INDEX

1 NATURE, OBJECTIVE AND SCOPE OF AUDIT

1. ORIGIN OF AUDITING

- The word "audit" originates from Latin word "audire" meaning "to hear".
- In medieval times, auditors used to hear the accounts read out to them to check that employees were not careless and negligent.
- Coming to more recent history, the first Auditor General of India was appointed in British India in 1860 having both accounting and auditing functions. Later on, office of Auditor General was given statutory recognition.
- Presently, Comptroller and Auditor General of India is an independent constitutional authority responsible for auditing government receipts and expenditures.
- The Institute of Chartered Accountants of India was established as a statutory body under an Act of Parliament in 1949 for regulating the profession of Chartered Accountancy in the country.

2. MEANING AND NATURE OF AUDITING

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

Note:

(1) Independence, here, implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.

(2) The purpose of audit is to express an opinion on the financial statements. Understand that preparation and presentation of financial statements of an entity is responsibility of management of entity. The auditor expresses an opinion on financial statements by means of written audit report.

(3) In doing so, he has to see that financial statements would not mislead anybody by ensuring that:

- the accounts have been drawn up with reference to entries in the books of account;
- the entries in the books of account are adequately supported by sufficient and appropriate evidence;
- none of the entries in the books of account has been omitted in the process of compilation;
- the information conveyed by the statements is clear and unambiguous;
- the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
- the statement of accounts presents a true and fair picture of the operational results and of the assets and liabilities.

3. INTERDISCIPLINARY NATURE OF AUDITINGRELATIONSHIP WITH DIVERSE SUBJECTS

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

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

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

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

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

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

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

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

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4. OBJECTIVES OF AUDIT

In conducting audit of financial statements, objectives of auditor in accordance with SA-200 "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" 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.

Note:

(1) Reasonable assurance is to be distinguished from absolute assurance. Absolute assurance is a complete assurance or a guarantee that financial statements are free from material misstatements. However, reasonable assurance is not a complete guarantee. Although it is a high-level of assurance but it is not complete assurance.

(2) Misstatements in financial statements can occur due to fraud or error or both. He has to see effect of misstatements on financial statements as a whole, in totality.

5. SCOPE OF AUDIT-WHAT IT INCLUDES

- Scope refers to range or reach of something.
- The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements.

The following points are included in scope of audit of financial statements:

(1) Coverage of all aspects of entity

Audit of financial statements should be organized adequately to cover all aspects of the entity relevant to the financial statements being audited.

(2) Reliability and sufficiency of financial information

The auditor should be reasonably satisfied that information contained in underlying accounting records and other source data (like bills, vouchers, documents etc.) is reliable and sufficient basis for preparation of financial statements.

The auditor makes a judgment of reliability and sufficiency of financial information by

(a) making a study and assessment of accounting systems and internal controls and

(b) by carrying out appropriate tests, enquiries and procedures.

(3) Proper disclosure of financial information

The auditor should also decide whether relevant information is properly disclosed in the financial statements. He should also keep in mind applicable statutory requirements in this regard.

It is done by ensuring that financial statements properly summarize transactions and events recorded therein and by considering the judgments made by management in preparation of financial statements.

The auditor evaluates selection and consistent application of accounting policies by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

5.1 What Scope does not include

(1) Auditor is not expected to perform duties which fall outside domain of his competence.

For example, physical condition of certain assets like that of sophisticated machinery cannot be determined by him. Similarly, it is not expected from an auditor to determine suitability and life of civil structures like buildings. These require different skillsets which may be performed by qualified engineers in their respective fields.

(2) An auditor is not an expert in authentication of documents. The genuineness of documents cannot be authenticated by him because he is not an expert in this field.

(3) An audit is not an official investigation into alleged wrong doing. He does not have any specific legal powers of search or recording statements

of witness on oath which may be necessary for carrying out an official investigation.

Audit is distinct from investigation. Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.

6. INHERENT LIMITATIONS OF AUDIT

The process of audit suffers from certain inbuilt limitations due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error. These fundamental limitations arise due to the following factors:

(1) Nature of financial reporting

Preparation of financial statements involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

(2) Nature of Audit procedures

- The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. For example, an auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.
- Management may not provide complete information as requested by auditor.
- The management may consist of dishonest and unscrupulous people and may be, itself, involved in fraud.
- It is quite possible that entity may have entered into some transactions with related parties. Such transactions may be only paper transactions and may not have actually occurred. The auditor may not be aware of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.

(3) Not in nature of investigation

As already discussed, audit is not an official investigation. Hence, auditor cannot obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

(4) Timeliness of financial reporting and decrease in relevance of information over time

The relevance of information decreases over time and auditor cannot verify each and every matter. Therefore, a balance has to be struck between reliability of information and cost of obtaining it.

Consider, for example, an auditor who is conducting audit of a company since last two years. During these two years, he has sought detailed information from management of company regarding various matters. During his thirdyear stint, he chooses to rely upon some information obtained as part of audit procedures of second year. However, it could be possible that something new has happened and that information is not relevant. So, the information being relied upon by auditor is not timely and may have lost its reliability.

(5) Future events

Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business. The business may cease to exist in future due to change in market conditions, emergence of new business models or products or due to onset of some adverse events.

7. WHAT IS AN ENGAGEMENT?

Engagement means an arrangement to do something. In the context of auditing, it means a formal agreement between auditor and client under which auditor agrees to provide auditing services. It takes the shape of engagement letter.

8.1. External audit engagements

The purpose of external audit engagements is to enhance the degree of confidence of intended users of financial statements. Such engagements are also reasonable assurance engagements. For example, in India, companies are required to get their annual accounts audited by an external auditor. Even non-corporate entities may choose to have their accounts audited by an external auditor because of benefits of such an audit.

8. BENEFITS OF AUDIT-WHY AUDIT IS NEEDED?

- Audited accounts provide high quality information. It gives confidence to users that information on which they are relying is qualitative and it is the outcome of an exercise carried out by following Auditing Standards recognized globally.
- The financial statements are prepared by management consisting of directors. As shareholders are owners of the company, they need an independent mechanism so that financial information is qualitative and reliable. Hence, their interest is safeguarded by an audit.
- An audit acts as a moral check on employees from committing frauds for the fear of being discovered by audit.
- Audited financial statements are helpful to government authorities for determining tax liabilities.
- Audited financial statements can be relied upon by lenders, bankers for making their credit decisions i.e. whether to lend or not to lend to a particular entity.
- An audit may also detect fraud or error or both.
- An audit reviews existence and operations of various controls operating in any entity. Hence, it is useful at pointing out deficiencies.

9. AUDIT- MANDATORY OR VOLUNTARY?

- It is not necessary that audit is always legally mandatory. There are entities like companies who are compulsorily required to get their accounts audited under law.

  Even non-corporate entities may be compulsorily requiring audit of their accounts under tax laws. For example, in India, every person is required to get accounts audited if turnover crosses certain threshold limit under income tax law.
- It is also possible that some entities like schools may be required to get their accounts audited for the purpose of obtaining grant or assistance from the Government.
- Audit is not always mandatory. Many entities may get their accounts audited voluntarily because of benefits from the process of audit. Many such concerns have their internal rules requiring audit due to advantages flowing from an audit.

10. WHO APPOINTS AN AUDITOR?

- Generally, an auditor is appointed by owners or in some cases by constitutional or government authorities in accordance with applicable laws and regulations. For example, in case of companies, auditor is appointed by members (shareholders) in Annual General Meeting (AGM).
- However, in case of government companies in India, auditor is appointed by Comptroller and Auditor General of India (CAG), an independent constitutional authority.

Note: Appointment of auditors is covered U/S 139 of Co-Act in Law syllabus.

11. TO WHOM REPORT IS SUBMITTED BY AN AUDITOR?

The report is submitted to person making the appointment. In case of companies, these are shareholders- in case of a firm, to partners who have engaged him.

12. MEANING OF ASSURANCE ENGAGEMENT

- "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.
- It means that the practitioner gives an opinion about specific information due to which users of information are able to make confident decisions knowing well that chance of information being incorrect is diminished.

13. ELEMENTS OF ASSURANCE ENGAGEMENT

1. A three party relationship involving a practitioner, a responsible party, and intended users
   - (i) A practitioner is a person who provides the assurance. The term practitioner is broader than auditor. Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information.
   - (ii) A responsible party is the party responsible for preparation of subject matter.
   - (ii) Intended users are the persons for whom an assurance report is prepared These persons may use the report in making decisions.

2. An appropriate subject matter

It refers to the information to be examined by the practitioner. For example, financial information contained in financial statements while conducting audit of financial statements.

3. Suitable criteria

These refer to benchmarks used to evaluate the subject matter like standards, guidance, laws, rules and regulations.

4. Sufficient appropriate evidence

"Sufficient" relates to quantity of evidence obtained by auditor. "Appropriate" relates to quality of evidence obtained by auditor.

5. A written assurance report in appropriate form

A written report is provided containing conclusion that conveys the assurance about the subject matter.

