is based on the assumptions that:

The Group has:

- **Certain components which have been audited by auditor/s other than the Principal Auditor and such component/s is/ are material to the consolidated financial statements of the Group. The auditors of such components which are Indian companies, there is no requirement to report on section 143(3)(i) of the Companies Act, 2013 and they did not have any matter to report under section 143(3)(f) of the Companies Act, 2013.**
- **Certain components which are unaudited and such component/s is/ are not material to the consolidated financial statements of the Group.**

[39] 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.

[40] Note that the opinion excludes the words 'true and fair' as this report is not under a fair presentation framework.

[41] Partner or Proprietor, as the case may be.

The independent auditor of Consolidated Financial Statements:

- **Gives an Unmodified Opinion on the consolidated financial statements**
- **Disclosed the aforementioned facts about the Components in the "Other Matters" Paragraph in accordance with the Announcement issued by the Auditing and Assurance Standards Board under the authority of the Council of ICAI in February 2014**
- **Does not have the responsibility to report on internal financial controls pursuant to section 143(3)(i) of the Companies Act 2013.**

ILLUSTRATIVE FORMAT OF INDEPENDENT AUDITOR'S REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS OF A GROUP UNDER THE COMPANIES ACT, 2013 AND THE RULES THEREUNDER

INDEPENDENT AUDITOR'S REPORT

TO THE MEMBERS OF ABC COMPANY LIMITED

Report on the Consolidated Financial Statements

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, comprising of the Consolidated Balance Sheet as at 31st March, 20XX, the Consolidated Statement of Profit and Loss, the Consolidated Cash Flow Statement for the year then ended, and a summary of the significant accounting policies and other explanatory information (hereinafter referred to as "the consolidated financial statements").

Management's Responsibility for the Consolidated Financial Statements

The Holding Company's Board of Directors is responsible for the preparation of these consolidated financial statements in terms of the requirements of the Companies Act, 2013 (hereinafter referred to as "the Act") 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, read with Rule 7 of the Companies (Accounts) Rules, 2014. 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 the 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.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. While conducting the audit, we have taken into account the provisions of the Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of the Act and the Rules made thereunder.

We conducted our audit in accordance with the Standards on Auditing specified under Section 143(10) of the Act. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and the disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal financial control relevant to the Holding Company's preparation of the consolidated 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 whether the Holding Company has an adequate internal financial controls system over financial reporting in place and the operating effectiveness of such controls. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of the accounting estimates made by the Holding Company's Board of Directors, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence obtained by us and the audit evidence obtained by the other auditors in terms of their reports referred to in sub-paragraph (a) of the Other Matters paragraph below, is sufficient and appropriate to provide a basis for our audit opinion on the consolidated financial statements.

Opinion

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 the consolidated state of affairs of the Group, its associates and jointly controlled entities as at 31st March, 20XX, and their consolidated profit/loss and their consolidated cash flows for the year ended on that date.

Emphasis of Matter

We draw attention to Note X to the consolidated financial statements which, describes the uncertainty related to the outcome of the lawsuit filed against the Holding Company by XYZ Company. Our opinion is not modified in respect of this matter.

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, insofar 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

1. 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 Act, based on the comments in the auditors' reports of the Holding company, subsidiary companies, associate companies and jointly controlled companies incorporated in India, we give in the Annexure a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.

2. 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, read with Rule 7 of the Companies (Accounts) Rules, 2014.

(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 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.[42]

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.[43]

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 India[44].

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 India[45].

Place of Signature:
Date:

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

Signature
(Name of the Member Signing the Audit Report)
(Designation[46])
(Membership No. XXXXX)

[42] Where applicable

[43] Where applicable

[44] Where applicable

[45] Where applicable

[46] Partner or Proprietor

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, 2011[1])

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)[2], the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

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: (Ref: Para A1)

(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.

Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

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.

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*Published in February, 2010 issue of the Journal.

[1] 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 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).

[2] SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements".

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, 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.

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, the auditor shall communicate the matter to those charged with governance 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: (Ref: Para A13-A14)

  (i) Resign from the audit, where practicable and not prohibited by law or regulation; or

  (ii) If resignation from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

14. If the auditor resigns as contemplated by paragraph 13(b)(i), before resigning, 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 report[3] 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

Basis for Modification Paragraph

16. When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by the SA 700 (Revised), include a paragraph in the auditor's report that provides a description of the matter giving rise to the modification. The auditor shall place this paragraph immediately before the opinion paragraph in the auditor's report and use the heading "*Basis for Qualified Opinion*", "*Basis for Adverse Opinion*", or "*Basis for Disclaimer of Opinion*", as appropriate. (Ref: Para. A17)

17. If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures), the auditor shall include in the basis for modification paragraph 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 the basis for modification paragraph. (Ref: Para. A18)

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[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.

18. If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the basis for modification paragraph an explanation of how the disclosures are misstated.

19. 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 modification paragraph 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. A19)

20. If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the basis for modification paragraph, the reasons for that inability.

21. 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 modification paragraph 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. A20)

Opinion Paragraph

22. 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 paragraph. (Ref: Para. A21, A23-A24)

23. When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state in the opinion paragraph that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph:

(a) The financial statements present fairly, in all material respects (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework; or

(b) The financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance 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. A22)

24. When the auditor expresses an adverse opinion, the auditor shall state in the opinion paragraph that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion paragraph:

(a) The financial statements do not present fairly (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework; or

(b) The financial statements have not been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.

25. When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall state in the opinion paragraph that:

(a) because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion; and, accordingly,

(b) the auditor does not express an opinion on the financial statements.

Description of Auditor's Responsibility When the Auditor Expresses a Qualified or Adverse Opinion

26. When the auditor expresses a qualified or adverse opinion, the auditor shall amend the description of the auditor's responsibility to state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion.

Description of Auditor's Responsibility When the Auditor Disclaims an Opinion

27. When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the introductory paragraph of the auditor's report to state that the auditor was engaged to audit the financial statements. The auditor shall also amend the description of the auditor's responsibility and the description of the scope of the audit to state only the following: "Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with Standards on Auditing issued by the Institute of Chartered Accountants of India. Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion".