13.1 Meaning of Review; Audit Vs. Review

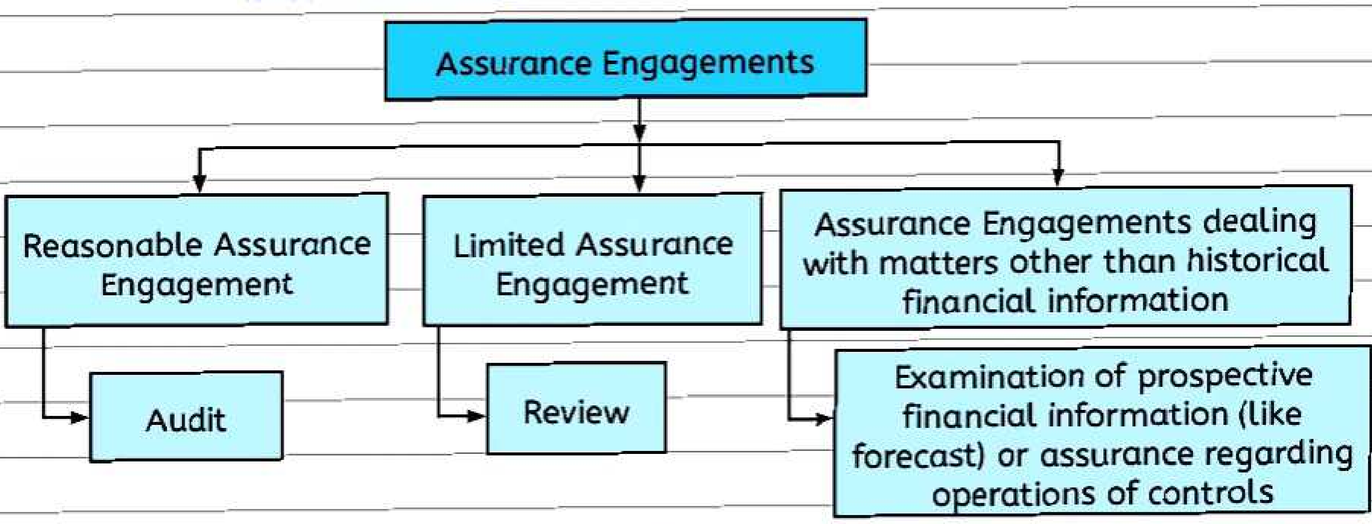
We have learnt that audit is a reasonable assurance engagement. It provides reasonable assurance. However, review is a limited assurance engagement. It provides lower level of assurance than audit. Further, review involves fewer procedures and gathers sufficient appropriate evidence on the basis of which limited conclusions can be drawn up. However, both "audit" and "review" are related to financial statements prepared on the basis of historical financial information.

13.2 Types of Assurance Engagements- Reasonable assurance engagement vs. Limited assurance engagement

Reasonable assurance engagement	Limited assurance engagement
Reasonable assurance engagement provides high level of assurance.	Limited assurance engagement provides lower level of assurance than reasonable assurance engagement.
It performs elaborate and extensive procedures to obtain sufficient appropriate evidence.	It performs fewer procedures as compared to reasonable assurance engagement.

It draws reasonable conclusions on the basis of sufficient appropriate evidence.	It involves obtaining sufficient appropriate evidence to draw limited conclusions.
Example of reasonable assurance engagement is an audit engagement.	Example of limited assurance engagement is review engagement.

- Besides reasonable assurance engagements and limited assurance engagements, there is another kind of assurance which is related to matters other than historical financial information. Such an assurance may relate to prospective financial information and not to historical financial information. It may relate to providing assurance on internal controls in an entity.
- "Prospective financial information" means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It can be in the form of a forecast or projection or combination of both.
- Prospective financial information relates to future events. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future-oriented. The auditor is, therefore, not in a position to express an opinion as to whether the results shown in the prospective financial information will be achieved.
- Therefore, in such assurance engagements, practitioner provides a report assuring that nothing has come to practitioner's attention to suggest that these assumptions do not provide a reasonable basis for the projection.
- Hence, such type of assurance engagement provides only a "moderate" level of assurance.



14. QUALITIES OF AUDITOR

- Tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability are some of qualities which an auditor should have. 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.
- 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.

15. ENGAGEMENT AND QUALITY CONTROL STANDARDS: AN OVERVIEW

The following Standards issued under authority of ICAI Council are collectively known as Engagement Standards: -

1. Standards on auditing (SAs) which apply in audit of historical financial information.
2. Standards on review engagements (SREs) which apply in review of historical financial information.
3. Standards on Assurance engagements (SAEs) which apply in assurance engagements other than audits and review of historical financial information.
4. Standards on Related Services (SRSs) which apply in agreed upon procedures to information, compilation engagements and other related service engagements. - No Assurance.

15.1 Standards on Auditing

Some examples of Standards on Auditing are:

- SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing
- SA 230 Audit Documentation
- SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment

- SA 500 Audit Evidence
- Revised SA 700 Forming an Opinion and Reporting on Financial Statements.

15.2 Standards on Review Engagements

Examples of Standards on Review engagements are:

- SRE 2400 (Revised) Engagements to Review Historical Financial Statements
- SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity

15.3 Standards on Assurance Engagements

Examples of Standards on Assurance Engagements are:

- SAE 3400 The Examination of Prospective Financial Information
- SAE 3420 Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

15.4 Standards on Related Services

Examples of Standards on related services are:

- SRS 4400 Engagements to perform agreed-upon procedures regarding financial information
- SRS 4410 (Revised) Compilation engagements

15.5 Standards on Quality Control

SQC 1 has been issued in this regard. It requires auditors/practitioners to establish system of quality control so that firm and its personnel comply with professional standards and regulatory & legal requirements and reports issued are appropriate.

15.6 Why are Standards needed?

- Standards ensure carrying out of audit against established benchmarks at par with global practices.
- Standards improve quality of financial reporting thereby helping users to make diligent decisions.
- Standards promote uniformity as audit of financial statements is carried out following these Standards.
- Standards equip professional accountants with professional knowledge and skill.
- Standards ensure audit quality.

15.7 Duties in relation to Engagement and Quality Control Standards

- It is the duty of professional accountants to see that Standards are followed in engagements undertaken by them. Ordinarily, these are to be followed by professional accountants. However, a situation may arise when a specific procedure as required in Standards would be ineffective in a particular engagement. In such a case, he is required to document how alternative procedures performed achieve the purpose of required procedure.
- Also, reason for departure has also to be documented unless it is clear.
- Further, his report should draw attention to such departures. It is also to be noted that a mere disclosure in the report does not absolve a professional accountant from complying with applicable Standards.

2 AUDIT STRATEGY, AUDIT PLANNING AND AUDIT PROGRAMME

1. AUDITOR'S RESPONSIBILITY TO PLAN AN AUDIT OF FINANCIAL STATEMENTS

1.1 Why Planning an audit is necessary? –

Its Benefits Planning an audit is necessary to carry out it effectively in a timely manner. Besides ensuring compliance with professional standards, it helps in performing audit engagement effectively.

Adequate planning benefits the audit of financial statements in several ways, including the following:-

1. Helping the auditor to devote appropriate attention to important areas of the audit.
2. Helping the auditor identify and resolve potential problems on a timely basis.
3. Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
4. 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.
5. Facilitating the direction and supervision of engagement team members and the review of their work.
6. Assisting, where applicable, in coordination of work done by others such as experts

1.2 Nature of Audit Planning- A Continuous and iterative process

(a) 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.

(b) 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.

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

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

2. Planning Process- Elements of Planning

The elements of planning can be categorized as under:

(I) Preliminary engagement activities

The auditor considers whether relationship with client should be continued and whether ethical requirements including independence continue to be complied with. It includes: -

Preliminary engagement activities include the following:

(A) Performing procedures regarding the Continuance of Client Relationships and Audit Engagements

Matters such as integrity of principal owners and key management, competence of engagement team to perform the audit engagement and implications of matters that have arisen during current and previous audit engagement may need to be considered.

(B) Evaluating compliance with ethical requirements including 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:

(i) Obtain relevant information from the firm to identify and evaluate circumstances and relationships that create threats to independence

(ii) 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

(iii) 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.

(C) Establishing an understanding of terms of engagement

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.

(II) Planning activities

Planning activities involve:

(A) Establishing the overall audit strategy- Assistance for the auditor

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

A.1 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: -

(i) 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

(ii) 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

(iii) When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates

(iv) 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

A.2 Factors to be taken into consideration by auditor for establishing audit strategy

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

There are many characteristics of engagement defining its scope. Some of characteristics are as under:

- Applicable financial reporting framework applicable to the entity
- Nature of business segments to be audited including the need for specialized knowledge
- Industry specific reporting requirements required by industry regulators
- Expected use of audit evidence obtained in previous audits

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

The ascertaining of reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also nature of communications. Some of the instances are given under:

- The entity's timetable for reporting
- Organization of meetings to discuss of nature, timing and extent of audit work with management
- Discussion with management regarding the expected type and timing of reports to be issued including the auditor's report
- Discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- Expected nature and timing of communications among engagement team members.

(c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts

The auditor needs to direct efforts of engagement team towards matters that in his professional judgment are significant.

Few examples are listed as under:

- Volume of transactions which may determine whether it is more efficient for the auditor to rely on internal control

- 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.

(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.

Examples

- 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.

(e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

(B) Development of Audit plan

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

SA-300 states that auditor shall develop an audit plan that shall include description of-

(i) The nature, timing and extent of planned risk assessment procedures

(ii) The nature, timing and extent of planned further audit procedures at assertion level

(iii) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

3. RELATIONSHIP BETWEEN AUDIT STRATEGY AND AUDIT PLAN

(a) Audit strategy sets the broad overall approach to the audit whereas audit plan addresses the various matters identified in the overall audit strategy.

(b) Audit strategy determines scope, timing and direction of audit. Audit plan describes how strategy is going to be implemented.

(c) 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.

(d) 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.

(e) The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

4. CHANGES TO PLANNING DECISIONS DURING THE COURSE OF AUDIT

As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks.

5. PLANNING SUPERVISION AND REVIEW OF WORK OF ENGAGEMENT TEAM MEMBERS

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

Which depend on many factors, including: -

1. The size and complexity of the entity.
2. The area of the audit.
3. The assessed risks of material misstatement
4. The capabilities and competence of the individual team members performing the audit work.

6. DOCUMENTATION

(a) 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.

(b) 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.

(c) 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.

7. AUDIT PROGRAMME

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

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

8.1 Evolving one audit programme- Not Practicable for All businesses

Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable.

8.2 The Assistant to keep an open mind

To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme. The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him.

8.3 Periodic review of the audit programme

There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions.

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.

8.4 Constructing an audit programme

→ 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.

→ While developing an audit programme, 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.

→ Further, 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.

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

(1) Stay within the scope and limitation of the assignment.

(2) Prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.

(3) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.

(4) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.