Communication with Those Charged with Governance

28. 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 proposed wording of the modification. (Ref: Para. A25)

Application and Other Explanatory Material

Scope of this SA

Types of Modified Opinions (Ref: Para. 2)

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

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[4]. This conclusion takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements in accordance with SA 450[5].

[4] SA 700 (Revised), paragraph 11.

[5] SA 450,"Evaluation of Misstatements Identified during the Audit", paragraph 4(a).

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 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 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.

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)-14)

A13. The practicability of resigning from the audit may depend upon 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 in the Basis for Disclaimer of Opinion paragraph prior to resigning.

A14. In certain circumstances, resignation 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 appointed to audit the financial statements of public sector entities. It may also be the case of 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 resigning 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[6].

A15. When the auditor concludes that resignation from the audit is necessary because of a scope limitation, there may be a professional, regulatory or legal requirement for the auditor to communicate matters relating to the resignation 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:

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[6] SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", paragraph A5.

- 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[7].
- 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 510[8]). 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

Basis for Modification Paragraph (Ref: Para. 16-17, 19(b), 21)

A17. Consistency in the auditor's report helps to promote the 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 basis for the modification may not be possible, consistency in both the form and content of the auditor's report is desirable.

A18. Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report. In circumstances where it is not practicable to quantify the effect of modifications made in the audit report accurately, the auditor may do so on the basis of estimates made by the management after carrying out such audit tests as are possible and clearly indicate the fact that the figures are based on management estimates. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements. An example of the financial effects of material misstatements that the auditor may describe in the basis for modification paragraph in the auditor's report is the quantification of the effects on income tax, profit before taxes, net profit and reserves if inventory is overstated.

A19. Disclosing the omitted information in the basis for modification paragraph 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.

A20. An adverse opinion or a disclaimer of opinion relating to a specific matter described in the basis for qualification paragraph 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.

Opinion Paragraph (Ref: Para. 22-23)

A21. Inclusion of this paragraph heading makes it clear to the user that the auditor's opinion is modified and indicates the type of modification.

A22. 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 paragraph as these are not sufficiently clear or forceful.

Illustrative Auditors' Reports

A23. Illustrations 1 and 2 in the Appendix contain auditors' reports with qualified and adverse opinions, respectively, as the financial statements are materially misstated.

[7] See paragraph A31 of SA 700 (Revised) for a description of this circumstance.

[8] SA 510, "Initial Audit Engagements —Opening Balances", paragraph 10.

A24. 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 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.

Communication with Those Charged with Governance (Ref: Para. 28)

A25. Communicating with those charged with governance the circumstances that lead to an expected modification to the auditor's opinion and the proposed wording of the modification enables:

(a) The auditor to give notice to those charged with governance of the intended modification(s) and the reasons (or circumstances) for the modification(s);

(b) 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

(c) 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).

Material Modifications *vis-a-vis* ISA 705, "Modifications to the Opinion in the Independent Auditor's Report"

Additions

Paragraph 17 and A18 of ISA 705 requires the auditor to include in the basis for modification paragraph, a description and quantification of the financial effect of the misstatement. Since the said paragraph covers only the effect of the individual quantification of the misstatement on the financial statements, the paragraph A18 has been changed also to include the effect of the aggregate quantifications of the misstatements on the financial statements.

Appendix

(Ref: Para. A23-24)

Illustrative Formats of Auditors' Reports with Modifications to the Opinion

<u>**Illustration 1**</u>

Circumstances include the following:

- **Audit of a complete set of separate general purpose financial statements of a company prepared under the Companies Act, 1956 financial reporting framework.**
- **The terms of the audit engagement reflect description of management's responsibility for the financial statements in SA 210.**
- **Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements. The audit opinion is qualified for the misstatement.**
- **In addition to the audit of financial statements, the auditor has other reporting responsibilities required under the Companies Act, 1956 and/or other regulatory requirements.**

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements

We have audited the accompanying 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 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 of these financial statements that give a true and fair view of the financial position, financial performance 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 the 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. 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 Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, <u>but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control</u>[9]. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the 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[10]

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 realisable value but has stated them solely at cost, which constitutes a departure from the Accounting Standards referred to in sub-section (3C) of section 211 of the Act. The

[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.

[10] "Basis for Qualified Opinion" and "Qualified Opinion" paragraphs are in italics as required under Sec. 227(3)(e) of the Companies Act.

Company's records indicate that had management stated the inventories at the lower of cost and net realisable value, an amount of Rs. XXX would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by Rs. XXX, and income tax, net profit and shareholders' funds would have been reduced by Rs. XXX, Rs. XXX and Rs. XXX , respectively.

Qualified Opinion

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 paragraph, the 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:

(a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the Profit and Loss Account, of the profit/ loss for the year ended on that date; and

(c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.

2. As required by section 227(3) of the Act, we report that:

a. We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;

b. In our opinion proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us][11];

c. 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[12];

d. The Balance Sheet, Statement of Profit and Loss and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited by us][13];

e. Except for the effects of the matter described in the Basis for Qualified Opinion paragraph, in our opinion, the Balance Sheet, Statement of Profit and Loss and Cash Flow Statement comply with the accounting standards referred to in sub-section (3C) of section 211 of the Act;

[11] To be included if relevant.

[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] To be included if relevant.

f. On the basis of written representations received from the directors as on March 31, 20XX, and taken on record by the Board of Directors, none of the directors is disqualified as on March 31, 20XX, from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Act.

g. Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the Company.[14]

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[15])
Membership Number

Place of Signature

Date

Illustration 2:

Circumstances include the following:

- **Audit of a complete set of consolidated general purpose financial statements of a parent company prepared under accounting principles generally accepted in India *(as required for compliance with SEBI's regulatory requirement).***
- **The terms of the group audit engagement reflect description of management's responsibility for the financial statements in SA 210.**
- **The financial statements are materially misstated due to the non-consolidation of a subsidiary. The material misstatement is deemed to be pervasive to the financial statements. The effects of the misstatement on the financial statements have not been determined because it was not practicable to do so. An adverse audit opinion is given under the circumstances.**

[14] Attention of the readers is invited to the Announcement issued by the Council of the ICAI (pursuant to a decision taken in this regard at its 312th meeting held in December, 2011) regarding the auditor's reporting responsibilities pursuant to clause 4(ix)(a) of the Companies (Auditor's Report) Order, 2003 and section 227(3)(g) of the Companies Act, 1956 wrt the cess payable under Section 441A of the Companies Act, 1956. Pursuant to the said Announcement since the operative date of section 227 (3)(g) has not yet been notified by the Central Government, the statutory auditor's report need not contain any comment on section 227 (3)(g) of the Companies Act, 1956. 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] Partner or Proprietor, as the case may be.

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of ABC Company Limited

We[16] have audited the accompanying consolidated financial statements of ABC Company Limited ("the Company") and its subsidiaries, which comprise the consolidated Balance Sheet as at March 31, 20XX, and the consolidated Statement of Profit and Loss and consolidated Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation of these consolidated financial statements that give a true and fair view of the consolidated financial position, consolidated financial performance and consolidated cash flows of the Company in accordance with accounting principles generally accepted in India. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the consolidated financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated 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. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and presentation of the consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, <u>but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control</u>[17]. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse audit opinion.

Basis for Adverse Opinion

As explained in Note X, the Company has not consolidated the financial statements of subsidiary XYZ Company it acquired during 20XX because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This acquisition is therefore accounted for as an investment. Under the accounting principles generally accepted in India, the subsidiary should have been consolidated because it is controlled by the Company. Had XYZ been consolidated, many elements in

[16] As there is no reporting on "Other Legal Requirements", there is no necessity of including the heading "Report on the Financial Statements" above the introductory paragraph.

[17] 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.

the accompanying financial statements would have been materially affected. The effects on the financial statements of the failure to consolidate have not been determined.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the consolidated Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the consolidated Profit and Loss Account, of the profit/ loss for the year ended on that date; and

(c) in the case of the consolidated Cash Flow Statement, of the cash flows for the year ended on that date.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[18])
Membership Number

Place of Signature

Date

Illustration 3:

Circumstances include the following:

- **Audit of a complete set of separate general purpose financial statements of a company prepared under the Companies Act, 1956 financial reporting framework.**
- **The terms of the audit engagement reflect description of management's responsibility for the financial statements in SA 210.**
- **The auditor was unable to obtain sufficient appropriate audit evidence regarding an investment in a foreign affiliate. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be material but not pervasive to the financial statement. The audit opinion is qualified for the misstatement.**
- **In addition to the audit of financial statements, the auditor has other reporting responsibilities required under the Companies Act, 1956 and/or other regulatory requirements.**

[18] Partner or Proprietor, as the case may be.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements

We have audited the accompanying 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 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 of these financial statements that give a true and fair view of the financial position, financial performance 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 presentation of the financial statements that give a true and fair view and 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. 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 Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, <u>but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control</u>[19]. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the 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

ABC Company Limited's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at Rs. XXX in the Balance Sheet as at March 31, 20XX, and ABC's share of XYZ Company's net income of Rs. XXX is included in ABC Company Limited's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC Company Limited's investment in XYZ Company as at March 31, 20XX and ABC Company Limited's share of XYZ Company's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ Company. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

[19] 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.

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects[20] of the matter described in the Basis for Qualified Opinion paragraph, the 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:

(a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the Profit and Loss Account, of the profit/ loss for the year ended on that date; and

(c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.

2. As required by section 227(3) of the Companies Act, 1956, we report that:

   a. we have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit except for the matter described in the Basis for Qualified Opinion paragraph;

   b. in our opinion proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us][21];

   c. <u>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[22];</u>

   d. the Balance Sheet, Statement of Profit and Loss and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited by us][23];

   e. *except for the possible effects[24] of the matter described in the Basis for Qualified Opinion paragraph, in our opinion, the Balance Sheet, Statement of Profit and Loss and Cash Flow Statement comply with the accounting standards referred to in sub-section (3C) of section 211 of the Act;*

   f. on the basis of written representations received from the directors as on March 31, 20XX, and taken on record by the Board of Directors, none of the directors is disqualified as on March

[20] Note the use of words "possible effects" as the auditor was unable to obtain sufficient appropriate audit evidence.

[21] To be included if relevant.

[22] 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.

[23] To be included if relevant.

[24] Note the use of words "possible effects" as the auditor was unable to obtain sufficient appropriate audit evidence.

31, 20XX, from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Act.

g. Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the Company.[25]

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[26])
Membership Number

Place of Signature

Date

<u>Illustration 4:</u>

Circumstances include the following:

- **Audit of a complete set of separate general purpose financial statements of a company prepared under the Companies Act, 1956 financial reporting framework.**
- **The terms of the audit engagement reflect description of management's responsibility for the financial statements in SA 210.**
- **The auditor was unable to obtain sufficient appropriate audit evidence about a single element of the financial statements. That is, the auditor was unable to obtain audit evidence about the financial information of a joint venture investment that represents over 90% of the Company'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 financial statements. <u>A disclaimer of audit opinion is given in the circumstances.</u>**
- **In addition to the audit of financial statements, the auditor has other reporting responsibilities required under the Companies Act, 1956 and/or other regulatory requirements.**

[25] Attention of the readers is invited to the Announcement issued by the Council of the ICAI (pursuant to a decision taken in this regard at its 312th meeting held in December, 2011) regarding the auditor's reporting responsibilities pursuant to clause 4(ix)(a) of the Companies (Auditor's Report) Order, 2003 and section 227(3)(g) of the Companies Act, 1956 wrt the cess payable under Section 441A of the Companies Act, 1956. Pursuant to the said Announcement since the operative date of section 227 (3)(g) has not yet been notified by the Central Government, the statutory auditor's report need not contain any comment on section 227 (3)(g) of the Companies Act, 1956. 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.