(5) Include the audit objectives for each area and sufficient details which serve as a set of instructions for the assistants involved in audit and help in controlling the proper execution of the work.

(6) Consider all possibilities of error.

(7) Co-ordinate the procedures to be applied to related items.

8.5 Audit Programme- Designed to provide audit evidence

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

8.6 Advantages and disadvantages of an audit programme

The advantages of an audit programme are: -

(a) It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.

(b) It is essential, particularly for major audits, to provide a total perspective of the work to be performed.

(c) Selection of assistants for the jobs on the basis of capability becomes easier.

(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.

(e) The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them.

(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.

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 RISK ASSESSMENT AND INTERNAL CONTROL

1. AUDIT RISK

Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated.

It means that an auditor expresses an unmodified opinion when financial statements are materially misstated.

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

1.1 Risks of material misstatement

It simply means that there is a probability of frauds or errors in financial statements before audit.

What is meant by misstatement?

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

The risks of material misstatement may exist at two levels:

(i) The overall financial statement level

(ii) The assertion level for classes of transactions, account balances, and disclosures.

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.

Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

1.2 Components of risk of material misstatement

The risk of material misstatement at assertion level comprises of two components i.e., inherent risk and control risk.

1.2A Inherent risk

Inherent risk is 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

Few examples

- An accounting standard provides guidance on some complex issue which might not be understood by the management. Therefore, recording of this issue in financial statements carries inherent risk of being misstated.
- There are large number of business failures in an industry. Therefore, assertions in financial statements of an entity operating in such an industry carry an inherent risk of being misstated.

1.2B Control risk

Control risk is 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.

Examples:

- A company has devised control that cash and cheque books should be kept in a locked safe and access is granted to authorized personnel only. There is risk that control is not being followed.

- An entity has devised a control that fire extinguishers and smoke detectors are in place and are in working condition at all times to reduce the risk of damage to inventories caused by fire. There is a risk that fire extinguishers in place are expired and are not being refilled.

1.3 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.

Detection risk comprises sampling and non-sampling risk.

Examples

- **Sampling risk** is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. It simply means that the sample was not representative of the population from which it was chosen.
- **Non-sampling risk** is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. Like an auditor may reach an erroneous conclusion due to application to some inappropriate audit procedure.

Examples

- Sizeable work-in-progress inventories are expected in financial statements of a company. However, auditor of the company does not devote time to attending inventory count. Instead, he chooses to rely upon alternative audit procedures.
- The auditor of a company has audited revenue of a company by taking a sample. However, there is a risk that sample of revenue is not representative of overall revenue.

The auditor can *only* influence detection risk. Inherent risk and control risk belong to the entity and are influenced by the entity.

Detection risk may be reduced by increasing area of checking, testing larger samples and by including competent and experienced persons in the engagement team.

1.4 Audit risk-What is not included?

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.

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.

1.5 Assessment of risks- A matter of professional Judgment

The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

1.5.1 Combined Assessment of the Risk of Material Misstatement

Standards on auditing do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement.

The assessment of the risks of material misstatement may expressed in quantitative terms, such as in percentages, or in non-quantitative terms.

It can be concluded from the above that:

Audit risk = Risks of material misstatement x Detection risk

it can also be shown as:

Audit risk = Inherent risk x Control risk x Detection risk

1.6 Identifying and assessing the risk of material misstatement

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

The objective of the auditor as stated in SA 315 is to identify and assess the risks of material misstatement.

(i) The auditor shall identify and assess the risks of material misstatement at:

(a) the financial statement level

(b) the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures

(ii) For the purpose of identifying and assessing the risks of material misstatement, the auditor shall: -

(a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements

(b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions

(c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test and

(d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

1.7 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 level are defined as risk assessment procedures.

What is included in risk assessment procedures?

The risk assessment procedures shall include the following:

(a) Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.

(b) Analytical procedures.

(c) Observation and inspection.

Example:

- Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control

- 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,

- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

- Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.

- Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system- related risks.

(b) Analytical Procedures: Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures 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.

(c) Observation and Inspection:

- The entity's operations.
- Documents (such as business plans and strategies), records, and internal control manuals.
- Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of director's meetings)
- The entity's premises and plant facilities.

2. MATERIALITY

2.1 What is meant by materiality?

SA 320 Materiality in Planning and Performing an Audit states 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.

Materiality is not always a matter of relative size. For example, a small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future.

2.2 Materiality in Planning and performing an audit- Auditor's responsibility

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.

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. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

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 above provide the auditor with such a frame of reference.

- ➢ 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.
- ➢ The auditor has to apply his professional judgement in determining materiality, choosing appropriate benchmark and determining level of benchmark.
- ➢ If there is any statutory requirement of disclosure, it is to be considered material irrespective of the value of amount. Examples are given below:
  - • As per Division I of schedule III of Companies Act, 2013, any item of income or xpenditure which exceeds one percent of the revenue from operations or ₹ 1,00,000, whichever is higher, needs to be disclosed separately.

- A company should disclose in notes to accounts, shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held as per requirements of Division I of Schedule III of Companies Act,2013.

2.3 Determination of materiality- a matter of professional judgment

The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

(a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;

(b) Understand that financial statements are prepared, presented and audited to levels of materiality;

(c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and (d) Make reasonable economic decisions on the basis of the information in the financial statements.

2.4 Performance Materiality

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.

2.5 Determining Materiality and Performance Materiality when Planning the Audit

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

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

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

- The elements of the financial statements like 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;
- The relative volatility of the benchmark.

Note 1: 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.

Note 2: 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.

2.6.1 Chosen Benchmark – Relevant financial data

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

- Prior periods' financial results and financial positions,

- The period to-date financial results and financial position, and
- Budgets or forecasts for the current period,
- Adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates.

Consider, for example, that the auditor may consider 5% of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider 1% 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.

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

Consider, for example, that the auditor may consider 5% of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider 1% 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.

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

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

1. Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items like in case of related party transactions, and the remuneration of management and those charged with governance.
2. The key disclosures in relation to the industry in which the entity operates. For example, research and development costs for a pharmaceutical company.

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

2.8 Revision in Materiality level as the Audit Progresses

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

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

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

2.9 Documenting the Materiality

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

(a) Materiality for the financial statements as a whole

(b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures

(c) Performance materiality and

(d) Any revision of (a)-(c) as the audit progressed

2.10 Materiality and Audit 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; &

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

3. UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

SA 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment states that the auditor shall obtain an understanding of the following: -

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

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 market and competition, whether entity is engaged in seasonal activities, product technology relating to the entity's products.

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 etc.

(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.

Examples of matters that the auditor may consider while obtaining understanding of nature of entity include: -

- Business operations such as nature of revenue sources, products or services, conduct of operations, location of production facilities, key customers and suppliers of goods and services

- Investment and investment activities such as capital investment activities and planned or recently executed acquisitions
- Financing and financing activities such as major subsidiaries, debt structure etc.
- Financial reporting such as accounting principles and revenue recognition practices

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto

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

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).

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

Examples for measuring and reviewing financial performance which may be used by an auditor may 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, and departmental or other level performance reports.
- Credit rating agency reports

3.1 Why understanding the entity and its environment is significant?

It helps the auditor in planning the audit and in identifying areas requiring special attention.

3.2 Understanding the entity-a continuous process

It is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

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

4. INTERNAL CONTROL

4.1 Meaning of Internal Control

As per SA-315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", the internal control may be defined as "the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to:

(a) reliability of financial reporting,

(b) effectiveness and efficiency of operations,

(c) safeguarding of assets, and

(d) compliance with applicable laws and regulations.

4.2 Benefits of Understanding of Internal Control

An understanding of internal control assists the auditor in:

(i) Identifying types of potential misstatements;

(ii) Identifying factors that affect the risks of material misstatement, and

(iii) Designing the nature, timing, and extent of further audit procedures.

4.3 Limitations of Internal Control

(i) Internal control can provide only reasonable assurance

Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control.

(ii) Human judgment in decision-making

Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control.

(iii) Lack of understanding the purpose

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

(iv) Collusion among People

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

(v) Judgements by Management

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

(vi) Limitations in case of Small Entities

(a) Smaller entities often have fewer employees due to which segregation of duties is not practicable.

(b) 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.

(c) 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.

4.4 Components of Internal Control

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

(A) The control environment

(B) The entity's risk assessment process

(C) The information system, including the related business processes, relevant to financial reporting, and communication

(D) Control activities

(E) Monitoring of controls

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

- **What is included in Control Environment?**

The control environment includes:

(i) the governance and management functions and

(ii) the attitudes, awareness, and actions of those charged with governance and management.

(iii) the control environment sets the tone of an organization, influencing the control consciousness of its people.

Elements of the Control Environment

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

(a) **Communication and enforcement of integrity and ethical values**

The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them.

(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 & knowledge.

(c) **Participation by those charged with governance**

It includes 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.

(d) **Management's philosophy and operating style**

Matters such as approach of management to taking and managing business risks, management's attitude towards information processing and accounting function and personnel reflects upon management's philosophy and operating style.

(e) **Organisational structure**

Establishing a relevant organisational structure includes considering key areas of authority and responsibility and appropriate lines of reporting.

(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.

➢ **Existence of a 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.

4.4(B) The Entity's Risk Assessment Process

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

(d) Deciding about actions to address those risks

4.4(C) The information system, including the related business processes, relevant to financial reporting and communication

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 by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements

(c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions

(d) How the information system captures events and conditions that are significant to the financial statements

(e) The financial reporting process used to prepare the entity's financial Statements

(f) Controls surrounding journal entries.

The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities. It may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda.

4.4(D) Control Activities

The auditor shall obtain an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement.

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

Example:

(a) policies and procedures relating to performance reviews (reviews of actual performance with budgets),

(b) information processing (for example controls over checking arithmetical accuracy of records, program change controls etc),

(c) physical controls(like controls over physical security of assets) and

(d) segregation of duties (controls over ensuring that different people are assigned the responsibilities of authorising transactions, recording transactions and maintaining custody of assets)

4.4(E)Monitoring of Controls

The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting.