[26] Partner or Proprietor, as the case may be.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements

We were engaged to audit the accompanying 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 and the 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 of these financial statements that give a true and fair view of the financial position, financial performance 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 the 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 in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

The Company's investment in its joint venture XYZ Company is carried at Rs. XXX in the Company's Balance Sheet, which represents over 90% of the Company's net assets as at March 31, 20XX. We were not allowed access to the management and the auditors of XYZ Company. As a result, we were unable to determine whether any adjustments were necessary in respect of the Company'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 Company's income and expenses for the year, and the elements making up the Cash Flow Statement.

Disclaimer of Opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.

2. As required by section 227(3) of the Companies Act, 1956, we report that:

   a. As described in the Basis for Disclaimer of Opinion paragraph, we were unable to obtain all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;

   b. Due to the possible effects[27] of the matter described in the Basis for Disclaimer of Opinion paragraph, we are unable to state whether proper books of account as required by law have been

[27] Note the use of words "possible effects" as the auditor was unable to obtain sufficient appropriate audit evidence.

kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us][28];

c. 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[29];

d. The Balance Sheet, Statement of Profit and Loss and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited by us][30];

e. Due to the possible effects of the matter described in the Basis for Disclaimer of Opinion paragraph, we are unable to state whether the Balance Sheet, Statement of Profit and Loss and Cash Flow Statement comply with the accounting standards referred to in sub-section (3C) of section 211 of the Act;

f. On the basis of written representations received from the directors as on March 31, 20XX, and taken on record by the Board of Directors, none of the directors is disqualified as on March 31, 20XX, from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Act.

g. Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the Company.[31]

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[32])
Membership Number

Place of Signature

Date

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[28] To be included if relevant.

[29] 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.

[30] To be included if relevant.

[31] Attention of the readers is invited to the Announcement issued by the Council of the ICAI (pursuant to a decision taken in this regard at its 312th meeting held in December, 2011) regarding the auditor's reporting responsibilities pursuant to clause 4(ix)(a) of the Companies (Auditor's Report) Order, 2003 and section 227(3)(g) of the Companies Act, 1956 wrt the cess payable under Section 441A of the Companies Act, 1956. Pursuant to the said Announcement since the operative date of section 227 (3)(g) has not yet been notified by the Central Government, the statutory auditor's report need not contain any comment on section 227 (3)(g) of the Companies Act, 1956. 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.

[32] Partner or Proprietor, as the case may be.

<u>Illustration 5:</u>

Circumstances include the following:

- **Audit of a complete set of separate general purpose financial statements of a company prepared under the Companies Act, 1956 financial reporting framework.**
- **The terms of the audit engagement reflect 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 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. <u>A disclaimer of audit opinion is given in the circumstances.</u>**
- **In addition to the audit of financial statements, the auditor has other reporting responsibilities required under the Companies Act, 1956 and/or other regulatory requirements.**

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements

We have audited the accompanying 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 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 of these financial statements that give a true and fair view of the financial position, financial performance 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 the 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 in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Because of the matters described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

We were appointed as auditors of the Company after March 31, 20XX and thus could not observe the counting of physical inventories at the beginning and end of the year. Accordingly, we were unable to satisfy ourselves by alternative means concerning the inventory quantities held at December 31, 20X0 and March 31, 20X1 which are stated in the Balance Sheet at Rs. XXX and Rs. XXX, respectively.

In addition, the introduction of a new computerised accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our audit 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 Cash Flow Statement.

Disclaimer of Opinion

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.

2. As required by section 227(3) of the Companies Act, 1956, we report that:

a. As described in the Basis for Disclaimer of Opinion paragraph, we were unable to obtain all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;

b. Due to the possible effects[33] of the matter described in the Basis for Disclaimer of Opinion paragraph, we are unable to state whether proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us][34];

c. 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[35];

d. The Balance Sheet, Statement of Profit and Loss and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited by us][36];

e. Due to the possible effects of the matter described in the Basis for Disclaimer of Opinion paragraph, we are unable to state whether the Balance Sheet, Statement of Profit and Loss and Cash Flow Statement comply with the accounting standards referred to in sub-section (3C) of section 211 of the Act;

f. On the basis of written representations received from the directors as on March 31, 20X1, and taken on record by the Board of Directors, none of the directors is disqualified as on March 31, 20X1, from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Act.

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[33] Note the use of words "possible effects" as the auditor was unable to obtain sufficient appropriate audit evidence.

[34] To be included if relevant.

[35] 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.

[36] To be included if relevant.

g. Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the Company.[37]

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[38])
Membership Number

Place of Signature

Date

Illustration 6:

The following illustrative format is based on the assumptions that:

The Group has:

- **Certain components which have been audited by auditor/s other than the Principal Auditor and such component/s is/ are material to the consolidated financial statements of the Group. The auditors of such components which are Indian companies, there is no requirement to report on section 143(3)(i) of the Companies Act, 2013.**
- **Certain components which are unaudited and such component/s is/ are not material to the consolidated financial statements of the Group.**

The independent auditor of Consolidated Financial Statements:

- **Has issued a Qualified Opinion with respect to the true and fair view of the financial statements on account of misstatement of inventories and unaudited financial statements of a branch of a subsidiary. The misstatement is deemed to be material but not pervasive to the financial statements.**
- **Disclosed the aforementioned facts about the Components in the "Other Matters" Paragraph in accordance with the Announcement issued by the Auditing and Assurance Standards Board under the authority of the Council of ICAI in February 2014**
- **Does not have the responsibility to report on internal financial controls pursuant to section 143(3)(i) of the Companies Act 2013**

[37] Attention of the readers is invited to the Announcement issued by the Council of the ICAI (pursuant to a decision taken in this regard at its 312th meeting held in December, 2011) regarding the auditor's reporting responsibilities pursuant to clause 4(ix)(a) of the Companies (Auditor's Report) Order, 2003 and section 227(3)(g) of the Companies Act, 1956 wrt the cess payable under Section 441A of the Companies Act, 1956. Pursuant to the said Announcement since the operative date of section 227 (3)(g) has not yet been notified by the Central Government, the statutory auditor's report need not contain any comment on section 227 (3)(g) of the Companies Act, 1956. 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.

[38] Partner or Proprietor, as the case may be.

ILLUSTRATIVE FORMAT OF INDEPENDENT AUDITOR'S REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS OF A GROUP UNDER THE COMPANIES ACT, 2013 AND THE RULES THEREUNDER

INDEPENDENT AUDITOR'S REPORT

TO THE MEMBERS OF ABC COMPANY LIMITED

Report on the Consolidated Financial Statements

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 , comprising of the Consolidated Balance Sheet as at 31st March, 20XX, the Consolidated Statement of Profit and Loss, the Consolidated Cash Flow Statement for the year then ended, and a summary of the significant accounting policies and other explanatory information (hereinafter referred to as "the consolidated financial statements").

Management's Responsibility for the Consolidated Financial Statements

The Holding Company's Board of Directors is responsible for the preparation of these consolidated financial statements in terms of the requirements of the Companies Act, 2013 (hereinafter referred to as "the Act") 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, read with Rule 7 of the Companies (Accounts) Rules, 2014. The respective Board of Directors of the companies included in the Group 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 the 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.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. While conducting the audit, we have taken into account the provisions of the Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of the Act and the Rules made thereunder.

We conducted our audit in accordance with the Standards on Auditing specified under Section 143(10) of the Act. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and the disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal financial control relevant to the Holding Company's preparation of the consolidated 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 whether the Holding Company has an adequate internal financial controls system over financial reporting in place and the operating effectiveness of such controls. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of the accounting estimates made by the Holding Company's Board of Directors, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence obtained by us and the audit evidence obtained by the other auditors in terms of their reports referred to in sub-paragraph (a) of the Other Matters paragraph below, is sufficient and appropriate to provide a basis for our qualified audit opinion on the consolidated financial statements.

Basis for Qualified Opinion

(a) The inventories are carried in the Consolidated Balance Sheet at Rs. XXX (As at 31st March 20YY: Rs. YYY). In one of the subsidiaries of the Holding Company, the other auditor who audited the financial statements / financial information of the subsidiary has reported that the Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from the Accounting Standard - 2 "Valuation of Inventories". The report of the other auditor states that had the Management stated the inventories at the lower of cost and net realisable value, an amount of Rs. XXX (As at 31st March 20YY: Rs. YYY) would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by Rs. XXX (Previous year ended 31st March, 20YY: Rs.YYY), and income tax, profit for the year, minority interest and shareholders' funds would have been reduced by Rs. X, Rs. XX, Rs. AA and Rs. XXX, respectively (Previous year ended 31st March, 20YY: Rs.Y, Rs.YY, Rs. ZZ and Rs.YYY, respectively). This matter was also qualified in our report/ the report of the predecessor auditors on the consolidated financial statements for the year ended 31st March 20YY.[39]

(b) In case of one of the subsidiaries of the Holding Company not audited by us, the other auditor who audited the subsidiary has reported that they did not audit the financial statements/information of ________(number) branches of the subsidiary 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 these consolidated financial statements. The financial statements/information of these branches is pending audit by their branch auditors whose reports have not yet been furnished to the auditors of the subsidiary, and their opinion in so far as it relates to the amounts and disclosures included in respect of these branches, is based solely on the unaudited information provided by the Management of the subsidiary.

Qualified Opinion

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 paragraph above, 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 the consolidated state of affairs of the Group, its associates and jointly controlled entities as at 31st March, 20XX, and their consolidated profit/loss and their consolidated cash flows for the year ended on that date.

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.______

[39] Where applicable and only in such case, disclosure of previous year figures is required - Attention of the readers is drawn to the provisions of Standard on Auditing (SA) 710, Comparative Information—Corresponding Figures And Comparative Financial Statements.

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

1. 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 Act, based on the comments in the auditors' reports of the Holding company, subsidiary companies, associate companies and jointly controlled companies incorporated in India, we give in the Annexure a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.

2. As required by Section 143(3) of the Act, we report, to the extent applicable, that:

(a) We have sought and, except for the possible effect of the matter described in sub-paragraph (b) of the Basis for Qualified Opinion above, 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, except for the effect of the matters described in the Basis for Qualified Opinion paragraph above, 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) Except for the matter described in sub-paragraph (b) of the Basis for Qualified Opinion paragraph above, the reports on the accounts of the branch offices of the Holding Company, and its subsidiaries, associate companies and jointly controlled companies incorporated in India, audited under Section 143 (8) of the Act by branch auditors have been sent to us / the other auditors, as applicable, and have been properly dealt with in preparing this report.

(d) 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.

(e) In our opinion, except for the effect of the matters described in the Basis for Qualified Opinion paragraph above, the aforesaid consolidated 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) The matters described in the Basis for Qualified Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Group.

(g) 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 other statutory auditors of its subsidiary companies, associate companies and jointly controlled companies incorporated in India, except for __ (number) director/s of ___(number) of the Group's subsidiary company /ies /, associate company/ies and jointly controlled company/ies incorporated in India who are disqualified from being appointed as a director in terms of Section 164(2) of the Act, none of the other directors of the Group's 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. The list of subsidiary company/ies, associate company / ies, jointly controlled companies incorporated in India where the disqualification arose and the respective directors are stated below:

XXXXXXXX

(h) The qualification relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Qualified Opinion paragraph above.

(i) 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. Except for the possible effect of the matter described in sub-paragraph (b) of the Basis of Qualified Opinion above, 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

    Except for the possible effect of the matter described in sub-paragraph (b) of the Basis of Qualified Opinion above, there were no pending litigations which would impact the consolidated financial position of the Group, its associates and jointly controlled entities.[40]

    ii. Except for the possible effect of the matter described in sub-paragraph (b) of the Basis of Qualified Opinion above, 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

[40] Where applicable.

financial statements in respect of such items as it relates to the Group and (b) the Group's share of net profit/loss in respect of its associates.

Or

Except for the possible effect of the matter described in sub-paragraph (b) of the Basis of Qualified Opinion above, the Group, its associates and jointly controlled entities did not have any material foreseeable losses on long-term contracts including derivative contracts.[41]

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 India.

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 India.