Monitoring of controls is a process to assess the effectiveness of internal control performance over time.

Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two.

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.

4.5 Are all Controls Relevant to the audit?

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.

4.6 Controls over the completeness and accuracy of information

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..

4.7 Internal control over safeguarding of assets

Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives.

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.

4.8 Controls relating to objectives that are not relevant to an audit

An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit.

4.9 Nature and Extent of the Understanding of Relevant Controls

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.

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.

5. RISKS THAT REQUIRE SPECIAL AUDIT CONSIDERATION

As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

(a) Whether the risk is a risk of fraud

(b) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention

(c) The complexity of transactions

(d) Whether the risk involves significant transactions with related parties

(e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty and

(f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

5.1 Identifying Significant Risks

Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement.

5.2 Risks of Material Misstatement - Greater for Significant Non-Routine Transactions

Examples:

(a) Greater management intervention to specify the accounting treatment.

(b) Greater manual intervention for data collection and processing.

(c) Complex calculations or accounting principles.

(d) The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

5.3 Risks of material misstatement– Greater for Significant Judgmental Matters

Examples:

- 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.

6. EVALUATION OF INTERNAL CONTROL SYSTEM

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.

6.1 Benefits of Evaluation of Internal Control to the Auditor

The review of internal controls will enable the auditor to know:

(i) whether errors and frauds are likely to be located in the ordinary course of operations of the business

(ii) whether an adequate internal control system is in use and operating as planned by the management

(iii) whether an effective internal auditing department is operating

(iv) whether the controls adequately safeguard the assets

(v) how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned

(vi) how reliable the reports, records and the certificates to the management can Be

(vii) the extent and the depth of the examination that he needs to carry out in the different areas of accounting

(viii) what would be appropriate audit technique and the audit procedure in the given circumstances

(ix) what are the areas where control is weak and where it is excessive and

(x) whether some worthwhile suggestions can be given to improve the control system.

Formulate Audit Program after understanding Internal Control

(a) 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.

(b) 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.

(c) 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.

6.2(A) The Narrative Record

(a) This is a complete and exhaustive description of the system as found in operation by the auditor.

(b) Actual testing and observation are necessary before such a record can be developed.

(c) 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.

6.2(B) Check List

(a) This is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer.

(b) When he completes instruction, he initials the space against the instruction. Answers to the check list instructions are usually Yes, No or Not Applicable.

(c) Example

A few examples of check list instructions are given hereunder:

1. Are tenders called before placing orders?
2. Are the purchases made on the basis of a written order?
3. Is the purchase order form standardised?
4. Are purchase order forms pre-numbered?

6.2(C) Internal Control Questionnaire

(a) This is a comprehensive series of questions concerning internal control.

(b) In the questionnaire, generally questions are so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. Prov ision 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.

(c) The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees.

6.2(D) Flow Chart

(a) It is a graphic presentation of each part of the company's system of internal control.

(b) A flow chart is considered to be the most concise way of recording the auditor's review of the system.

(c) It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form.

7. TESTING OF INTERNAL CONTROL

Test of controls are performed to obtain audit evidence about the effectiveness of the:-

(i) Design of the accounting and internal control system

(ii) Operation of the internal control throughout the period

Test of controls may include:

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

8. WHAT IS AN AUTOMATED ENVIRONMENT?

An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems - also known as Information Systems (IS) or Information Technology (IT) systems. Nowadays, it is very common to see computer systems being used in almost every type of business.

8.1 Key features of an automated environment

The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.

Key features of an automated environment are as under: -

- Enables faster business operation
- Accuracy in data processing and computation
- Ability to process large volume of transactions
- Integration amongst business operations
- Better security and controls
- Less prone to human errors
- Provides latest information
- Connectivity and networking capability

If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using an off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment.

8.2 Understanding and documenting automated environment

Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment:

- Information systems being used (one or more application systems and what they are)
- Their purpose (financial and non-financial)
- Location of IT systems - local vs global
- Architecture (desktop based, client-server, web application, cloud based)
- Version (functions and risks could vary in different versions of same application).
- Interfaces within systems (in case multiple systems exist).
- In-house vs Packaged.
- Outsourced activities (IT maintenance and support).
- Key persons (CIO, CISO, Administrators).

The understanding of a company's IT environment that is obtained should be documented.

8.3 Risks arising from use of IT Systems

- Inaccurate processing of data, processing inaccurate data, or both.
- Unauthorized access to data.
- Direct data changes (backend changes).
- Excessive access / Privileged access (super users).
- Lack of adequate segregation of duties.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Loss of data.

8.4 Impact of IT related risks

The above risks have to be mitigated. If not mitigated, such risks, could have an impact on audit in different ways discussed as under: -

(a) Impact on substantive checking

Inability to address above discussed risks may lead to non-reliance of data obtained from systems. In such a case, all information, data, and reports would have to be tested thoroughly for their completeness and accuracy. It could lead to increased substantive checking i.e., detailed checking.

(b) Impact on controls

It can lead to non-reliance on automated controls, system calculations and accounting procedures built into applications. It may result in additional audit work.

(c) Impact on reporting

Due to regulatory requirements in respect of internal financial controls (discussed in subsequent paras) in case of companies, it may lead to modification of auditor's report in some instances.

8.5 Types of Controls in an automated environment

Controls in an automated environment can be categorized as under: -

(A) General IT controls

(B) Application controls

(C) IT-dependent controls

8.5(A) General IT controls

General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data centre and network operations
- Program change
- Access security
- Application system acquisition, development, and maintenance (Business Applications)

General IT controls are known as "pervasive" controls or "indirect" controls.

(a) Controls over Data centre and network operations

(i) The objective of controls over Data centre and network operations is to ensure that production systems are processed to meet financial reporting objectives.

(ii) These include activities such as overall management of computer operation activities, preparing, scheduling and executing of batch jobs, monitoring, storage and retention of backups. Such controls also help in performance monitoring of operating system, database and networks. Matters such as BCP (Business continuity plan) and DRP (Disaster recovery plan) which deal with recovery from failures are also taken care of by such type of controls.

(b) Program Change

(i) The objective of program change controls is to ensure that modified systems continue to meet financial reporting objectives.

(ii) It includes activities such as change management process, recording, managing and tracking change requests, making and testing changes etc.

(c) Access Security

(i) The objective of controls over access security is to ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.

(ii) It includes activities such as security organization & management, security policies & procedures, application security, data security, operating system security, network security, physical security etc.

(d) Application system acquisition, development, and maintenance

(i) The objective of such controls is to ensure that systems are developed, configured and implemented to meet financial reporting objectives.

(ii) It includes overall management of development activities, project initiation, analysis & design, construction, testing & quality assurance etc.

8.5(B) Application Controls

(i) Application controls include both automated or manual controls that operate at a business process level.

(ii) Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems.

(ii) Examples of automated applications include edit checks and validation of input data, sequence number checks, user limit checks, reasonableness checks, mandatory data fields.

8.5(c) IT dependent Controls

(i) IT dependent controls are basically manual controls that make use of some form of data or information or report produced from IT systems and applications. In this case, even though the control is performed manually, the design and effectiveness of such controls depends on the reliability of source data.

8.6 General IT Controls vs. Application Controls

- These two categories of control over IT systems are interrelated.
- The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems.

8.7 Testing methods in an automated environment

There are basically four types of audit tests that should be used. These are inquiry, observation, inspection and Reperformance.

(a) Inquiry is the most efficient audit test but it also gives the least audit evidence.

Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient. Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.

(b) Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors including risk assessment, control environment, desired level of evidence required, history of errors/ misstatements, complexity of business, assertions being addressed etc.

(c) When testing in an automated environment, some of the more common methods are as follows:

- Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
- Observe how a user processes transactions under different scenarios.
- Inspect the configuration defined in an application.

(d) Where the general IT controls are not existing or existing but ineffective, the auditor should plan alternative audit procedures in order to rely on the system-based information.

9. 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.

(a) 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.

(b) 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.

9.1 Manual elements vs automated elements in entity's internal control

(a) 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.

(b) 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.

(c) 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.

(d) 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.

10. AUDIT APPROACH IN AN AUTOMATED ENVIRONMENT

Risk Assessment	Understand and Evaluate	Test for Operating Effectiveness	Reporting
• Identify significant accounts and disclosures	• Document understanding of business processes using Flowcharts / Narratives	• Assess Nature Timing and Extent (NTE) of controls testing	• Evaluate Control Deficiencies
• Qualitative and Quantitative considerations	• Prepare Risk and Control Matrices (RCM)	• Assess reliability of source data; completeness of population	• Significant deficiencies, Material Weakness
• Relevant Financial Statement Assertions (FSA)	• Understand design of controls by performing walk thoughts of end-to-end process	• Testing of key reports and spreadsheets	• Remediation of control weakness
• Identify likely sources of misstatement	• Process wide considerations for Entity Level Controls, Segregation of Duties.	• Sample testing	• Internal Controls Memo (ICM) or Management Letter
• Consider risk arising from use of IT systems	• IT General Controls, Application Controls	• Consider competence and independence of staff/team performing controls testing.	• Auditors report

11. DATA ANALYTICS FOR AUDIT

The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics.

The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short.

Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

- Check completeness of data and population that is used in either test of controls or substantive audit tests.
- Selection of audit samples – random sampling, systematic sampling.
- Re-computation of balances – reconstruction of trial balance from transaction data.
- Reperformance of mathematical calculations – depreciation, bank interest calculation.
- Analysis of journal entries
- Fraud investigation.
- Evaluating impact of control deficiencies.

12. DIGITAL AUDIT

(a) Entities are embracing digitization as part of their operations to keep pace with changing times. New technologies are helping companies revamp their operations and rethink the way business is conducted. Companies are restructuring their business models driven by technology. Automation is key to digitization.

(b) In such a business environment, use of digital technology is being made by auditors right from planning to expression of final opinion. Auditors are making use of artificial intelligence, data analytics and other latest technologies to help understand business processes in a better way. By using such tools, auditors can conduct audit in a better way and devote more attention to areas requiring greater focus. Digital audit is helping auditors to better identify risks making use of technology.