Place of Signature:

Date:

For XYZ & Co

Chartered Accountants

(Firm's Registration No.)

Signature

(Name of the Member Signing the Audit Report)

(Designation[42])

(Membership No. XXXXX)

[41] Where applicable

[42] 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, 2011[1])

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. Other Standards on Auditing (SAs) may 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 and placement of such paragraphs apply.

Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

Objective

4. 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

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

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*Published in February, 2010 issue of the Journal.

[1] 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 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).

(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

6. 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 the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements. (Ref: Para. A1-A2)

7. When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(a) Include it immediately after the Opinion paragraph in the auditor's report;

(b) Use the heading "Emphasis of Matter", or other appropriate heading;

(c) Include in the paragraph a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements; and

(d) Indicate that the auditor's opinion is not modified in respect of the matter emphasised. (Ref: Para. A3-A4)

Other Matter Paragraphs in the Auditor's Report

8. 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 and this is not prohibited by law or regulation, the auditor shall do so in a paragraph in the auditor's report, with the heading "Other Matter", or other appropriate heading. The auditor shall include this paragraph immediately after the Opinion paragraph and any Emphasis of Matter paragraph, or elsewhere in the auditor's report if the content of the Other Matter paragraph is relevant to the Other Reporting Responsibilities section. (Ref: Para. A5-A11)

Communication with Those Charged with Governance

9. 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 proposed wording of this paragraph. (Ref: Para. A12)

Application and Other Explanatory Material

Emphasis of Matter Paragraphs in the Auditor's Report

Circumstances in Which an Emphasis of Matter Paragraph May Be Necessary (Ref: Para. 6)

A1. Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
- Early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.

- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

A2. A widespread use of Emphasis of Matter paragraphs diminishes the effectiveness of the auditor's communication of such matters. Additionally, to include more information in an Emphasis of Matter paragraph than is presented or disclosed in the financial statements may imply that the matter has not been appropriately presented or disclosed; accordingly, paragraph 6 limits the use of an Emphasis of Matter paragraph to matters presented or disclosed in the financial statements.

Including an Emphasis of Matter Paragraph in the Auditor's Report (Ref: Para. 7)

A3. 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 either:

(a) The auditor expressing a qualified opinion or an adverse opinion, or disclaiming an opinion, when required by the circumstances of a specific audit engagement (see SA 705[2]); or

(b) Disclosures in the financial statements that the applicable financial reporting framework requires management to make.

A4. The illustrative report in the Appendix includes an Emphasis of Matter paragraph in an auditor's report that contains a qualified opinion.

Other Matter Paragraphs in the Auditor's Report (Ref: Para. 8)

Circumstances in Which an Other Matter Paragraph May Be Necessary

Relevant to Users' Understanding of the Audit

A5. In the rare circumstance where the auditor is unable to resign 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[3], 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 resign from the engagement.

Relevant to Users' Understanding of the Auditor's Responsibilities or the Auditor's Report

A6. Law, regulation or generally accepted practice in a jurisdiction 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. Where relevant, one or more sub-headings may be used that describe the content of the Other Matter paragraph.

A7. 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 to report on the financial statements (see "Other Reporting Responsibilities" section in SA 700 (Revised)[4]), 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

A8. 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

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[2] SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

[3] See paragraph 13(b)(ii) of SA 705 for a discussion of this circumstance.

[4] SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements", paragraph 38.

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

A9. 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

A10. 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 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.

A11. The placement of an Other Matter paragraph depends on the nature of the information to be communicated. When an Other Matter paragraph is included to draw users' attention to a matter relevant to their understanding of the audit of the financial statements, the paragraph is included immediately after the Opinion paragraph and any Emphasis of Matter paragraph. 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 section sub-titled "Report on Other Legal and Regulatory Requirements". Alternatively, 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 Financial Statements and the Report on Other Legal and Regulatory Requirements.

Communication with Those Charged with Governance (Ref: Para. 9)

A12. Such communication 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.

Modifications *vis-à-vis* ISA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report"

SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" does not contain any modifications *vis-a-vis* ISA 706.

Appendix

(Ref: Para. A4)

Illustrative Formats of an Auditor's Report that Includes an Emphasis of Matter Paragraph/Other Matter Paragraph

Illustration 1:

Circumstances include the following:

- **Audit of a complete set of separate general purpose financial statements of a company prepared under the Companies Act, 1956 financial reporting framework.**
- **The terms of the audit engagement reflect description of management's responsibility for the financial statements in SA 210.**
- **Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements. The audit opinion is qualified for the misstatement.**
- **There is uncertainty relating to a pending exceptional litigation matter. This is highlighted in the auditor's report by an Emphasis of Matter paragraph.**
- **In addition to the audit of financial statements, the auditor has other reporting responsibilities required under the Companies Act, 1956 and/or other regulatory requirements.**

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements

We have audited the accompanying 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 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 of these financial statements that give a true and fair view of the financial position, financial performance 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 the 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. 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 judgement, 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 Company'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[5]. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the 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

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 realisable value but has stated them solely at cost, which constitutes a departure from the accounting standards referred to in sub-section (3C) of section 211 of the Act. The Company's records indicate that had management stated the inventories at the lower of cost and net realisable value, an amount of Rs. XXX would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by Rs. XXX, and income tax, net profit and shareholders' funds would have been reduced by Rs. XXX, Rs. XXX and Rs. XXX, respectively.

Qualified Opinion

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 paragraph, the 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:

(a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the Profit and Loss Account, of the profit/ loss for the year ended on that date; and

(c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

Emphasis of Matter

We draw attention to Note X to the financial statements which describes the uncertainty[6] related to the outcome of the lawsuit filed against the Company by XYZ Company. Our opinion is not qualified in respect of this matter.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.

2. As required under provisions of section 227(3) of the Companies Act, 1956, we report that:

a. we have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;

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[5] 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.

[6] In highlighting the uncertainty, the auditor uses the same terminology that is used in the note to the financial statements.

b. in our opinion proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us][7];

c. <u>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[8];</u>

d. the Balance Sheet, Statement of Profit and Loss and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited by us][9];

e. except for the matter described in the Basis for Qualified Opinion paragraph, in our opinion, the Balance Sheet, Statement of Profit and Loss and Cash Flow Statement comply with the accounting standards referred to in sub-section (3C) of section 211 of the Act;

f. on the basis of written representations received from the directors as on March 31, 20XX, and taken on record by the Board of Directors, none of the directors is disqualified as on March 31, 20XX, from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Act.

g. Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the Company.[10]

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[11])
Membership Number

Place of Signature

Date

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[7] To be included if relevant.

[8] 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.

[9] To be included if relevant.

[10] Attention of the readers is invited to the Announcement issued by the Council of the ICAI (pursuant to a decision taken in this regard at its 312th meeting held in December, 2011) regarding the auditor's reporting responsibilities pursuant to clause 4(ix)(a) of the Companies (Auditor's Report) Order, 2003 and section 227(3)(g) of the Companies Act, 1956 wrt the cess payable under Section 441A of the Companies Act, 1956. Pursuant to the said Announcement since the operative date of section 227 (3)(g) has not yet been notified by the Central Government, the statutory auditor's report need not contain any comment on section 227 (3)(g) of the Companies Act, 1956. 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.

[11] Partner or Proprietor, as the case may be.

Illustration 2:

Circumstances include the following:

- **Audit of a complete set of consolidated general purpose financial statements of a parent company prepared under accounting principles generally accepted in India, as required for compliance with SEBI's regulatory requirement, which is a fair presentation framework.**
- **The terms of the group audit engagement reflect description of management's responsibility for the financial statements in SA 210.**
- **The report includes an Other Matter paragraph in respect of the auditor's responsibility in respect of subsidiaries not audited by him but which form part of the consolidated financial statements under report.**

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of ABC Company Limited

We[12] have audited the accompanying consolidated financial statements of ABC Company Limited ("the Company") and its subsidiaries, which comprise the consolidated Balance Sheet as at March 31, 20XX, and the consolidated Statement of Profit and Loss and consolidated Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation of these consolidated financial statements that give a true and fair view of the consolidated financial position, consolidated financial performance and consolidated cash flows of the Company in accordance with accounting principles generally accepted in India; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the consolidated financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated 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. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and presentation of the consolidated 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[13]. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

[12] As there is no reporting on 'Other Legal and Regulatory Requirements', there is no necessity of including the heading 'Report on the Financial Statements' above the introductory paragraph.

[13] 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.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion and to the best of our information and according to the explanations given to us and based on the consideration of the reports of the other auditors on the financial statements of the subsidiaries as noted below, the consolidated financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the consolidated Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the consolidated Profit and Loss Account, of the profit/ loss for the year ended on that date; and

(c) in the case of the consolidated Cash Flow Statement, of the cash flows for the year ended on that date.

Other Matter[14]

We did not audit the financial statements of certain subsidiaries, whose financial statements reflect total assets (net) of Rs. XXXX as at March 31, 20XX, total revenues of Rs. XXXX and net cash outflows amounting to Rs. XXXX for the year then ended. These financial statements have been audited by other auditors whose reports have been furnished to us by the Management, and our opinion is based solely on the reports of the other auditors. Our opinion is not qualified in respect of this matter.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[15])
Membership Number

Place of Signature

Date

[14] This matter is given in "Other Matter" paragraph as it is currently permitted in India for an auditor to sign off a consolidated audit opinion, even where he has not performed a substantial part of the audit himself.

[15] 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 510[1] 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 figures[2] 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.

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* 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 560[3].

9. As required by SA 580[4], 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 statements[5]. (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 706[6]. (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 paragraph:

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[5] SA 510, paragraph 6.

[6] SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", paragraph 8.

(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 statements[7].

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 matter that gave rise to the modification may not be relevant to the current period figures. Nevertheless, a

[7] SA 510, paragraph 6.

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 Statements[8]

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.

[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.

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 control[9]. 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").

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[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 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

[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.

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 control[12]. 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)
(Designation[13])
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 Statements[14]

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, <u>but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control</u>[15]. 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.

Opinion

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[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.

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)
(Designation[16])
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 Statements[17]

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, <u>but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control</u>[18]. 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

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[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.

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)
(Designation[19])
Membership Number

Place of Signature

Date

[19] Partner or Proprietor, as the case may be.

SA 720*

The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements

(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 responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion does not cover other information and the auditor has no specific responsibility for determining whether or not other information is properly stated. However, the auditor reads the other information because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. *(Ref: Para. A1)*

2. In this SA "documents containing audited financial statements" refers to annual reports (or similar documents), that are issued to owners (or similar stakeholders), containing audited financial statements and the auditor's report thereon. This SA may also be applied, adapted as necessary in the circumstances, to other documents containing audited financial statements. *(Ref: Para. A2-A4)*

Effective Date

3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

4. The objective of the auditor is to respond appropriately when documents containing audited financial statements and the auditor's report thereon include other information that could undermine the credibility of those financial statements and the auditor's report.

Definitions

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

(a) 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.

(b) 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.

(c) Misstatement of fact – Other information that is unrelated to matters appearing in the audited financial

* Published in April, 2009 issue of the Journal.

statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.

Requirements

Reading Other Information

6. The auditor shall read the other information to identify material inconsistencies, if any, with the audited financial statements.

7. The auditor shall make appropriate arrangements with management or those charged with governance to obtain the other information prior to the date of the auditor's report. If it is not possible to obtain all the other information prior to the date of the auditor's report, the auditor shall read such other information as soon as practicable. *(Ref: Para. A5)*

Material Inconsistencies

8. If, on reading the other information, the auditor identifies a material inconsistency, the auditor shall determine whether the audited financial statements or the other information needs to be revised.