13. INTERNAL FINANCIAL CONTROLS AS PER REGULATORY REQUIREMENTS

The term Internal Financial Controls (IFC) basically refers to the policies and procedures put in place by companies for ensuring:

- Reliability of financial reporting
- Effectiveness and efficiency of operations
- Compliance with applicable laws and regulations
- Safeguarding of assets
- Prevention and detection of frauds

The term "internal financial controls" is used at some places in Companies Act, 2013 casting responsibilities as under: -

Relevant provision of Companies Act,2013	Nature of Responsibility
Section 134 (5)(e)	In case of listed Companies, the Directors' responsibility statement shall state that the Directors had laid down Internal financial controls to be followed by the company and that such Internal financial controls are adequate and were operating effectively
Section 143(3)(i) of the Act	The auditor's report shall state whether the company has adequate Internal financial controls system in place and also on the operating effectiveness of such controls. This requirement shall not apply to a private company which – (i) is One Person Company or a small company; or (ii) has turnover less than ₹ 50 crore as per latest audited Financial Statements; and which has aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial Year for less than ₹ 25 crore.
Section 177(4)(vii) of the Act	Every audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall, inter alia, include - evaluation of internal financial controls and risk management systems.

As per Section 149(8) of the Act	The company and independent directors shall abide by the provisions specified in Schedule IV which lays down the Code for independent Directors. As per this code, the role and functions of independent directors include that they shall satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible.

14. DOCUMENTING THE RISKS

The auditor shall document:

(a) The discussion among the engagement team and the significant decisions reached

(b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment and of each of the internal control components, the sources of information from which the understanding was obtained; and the risk assessment procedures performed

(c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level and

(d) The risks identified, and related controls about which the auditor has obtained an understanding.

15. ASSESS AND REPORT AUDIT FINDINGS

At the conclusion of each audit, it is possible that there will be certain findings or exceptions in IT environment and IT controls of the company that need to be assessed and reported to relevant stakeholders including management and those charged with governance viz., Board of directors, Audit committee.

Some points to consider are as follows:

Are there any weaknesses in IT controls?

- What is the impact of these weaknesses on overall audit?
- Report deficiencies to management – Internal controls memo or Management letter.
- Communicate in writing any significant deficiencies to those Charged with governance.

The auditor needs to assess each finding or exception to determine impact on the audit and evaluate if the exception results in a deficiency in internal control.

Each finding should be looked at individually and in the aggregate by combining with other findings/deficiencies.

16. THE AUDITOR'S RESPONSES TO ASSESSED RISKS

(a) SA 330- The auditor's responses to assessed risks 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,

(b) SA 330 states that: -

   (i) The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.

   (ii) 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.

(c) In designing the further audit procedures to be performed, the auditor shall:

   (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level 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 and

   (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

(d) 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

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

16.1 Nature and Extent of Test of Controls

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

(a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:

(i) How the controls were applied at relevant times during the period under audit.

(ii) The consistency with which they were applied.

(iii) By whom or by what means they were applied.

(b) Determine whether the controls to be tested depend upon other controls (indirect controls), and if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls.

Note: 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.

(B) Matters the auditor may consider in determining the extent of test of controls include the following:

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

16.2 Timing of Test of Controls

The auditor shall test controls for the particular time, or throughout the period, 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.

16.3 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

16.5 Specific inquiries by auditor when deviations from controls are detected

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

(a) The test of controls that have been performed provide an appropriate basis for reliance on the controls

(b) Additional test of controls are necessary or

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

- 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.

  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.

16.7.1 Nature and extent of Substantive procedures

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.

4 AUDIT EVIDENCE

1. AUDIT EVIDENCE

1.1 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.

1.2 Meaning of Audit Evidence as per SA 500

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:-

(1) Information contained in the accounting records

Accounting records include

- invoices;
- contracts;

(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

For example,

- minutes of the meetings,
- written confirmations from trade receivables and trade payables

1.3 Types of Audit Evidence

(a) **Depending upon nature:**

1. **Visual:** For example, observing physical verification of inventory conducted by the client's staff.
2. **Oral:** For example, discussion with the management and various officers of the client.
3. **Documentary:** For example, fixed deposit certificate, loan agreement, sales bill etc.

(b) **Depending upon source:**

1. **Internal Evidence:** Evidence which originates within the organisation being audited is internal evidence.

   Example: Sales invoice, goods received note, inspection report, etc.

2. **External evidence:** The evidence that originates outside the client's organization is external evidence.

   Example: Purchase invoice, debit notes and credit notes coming from parties, quotations, confirmations, etc.

1.4 Relevance and Reliability of audit evidence

The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

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

Example:

If the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure.

On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. **For example,** 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.

1.4.2 Reliability

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.

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 obtained as original documents is more reliable than audit evidence obtained as photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form because in these cases the reliability of which may depend on the controls over their preparation and maintenance.

1.5 Sufficient appropriate audit evidence

1.5.1 Sufficiency and Appropriateness are interrelated.

Sufficiency is the measure of the quantity of audit evidence.

Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability.

1.5.2 Obtaining Sufficient and appropriate Audit Evidence by the Auditor

The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient and appropriate 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.

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.

SA 330 requires the auditor to conclude 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.

1.5.3 Further, auditor's judgement as to sufficiency may be affected by the factors such as:

(a) **Materiality:** 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.

(b) **Risk of material misstatement:** Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand, if assertions have a higher risk of material misstatement, more evidence would be required.

(c) **Size & characteristics of a population:** It 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.

1.7 Audit procedures for obtaining 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.

1.7.1 Audit procedures to obtain audit evidence can include:

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

(i) Inspection

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

Example: inspection of records for evidence of authorisation.

(ii) 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.

(iii) 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.

(iv) Recalculation

Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

(v) Reperformance

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

Example:

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

(vi) Analytical Procedures

(a) Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.

(b) Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

(vii) Inquiry

(a) 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.

(b) Inquiries may range from formal written inquiries to informal oral inquiries.

Evaluating responses to inquiries is an integral part of the inquiry process.

(c) 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.

(d) Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence.

1.7.3 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.

Also, 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 request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

1.7a Risk assessment procedures:

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.

1.7b Further Audit Procedures/Other Audit Procedures

Further Audit Procedures comprise of:

(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.

1.7.b(i) 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.

1.7.b(ii) Substantive Procedures- Tests of details and Substantive analytical procedures

Substantive procedures are designed to detect material misstatements at the assertion level.

1.8 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.

1.8.1 Assertions contained in the Financial Statements.

(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.

4. When making assertions about the financial statements of certain entities, especially.

For example, where the Government is a major stakeholder, in addition to above assertions assert that transactions and events have been carried out in accordance with legislation or proper authority.

Example:

Particulars	₹	₹
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 illustration 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.

1.9 Audit Trail

An audit trail is a documented flow of a transaction.

It is used as audit evidence to establish authentication and integrity of a transaction. Audit trails (or audit logs) act as record-keepers that document evidence of certain events, procedures or operations, because their purpose is to reduce fraud, material errors, and unauthorized use. Audit trails help to enhance internal controls and data security. Audit trails can help in fixing responsibility, rebuilding events and in thorough analysis of problem areas.

However, audit trails involve costs. The cost is not only in terms of system expenditure but also in terms of time involved in analysing data made available by audit trails. However, use of automated tools can be made to analyse large volume of data thrown up by audit trails.

1.10 Information to Be Used as Audit Evidence

1.10.1 When information to be used as audit evidence has been prepared using the work of a management's expert, the nature, timing and extent of audit procedures may be affected by such matters;

- 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.

1.10.2 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

(b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.

1.11(a) Selecting All Items

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.

1.11(b) Selecting Specific Items

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.**
- **All items over a certain amount.**
- **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.**

1.11(c) Audit Sampling

Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it.

1.12 Inconsistency in or Doubts over Reliability of Audit Evidence

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.

1.13 Relying on the work of a management's expert

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;

(a) Evaluate the competence, capabilities and objectivity of that expert;

(b) Obtain an understanding of the work of that expert; and

(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Note:

Who is 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.

2. USING THE WORK OF INTERNAL AUDITORS (SA 610)

2.1 Definition of Internal Audit Function

Internal audit function refers to

A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance , risk management and internal control processes.

The objectives and scope of internal audit functions typically include.

(1) Activities Relating to Governance

The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

(2) Activities Relating to Risk Management

- **The internal audit function may assist the entity by identifying and evaluating significant exposures to risk** and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process).
- The internal audit function may perform procedures to assist the entity in the detection of fraud.

(3) Activities Relating to Internal Control

- **Evaluation of internal control.** The internal audit function may be assigned specific responsibility for reviewing controls, evaluating 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, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

- Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non- financial activities of an entity.

- Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations, and other external requirements, and with management policies and directives and other internal requirements.

2.3 Scope of SA 610

Standard on Auditing (SA) 610 deals with the external auditor's responsibilities if using the work of internal auditors. This includes

(a) using the work of the internal audit function in obtaining audit evidence &

(b) using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.

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

2.4 External Auditor's Responsibility for the audit

The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement. Although they may perform audit procedures similar to those performed by the external auditor, neither the internal audit function nor the internal auditors are independent of the entity as is required of the external auditor in an audit of financial statements in accordance with SA 200.

2.5 Objectives of the external auditor, where the entity has an internal audit function

The objectives of the external auditor, are:

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

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

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

2.6 Evaluating the Internal Audit Function

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

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

(B) The level of competence of the internal audit function; and

(C) Whether the internal audit function applies a systematic and disciplined approach, including quality control.

2.6A Objectivity and its evaluation

Objectivity refers to the ability to perform those tasks without allowing bias, conflict of interest or undue influence of others to override professional judgments.

Factors that may affect the external auditor's evaluation in relation to Objectivity include the following:

1. Whether the organizational status of the internal audit function, including the function's authority and accountability, supports **the ability of the function to be free from bias, conflict of interest or undue influence of others** to override professional judgments.

   For example:

   whether the internal audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.

2. Whether those charged with governance oversee employment decisions related to the internal audit function.

   For example, determining the appropriate remuneration policy.

3. Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance, **for example,** in communicating the internal audit function's findings to the external auditor.

4. Whether the internal audit function is free of any conflicting responsibilities, **for example,** having managerial or operational duties or responsibilities that are outside of the internal audit function.

2.6B Competence and its evaluation

Competence of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards.

Factors that may affect the external auditor's determination in relation to competence include the following:

1. Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations.
2. Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.
3. Whether the internal auditors have adequate technical training and proficiency in auditing.
4. Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework.

   Note: Objectivity and competence may be viewed as a continuum.(i.e. Both should run together)

2.6C Application of a Systematic and Disciplined Approach

Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following:

1. The existence, adequacy and use of documented internal audit procedures or guidance.
2. Whether the internal audit function has appropriate quality control policies and procedures.

2.7 Circumstances When Work of the Internal Audit Function Cannot Be Used

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

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

(b) The function lacks sufficient competence; or

(c) The function does not apply a systematic and disciplined approach, including quality control.

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

Once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, a first consideration is whether the planned nature and scope of the work of the internal audit function that has been performed, or is planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established.

Examples of work of the internal audit function that can be used by the external auditor include the following:

1. Testing of the operating effectiveness of controls.
2. Substantive procedures involving limited judgment.
3. Observations of inventory counts.
4. Tracing transactions through the information system relevant to financial reporting.
5. Testing of compliance with regulatory requirements.

2.9 Circumstances in which the external auditor shall plan to use less of the work of the Internal audit function and perform more of the work directly

(a) The more judgment is involved in:
  (i) Planning and performing relevant audit procedures; and
  (ii) Evaluating the audit evidence gathered;

(b) The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant;

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

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

2.10 Using the Work of the Internal Audit Function

If the external auditor plans to use the work of the internal audit function, the external auditor shall

(A) discuss the planned use of its work with the function as a basis for coordinating their respective activities.

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

(C) perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit.

Discussion and Coordination with the Internal Audit Function

In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:

1. The timing of such work.
2. The nature of the work performed.
3. The extent of audit coverage.
4. 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.
5. Proposed methods of item selection and sample sizes.
6. Documentation of the work performed.
7. Review and reporting procedures.

Coordination between the external auditor and the internal audit function is effective when, for example;

1. Discussions take place at appropriate intervals throughout the period.
2. The external auditor informs the internal audit function of significant matters that may affect the function.
3. The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

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

Direct assistance refers to the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

The external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors.

If using internal auditors to provide direct assistance is not prohibited by law or regulation, and the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance.

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

(a) Involve making significant judgments in the audit;

(b) Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited;

(c) Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or

(d) Relate to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.

Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall:

(a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and

(b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

2.12 Basics of Internal Financial Control and Reporting Requirements

Distinction between Internal Financial Control and Internal Control over financial reporting

The term Internal Financial Controls (IFC) refers to the policies and procedures put in place by companies for ensuring reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws and regulations, safeguarding of assets and prevention and detection of frauds.

On the other hand, Internal controls over financial reporting is required where auditors are required to express an opinion on the effectiveness of an entity's internal controls over financial reporting, such opinion is in addition to and distinct from the opinion expressed by the auditor on the financial statements. Therefore, "internal financial control" is a wider term where as "internal controls over financial reporting" is a narrower term restricted to entity's internal controls over financial reporting only.

3. AUDIT SAMPLING (SA 530)

3.1 Sampling: An Audit Procedure

➢ There is a growing realisation that the traditional approach to audit is economically wasteful because all the efforts are directed to check all transactions. 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 Thus the auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment of nonconsequential routine checking.

➢ 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 has to be done. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do as an auditor is to express his opinion on the financial statements 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 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 (i.e sampling), 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. This enables the auditor to make conclusions and express fair opinion without having to check all of the items within the financial statements.

3.2 Meaning of Audit Sampling

According to SA 530 "Audit sampling", 'audit sampling' refers to the application of audit procedures to less than 100% of items within a population relevant under the audit, such that all sampling units (i.e all the items in the population) have a equal chance of selection.

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.

Scope of SA-530

SA 530 becomes applicable when the auditor has decided to use audit sampling in performing audit procedures. This standard deals with the auditor's use of -

- Statistical and
- Non-statistical sampling

when designing and selecting the-

(i) audit sample,

(ii) performing tests of controls and tests of details, and

(iii) evaluating the results from the sample.

SA 500 lays down the means available to the auditor for selecting the items for testing. One of those is audit sampling. Hence SA 530 complements SA 500.

3.3 Population

Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

3.3.1 Characteristics of Population

1. **Appropriateness:**

   Appropriate means population from which the samples are drawn shall be relevant for the specific objective under audit.

Example:

If the auditor's objective were to test for overstatement of accounts receivable, thepopulation could be defined as the accounts receivable listing. On the other hand, when testing for understatement of accounts payable, the population would not be the accounts payable listing, but rather subsequent disbursements, unpaid invoices, suppliers' statements.

2. **Completeness:**

   If population is complete in all respects, the conclusions drawn on the population will be considered to be reasonable.

3. **Reliable:**

   If population is not reliable with respect to accuracy and source, the sample drawn will definitely not be relevant for the specific audit objective.

3.4 Sampling Unit

The individual items that make up the population are known as sampling units.

Sample must be representative

Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily *exactly the same.*

3.5 Approaches to Sampling (Types of Sampling)

3.5A Statistical Sampling-More Scientific

1. 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.
2. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.
3. There Is no personal bias of the auditor in case of statistical sampling. Since it is scientific, the results of sample can be evaluated and projected on the whole population in a more reliable manner.

   In larger organisations, with huge transactions, statistical sampling is always recommended as it is unbiased and the samples selected are not prejudged.

3.5B 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.

For example, March, June and September may be selected in year one and different months would be selected in the next year, On basis of value of items, top 10 highest value. Etc.

The non-statistical sampling is criticized on the grounds that it is neither objective nor scientific. The expected degree of objectivity cannot be assured in nonstatistical sampling because the risk of personal bias in selection of sample items cannot be eliminated.

3.6 Sampling Vs Traditional method of Auditing

- 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.
- Sampling is used as a part of Tests of controls. Auditor will check few internal controls and their operating effectiveness. Based on the conclusion derived, he can then design the sample size for tests of details (i.e checking of transactions and balances)
- If the internal control is satisfactory in its design and implementation, a much smaller sample can give the auditor the necessary reliability of the result he obtains.
- 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.

- The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgement. However, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

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.

3.7 Appropriateness of Sampling Approaches

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.

(6) It is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.

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.

3.8 Sampling Process

SAMPLE DESIGN
↓
SAMPLE SIZE
↓
SAMPLE SELECTION
↓
AUDIT PROCEDURES
↓
NATURE AND CAUSE OF DEVIATION AND
↓
PROJECTING
↓
EVALUATING RESULTS OF AUDIT

3.9 Sample Design, Size and Selection of Items for Testing

3.9.1 Sample Design

When designing an audit sample,

(i) 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.

(ii) 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.

(iii) In fulfilling the requirement of SA 500 "Audit Evidence", when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size.

Example : If the expected rate of deviation is unacceptably high, the auditorwill 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 performir tests of details.

3.9.1A 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.

Stratification:

(a) Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic.

(b) 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.

(c) 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.

(d) 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.

(e) 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.

Note:

Stratification: Dividing a population into discrete sub population which have identifying characteristics is called as Stratification. Each Sub population is called as Stratum and units under those sub population are referred to as Strata.

Value-Weighted Selection:

When performing tests of details, it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units One benefit of this approach to defining the sampling unit is that audit effo is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.

In value weighted selection, the sample size, its selection and evaluation will result in a conclusion in monetary amounts.

3.9.2 Sample Size

The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

3.9.2A Examples of Factors Influencing Sample Size for Tests of Controls

(i) 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.

(ii) If there is an increase in the tolerable rate of deviation. Then sample size will decrease. Tolerable error is the maximum error in the population that auditor is ready to accept in a given sample size.

(iii) When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase.

(iv) An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size.

(v) In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be negligible effect on sample size due to increase in the number of sampling units in the population.

3.9.2B Examples of Factors Influencing Sample Size for Tests of Details

(i) The higher the auditor's assessment of the risk of material misstatemen the larger the sample size needs to be.

(ii) 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.

(iii) An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population will increase the sample size.

(iv) An increase in tolerable misstatement will decrease the sample size as lower the tolerable misstatement, the larger the sample size needs to be.

(v) The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size needs to be.

(vi) When stratification of the population is appropriate then sample size will decrease

(vii) There will be negligible effect on sample size due to number of sampling units in the population.

3.9.3 Selection of Items for Testing

The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

3.9.3A Sample Selection Methods

(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.

Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum).

This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within reasonable range i.e it is suitable for a homogeneous populatic having a similar range.

(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.

The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences.

(2) **Interval Sampling or Systematic Sampling:** Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.

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.

(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.

Haphazard sampling has no structured approach, does not involve judgement and does not even use the random number tables.

(5) **Block Sampling:** This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Selection of a group at one time will not give a reasonable basis for opinion on the overall population as different types of transactions and unusual transactions may not be covered in the group taken all at once. Further, if the client has the idea of the block selection pattern of the auditor, then material misstatements and deviations can be easily overlooked by management's practice of recording them.

3.10 Performing Audit Procedures

(i) The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.

(ii) If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item.

(iii) 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 authorization. If the auditor is satisfied that the check has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined. A replacement would then mean a proper and valid cheque through which payment has been made.

(iv) 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.

(v) 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. If the documentation of a sales is lost, like the sales order record, sales invoice, document for dispatch etc., then confirmation can be sought from the debtor as per SA 505. If it is a cash sale, the cash book can be cross verified for the existence of such transactions.

(vi) 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.

3.11 Nature and Cause of Deviations and Misstatements

(i) In analyzing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time.