Material Inconsistencies Identified in Other Information Obtained Prior to the Date of the Auditor's Report

9. When revision of the audited financial statements is necessary and management refuses to make the revision, the auditor shall modify the opinion in accordance with SA 705.[1]

10. When revision of the other information is necessary and management refuses to make the revision, the auditor shall communicate this matter to those charged with governance; and

(a) Include in the auditor's report an Other Matter(s) paragraph describing the material inconsistency in accordance with SA 706[2]; or

(b) Where withdrawal is legally permitted, withdraw from the engagement. *(Ref: Para. A6- A7)*

Material Inconsistencies Identified in Other Information Obtained Subsequent to the Date of the Auditor's Report

11. When revision of the audited financial statements is necessary, the auditor shall follow the relevant requirements in SA 560.[3]

12. When revision of the other information is necessary and management agrees to make the revision, the auditor shall carry out the procedures necessary under the circumstances. *(Ref: Para. A8)*

13. When revision of the other information is necessary, but management refuses to make the revision, the auditor shall notify those charged with governance of the auditor's concern regarding the other information and take any further appropriate action. *(Ref: Para. A9)*

Material Misstatements of Fact

14. If, on reading the other information for the purpose of identifying material inconsistencies, the auditor becomes aware of an apparent material misstatement of fact, the auditor shall discuss the matter with management. *(Ref: Para. A10)*

15. When, following such discussions, the auditor still considers that there is an apparent material

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[1] SA 705, "Modifications to the opinion in the Independent Auditor's Report".

[2] SA 706, "Emphasis of Matter paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", paragraph 8.

[3] SA 560, "Subsequent Events", paragraphs 10-17.

misstatement of fact, the auditor shall request management to consult with a qualified third party, such as the entity's legal counsel, and the auditor shall consider the advice received.

16. When the auditor concludes that there is a material misstatement of fact in the other information which management refuses to correct, the auditor shall notify those charged with governance of the auditor's concern regarding the other information and take any further appropriate action. *(Ref: Para. A11)*

Application and Other Explanatory Material

Scope of this SA (Ref: Para. 1-2)

A1. The auditor may have additional responsibilities, through statutory or other regulatory requirements, in relation to other information that are beyond the scope of this SA. For example, certain statutory and regulatory requirements may require the auditor to apply specific procedures to certain of the other information such as required supplementary data or to express an opinion on the reliability of performance indicators described in the other information. When there are such obligations, the auditor's additional responsibilities are determined by the nature of the engagement and by law, regulation and professional standards. If such other information is omitted or contains deficiencies, the auditor may be required by law or regulation to refer to the matter in the auditor's report.

A2. Other information may comprise, for example:

- A report by management or those charged with governance on operations.
- Financial summaries or highlights.
- Planned capital expenditures.
- Financial ratios.
- Selected quarterly data.

A3. For purposes of the SAs, other information does not encompass, for example:

- A press release or a transmittal memorandum, such as a covering letter, accompanying the document containing audited financial statements and the auditor's report thereon.
- Information contained in analyst briefings.
- Information contained on the entity's web site.

Considerations Specific to Smaller Entities (Ref: Para. 2)

A4. Unless required by law or regulation, smaller entities are less likely to issue documents containing audited financial statements. However, an example of such a document would be where a legal requirement exists for an accompanying report by those charged with governance.

Reading Other Information (Ref: Para. 7)

A5. Obtaining the other information prior to the date of the auditor's report enables the auditor to resolve possible material inconsistencies and apparent material misstatements of fact with management on a timely basis. An agreement with management as to when the other information will be available may be helpful.

Material Inconsistencies

Material Inconsistencies Identified in Other Information Obtained Prior to the Date of the Auditor's Report (Ref: Para. 10)

A6. When management refuses to revise the other information, the auditor may base any decision on what further action to take on advice from the auditor's legal counsel.

A7. In case of certain entities such as, Central/State governments and related government entities (for example, agencies, boards, commissions), withdrawal from the engagement may not be an option. In such cases the auditor may issue a report to the appropriate statutory body giving details of the inconsistency.

Material Inconsistencies Identified in Other Information Obtained Subsequent to the Date of the Auditor's Report (Ref: Para. 12-13)

A8. When management agrees to revise the other information, the auditor's procedures may include reviewing the steps taken by management to ensure that individuals in receipt of the previously issued financial statements, the auditor's report thereon, and the other information are informed of the revision.

A9. When management refuses to make the revision of such other information that the auditor concludes is necessary, appropriate further actions by the auditor may include obtaining advice from the auditor's legal counsel.

Material Misstatements of Fact (Ref: Para. 14-16)

A10. When discussing an apparent material misstatement of fact with management, the auditor may not be able to evaluate the validity of some disclosures included within the other information and management's responses to the auditor's inquiries, and may conclude that valid differences of judgment or opinion exist.

A11. When the auditor concludes that there is a material misstatement of fact that management refuses to correct, appropriate further actions by the auditor may include obtaining advice from the auditor's legal counsel.

Material Modifications *vis a vis* ISA 720, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements"

Deletions

1. Paragraph 10 of ISA 720 dealt with the circumstances where the revision of the financial statements is necessary and management refuses to make the revision. In these circumstances, the auditor shall communicate this matter to those charged with governance and include in the auditor's report an Other Matter(s) paragraph describing the material inconsistency in accordance with ISA 706; or withhold the auditor's report; or where withdrawal is legally permitted, withdraw from the engagement. Since in India, the practice of withholding the auditor's report is not in vogue, an option of withholding the auditor's report by the auditor has been deleted. Similarly in paragraph A7 of the Application Section, an option of withholding the auditor's report by the auditor has been deleted.

2. Paragraph A2 of ISA 720 provides the examples of the other information including 'employment data' and 'names of officers and directors'. Reference to these two specific examples has been deleted so that the auditor can focus on more relevant aspects of other information.

3. Paragraph A4 of ISA 720 provides an example of the other information that may be included in a document containing the audited financial statements of a smaller entity are a detailed income statement and a management report..Since, in India, the terminology of "detailed income statement" and a "management report" do not exist; these have been deleted completely from the SA.

4. Paragraph A7 of ISA 720 provides that in case of public sector entitles, withdrawal from the engagement or withholding the auditor's report may not be the options. In such cases the auditor may issue a report to the appropriate statutory body giving details of the inconsistency. 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 withdrawal from the engagement may not be an option even in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Paragraph A7 has, accordingly, been made more generic in its application.