(ii) 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.

(iii) Therefore, the auditor shall investigate the nature and causes of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.

(iv) 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.

(v) 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.

Anomaly may be defined as a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

3.12 Projecting Misstatements

(i) 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.

(ii) 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.

(iii) For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

3.13 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.

Few Important terms to make the understanding better

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.

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.

4. AUDIT EVIDENCE-SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS (SA 501)

4.2 Objective of the Auditor in respect of Specific Considerations for Selected Items

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

(A) Existence and condition of inventory;

(B) Completeness of litigation and claims involving the entity; and

(C) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

4.3 Inventory

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

(1) Attendance at physical inventory counting, unless impracticable, to:

(i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting:

(ii) Observe the performance of management's count procedures;

(iii) Inspect the inventory; and

(iv) Perform test counts.

(2) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

4.4 Attendance at Physical Inventory Counting

Attendance at Physical Inventory Counting Involves:

(a) Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;

(b) Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and

(c) Obtaining audit evidence as to the reliability of management's count procedures.

4.5 Matters Relevant in Planning Attendance at Physical Inventory Counting

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

(a) Nature of inventory.

(b) Stages of completion of work in progress.

(c) The risks of material misstatement related to inventory.

(d) The nature of the internal control related to inventory.

(e) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.

(f) The timing of physical inventory counting.

(g) Whether the entity maintains a perpetual inventory system.

(h) The locations at which inventory is held.

(i) Whether the assistance of an auditor's expert is needed to obtain sufficient appropriate audit evidence.

4.6 Physical Inventory Counting Conducted other than at the Date of the Financial Statements

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

Relevant matters for consideration 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.

4.7 If the auditor unable to Attend Physical Inventory Counting due to Unforeseen Circumstances

The auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

4.8 Attendance at Physical Inventory Counting becomes impractical

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.

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.

4.9 When inventory under the custody and control of a third party- What will the auditor do?

The auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

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

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

Other audit procedure may include -

For Example:

- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral.
- 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.

4.10 Litigation and Claims

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

(a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

(b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

(c) Reviewing legal expense accounts.

In addition to the procedures identified above 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.

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

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

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

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

If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry.

The auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:

(a) A list of litigation and claims;

(b) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and

(c) A request that the entity's external legal counsel confirm the reasonableness of management's 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.

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:

(i) The auditor determines that the matter is a significant risk.

(ii) The matter is complex.

(iii) 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.

Further 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.

4.12 Segment Information

Definition of segment information

Segment Information refers to information about different types of products and services of an enterprise and its operations in different geographical areas.

4.13 Obtaining sufficient appropriate audit evidence regarding the presentation and disclosure of segment information

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:

(a) Obtaining an understanding of the methods used by management in determining segment information, and:

   (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.

   Note: 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.

4.15 Understanding of the Methods Used by Management

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:

1. Sales, transfers and charges between segments, and elimination of intersegment amounts.
2. Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
3. The allocation of assets and costs among segments.
4. Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

5. EXTERNAL CONFIRMATIONS (SA 505):

5.3 Definition of External Confirmation:

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

5.4 Definitions of other terms:

(a) **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.

(b) **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.

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

(d) **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.

5.5 External Confirmation Procedures adopted by the Auditor to Obtain Audit Evidence

(a) **Determining the Information to be Confirmed or Requested**

External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties.

(b) **Selecting the Appropriate Confirming Party**

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.

(c) **Designing Confirmation Requests**

1. **Design of a confirmation request**

   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.

2. **Factors to be considered by auditor when designing confirmation requests**

   Factors to consider when designing confirmation requests include:

   (i) The assertions being addressed.

   (ii) Specific identified risks of material misstatement, including fraud risks.

   (iii) The layout and presentation of the confirmation request.

   (iv) Prior experience on the audit or similar engagements.

   (v) The method of communication (for example, in paper form, or by electronic or other medium)

   (vi) 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.

   (vii) The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

3. **Positive confirmation request**

   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.

4. **Determination of properly addressed requests**

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.

(d) **Follow-Up on Confirmation Requests**

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.

5.6 Management's refusal to allow the auditor to send a confirmation request-steps taken by the Auditor

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;

Example:

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.

(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

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.

(c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

For Example:

- 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.

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

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

5.7 Negative Confirmations

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:

(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.

5.8 Evaluating the Evidence Obtained

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.

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.

6. INITIAL AUDIT ENGAGEMENTS - OPENING BALANCES (SA 510)

6.2 Definitions

1. **Initial audit engagement refers** to 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 predecessor auditor.

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

To obtain sufficient appropriate audit evidence about whether:

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

(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

6.4 Obtaining sufficient appropriate Audit evidence about opening balances by the Auditor

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

(a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;

(b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(c) Performing one or more of the following:

   (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;

(ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

(iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements.

If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance.

6.5 Procedures adopted by the Auditor to Obtain Audit Evidence regarding opening balances:

6.5.1 Nature and extent of Audit Procedures

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.

6.5.2 If the prior period's f inancial statements were audited by a predecessor auditor

If the prior period's financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

6.5.3 For current assets and liabilities

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.

6.5.4 For non- current assets and liabilities

For non-current assets and liabilities,

(i) 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.

(ii) In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties.

6.6 Consistency of Accounting Policies relating to opening balances

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.

6.7 Reporting by the auditor with regard to opening balances

1. 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.
2. If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with SA 705.

7. RELATED PARTIES (SA 550)

7.1 Definition of Related Party

A party that is either

(i) A related party as defined in the applicable financial reporting framework; or

(ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:

(a) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;

(b) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or

(c) Another entity that is under common control with the reporting entity through having:

- (i) Common controlling ownership;
- (ii) Owners who are close family members; or
- (iii) Common key management.

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

7.2 Nature of Related Party Relationships and Transactions

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties.

However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

For example

(A) 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.

(B) Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.

(C) Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

7.3 Understanding the Entity's Related Party Relationships & Transactions

The auditor shall inquire of management regarding:

(a) The identity of the entity's related parties, including changes from the prior period;

(b) The nature of the relationships between the entity and these related parties; and

(c) Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

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 -

(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

(c) Authorise and approve significant transactions and arrangements outside the normal course of business.

7.4 Considerations specific to smaller entities by the auditor

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.

For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management's oversight and review activities, and inspection of available relevant documentation.

7.4 How can an auditor verify the existence of related party relationships and transactions?

He may inspect the following records or documents that may provide information about related party relationships and transactions,

For example:

1. Entity income tax returns.
2. Information supplied by the entity to regulatory authorities.
3. Shareholder registers to identify the entity's principal shareholders.
4. Statements of conflicts of interest from management and those charged with governance.
5. Records of the entity's investments and those of its pension plans.
6. Contracts and agreements with key management or those charged with governance.
7. Significant contracts and agreements not in the entity's ordinary course of business.
8. Specific invoices and correspondence from the entity's professional advisors.
9. Life insurance policies acquired by the entity.
10. Significant contracts re-negotiated by the entity during the period.
11. Internal auditors' reports.
12. Documents associated with the entity's filings with a securities regulator e.g, prospectuses)

8. ANALYTICAL PROCEDURES (SA520)

8.1 Meaning of Analytical Procedures

Meaning of Analytical Procedures. As per the Standard on Auditing **(SA) 520 "Analytical Procedures"**, the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.

Examples of Analytical Procedures having consideration of comparisons of the entity's financial information are:

- Comparable information for prior periods.

  Example:

  CA Brijesh, while verifying the travelling expenses of PRT Ltd., may compare the travelling expenses of current year amounting to ₹ 2.50 lakhs with previous year travelling expense of PRT Ltd. amounting to ₹ 2 lakhs and infer that there has been an increase of 25% in the travelling expense incurred by the company. CA Brijesh may compare such percentage increase with the trend of the earlier several years.

  Thus, CA Brijesh, can use comparable information for prior periods of PRT Ltd. while applying analytical procedure with respect to the expenses incurred by the company.

- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.

- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Examples of Analytical Procedures having consideration of relationships are:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.

- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

8.2 Scope of SA 520

Objectives

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.

8.3 Purpose and timing of Analytical Procedures

8.3A Purpose of Analytical Procedures

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

Example:

(1) Comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio. Therefore, it became necessary for the auditor to make further enquiries as it may be due to pilferage of inventories/ misappropriation of a part of the sale proceeds/ a change in the cost of sales without a corresponding increase in the sales price.

(2) On verifying the balances of sundry account receivables by obtaining the confirmation of their statements of account, it will be possible for the auditor to find out whether the discrepancy in the balance of an account receivable is due to the failure to debit his account with the cost of goods supplied to him or is the result of non-adjustment of a remittance received from him.

(3) 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.

(4) 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.

(5) 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 anipulated to inflate or suppress profits.

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

8.3B Timing of Analytical Procedures

Analytical Procedures are required in the (a) planning phase (b) testing phase. (c) completion phase.

8.3C Analytical Procedures in Planning the Audit

(a) In the planning stage, analytical procedures assist the auditor in understanding the client's business and

(b) in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware.

(c) This information will assist the auditor in determining the nature, timing and extent of his other audit procedures.

(d) 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.

8.5 Factors to be considered for Substantive Audit Procedures

The auditor should consider the following factors for Substantive Audit Procedures:

(i) Availability of Data – The availability of reliable and relevant data will facilitate effective analytical procedures.

(ii) Disaggregation – The degree of disaggregation in available data can directly affect the degree of its usefulness in detecting misstatements.

(iii) Account Type – Substantive analytical procedures are more useful for certain types of accounts than for others. Income statement accounts tend to be more predictable because they reflect accumulated transactions over a period, whereas balance sheet accounts represent the net effect of transactions at a point in time or are subject to greater management judgment.

(iv) Source – Some classes of transactions tend to be more predictable because they consist of numerous, similar transactions, (e.g., through routine processes). Whereas the transactions recorded by non-routine and estimation SCOTs (Significant Classes of Transactions) are often subject to management judgment and therefore more difficult to predict.

Example

Transactions of routine nature like transactions related to sales and purchases are predictable and repetitive in nature. Therefore, on such data analytical procedures can be efficiently applied.

Expenditure on Research & Advertisement is not of routine nature and are subject to management judgement and therefore more difficult to predict.

(v) Predictability – Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable (e.g., between sales and cost of sales or between trade receivables and cash receipts). A predictable relationship is one that may reasonably be expected to exist and continue over time.

(vi) Nature of Assertion – Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). Predictive analytical procedures using data analytics can be used to address completeness, valuation/measurement and occurrence.

(vii) Inherent Risk or "What Can Go Wrong" – When we are designing audit procedures to address an inherent risk or "what can go wrong", we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk.

Example:

When side agreements with respect to revenue recognition have been identified as a significant or fraud risk, it is unlikely that an analysis of sales compared to cash receipts or cost of sales would be appropriate to respond to that risk.

8.6 Techniques available as Substantive Analytical Procedures

(i) Trend analysis – Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. The auditor evaluates whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

(ii) Ratio analysis – Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales).

Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

(iii) Reasonableness tests – Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense).

Example:

- Interest expense against interest bearing obligations
- Raw Material Consumption to Production (quantity)
- Wastage & Scrap % against production & raw material consumption (quantity)

(iv) Structural modelling – A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

8.7 Analytical Procedures used as Substantive Tests

(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;

The determination of the suitability of particular substantive analytical procedure is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.

Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

(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.

8.8 Suitability of particular analytical procedures for given assertions

1. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.
2. 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.
3. 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.

4. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure.

Example:

If an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll.

8.9 The reliability of DATA

(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.

8.10 Evaluation of whether the expectation is sufficiently precise

Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

(i) The accuracy with which the expected results of substantive analytical procedures can be predicted.

For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

(ii) The degree to which information can be disaggregated.

For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

(iii) The availability of the information, both financial and non-financial.

For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.

8.11 Amount of difference of recorded amounts from expected values that is acceptable

The auditor's determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by materiality 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.

8.12 Investigating results of Analytical Procedures

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

5 AUDIT OF ITEMS OF FINANCIAL STATEMENTS

BALANCE SHEET CAPTIONS COMPRISING ASSETS, LIABILITIES AND EQUITY BALANCES

- Existence
- Completeness
- Cut off
- Valuation
- Rights & Obligations
- Presentation & Disclosure

INCOME STATEMENT CAPTIONS COMPRISING REVENUE AND EXPENSE BALANCES

- Occurrence
- Completeness
- Cut off
- Measurement
- Presentation & Disclosure

INTRODUCTION

DEFINITION OF ASSERTION:

It refers to the representations by management, explicit or otherwise, that are embodied in the fnancial statements, as used by the auditor to consider the di erent types of potential misstatements that may occur.

1. INCOME STATEMENT CAPTIONS COMPRISING REVENUE AND EXPENSE BALANCES

Assertions	Explanation	Example: Employee benefit expenses and sales
Occurrence	Transactions recognized in the financial statements have occurred and relate to the entity.	(i) Employee benefit expense has been incurred during the period in respect of the personnel employed by the entity. Employee benefit expense does not include the cost of any unauthorized personnel.

		(ii)	Recorded Sales represent goods which were ordered by valid customers and were despatched and invoiced in the period.
Completeness	All transactions that were supposed to be recorded have been recognized in the financial statements. Transactions have not been omitted.	(i)	Employee benefit expenses in respect of all personnel have been fully accounted for.
		(ii)	All genuine Sales have been recorded.
Cut-off	Whether all income and expenses are reported in thecorrect accounting period. Cut-off is a separate assertion because the substantive procedures to verify it are typically different from those applied to the other components of completeness.	(i)	Employee benefit expenses recognized during the period relates to the current accounting period only.
		(ii)	Sales shall include the despatch of goods made at the year end as they belong to the relevant period.
Measurement	Transactions have been recorded accurately at their appropriate amounts in the financial statements. There have been no errors while preparing documents or in posting transactions to ledger. The figures and explanations are not misstated.	(i)	Employee benefit expense has been measured/ calculated accurately. Any adjustments such as tax deduction at source have been correctly reconciled and accounted for.
		(ii)	Sales are recorded correctly in the books base on the invoices. Discounts have been properly adjusted or accounted for.
Presentation and Disclosure	Transactions have been classified and presented fairly in the financial statements.	(1)	A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:–

	Transactions and events are appropriately segregated or disaggregated. Presentation and disclosure assertions are considered during the course of the audit to determine that the disclosures are complete and accurate. The disclosures that are most susceptible to material misstatement are those that require significant judgement and qualitative assessments. Audit teams assess the completeness and accuracy of disclosures by determining that the disclosures provide information in a manner that does not materially omit, distort or mislead the user. The description and disclosure of transactions are relevant and easy to understand.	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]. (2) In respect of a company other than a finance company revenue from operations shall disclos separately in the notes revenu from– (a) Sale of products; (b) Sale of services; (ba) Grants or donations received (relevant in case of section 8 companies only),] (c) Other operating revenues; Less: (d) Excise duty

2. BALANCE SHEET CAPTIONS COMPRISING ASSETS, LIABILITIES AND EQUITY BALANCES

Assertions	Explanation	Example: Inventory balance
Existence	Assets, liabilities and equity balances exist as at the period end.	Inventory recognized in the balance sheet actually existed as at the period end.
Completeness	All assets, liabilities and equity balances that were supposed to be recorded have been recognized in the financial statements.	All inventory units held by the entity that should have been recorded, have been recognized appropriately in the financial statements. Any inventory held by a third party on

		behalf of the entity has been included as part of the inventory balance. Inventory held by the entity as a Consignee (on behalf of third party i.e. Consignor) shall be excluded.
Cut-off	Whether all assets and liabilities are reported in the appropriate period.	Inventory balance as at the yearend does not include any element of next financial year. All items of inventory pertaining to the relevant year shall be included regardless of the location.
Valuation	Assets, liabilities and equity balances have been valued appropriately i.e. the amounts at which they are recorded are appropriate. There has been no overstatement or understatement.	Inventory has been recognized at the lower of -cost and - net realizable value in accordance with AS 2 - Inventories. Any costs that could not be reasonably allocated to the cost of production (e.g. general and administrative costs) and any abnormal wastage have been excluded from the cost of inventory. An acceptable valuation basis (eg. FIFO, Weighted average etc.) has been used to value inventory as at the periodend.
Rights & Obligations	Entity has the right to assets i.e. (whether the entity has ownership and legal title to assets) and the liabilities recognized in the financial statements represent all the entity's obligations to repayment as at a given date.	The entity owns or controls the inventory recorded in the financial statements i.e. the purchase invoices have been made in the name of client. Any inventory held by the entity on behalf of another entity has not been recognized as part of inventory of the entity. (Eg: Consignment agreements can be checked).

Presentation and Disclosure	Whether particular items in the financial statements are properly classified, described and disclosed. Presentation and disclosure assertions are considered during the course of the audit to determine that disclosures are complete and accurate. The disclosures that are most susceptible to material misstatement are those that require significant judgement and qualitative assessments. Audit teams assess the completeness and accuracy of disclosures by determining that the disclosures provide	Example 1 : 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. Example 2: For Share capital, a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period is required to be disclosed in the notes to accounts of the company.

1 SHARE CAPITAL

1.1 Existence

→ 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

1.2 Valuation

→ Tally the period- end share capital balance- authorised, issued and paid up, to the previous year audited financial statements

→ In case there in no change during the year, obtain a written confirmation/ representation from the Company Secretary that there were no changes to entity's capital structure during the year.

→ In case there is any change, obtain the certified copies of relevant resolutions passed at the meetings of board of directors, shareholders authorising the increase/ decrease in authorised and paid up share capital

→ Verify whether the paid up capital as at the period- end is within the limits of authorised capital

1.3 Completeness

→ "issued capital" means that part of authorised capital which is offered by the company for subscription and includes the shares allotted for consideration other than cash.

1.4 Presentation and Disclosure

→ It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013

2 RESERVES AND SURPLUS

2.1 Existence/Valuation/Completeness

→ Tally the opening balance of reserves and surplus to the previous year audited financial statements.

→ For addition/ utilisation in current year, in case of:

(a) Profit and Loss balance - trace the movement as disclosed in Statement of changes in Equity to Surplus/ Deficit as per Income Statement for the year under audit

(b) For adjustment related to dividend payment and the tax related thereto i.e. dividend distribution tax, verify the resolution passed by the board of directors regarding declaration of dividend

(c) Students should note that as per Ind AS 10 and AS-4 (revised), if dividends to holders of equity instruments are proposed or declared after the balance sheet date, an entity should not recognize those dividends as a liability as at the balance sheet date. It should, however, disclose the amount of dividends that were proposed or declared after the balance sheet date, but before the financial statements were approved for issue.

(d) Utilisation of share premium as discussed under topic 1

2.2 Presentation and Disclosure

→ It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013

3 BORROWINGS

3.1 Existence

→ Review board minutes for approval of new lending agreements. During review, make sure that any new loan agreements or bond issuances are authorized. Ensure that significant debt commitments should be approved by the board of directors.

→ Agree details of loans recorded (interest rate, nature and repayment terms) to the loan agreement. Verify that borrowing limits imposed by agreements are not exceeded

→ Agree overdrafts and loans recorded to bank confirmation / confirmation to lenders

→ Agree details of leases and hire purchase creditors recorded to underlying agreement

→ Examine trust deed for terms and dates of redemption, borrowing restrictions and compliance with covenants

3.2 Valuation

→ Determine that the accounting policies and methods of recording debt are appropriate and applied consistently.

→ Recalculate the interest accrual, and discount or premium on redemption

→ For foreign current loans, agree the closing exchange rate(s) used and test the translation calculations

→ Check computation of the amortization of premium or discount.

3.3 Completeness

→ Obtain a schedule of short term and long term borrowing (including debt outstanding at the end of the prior year, as well as any new debt or renewal of debt) showing beginning and ending balances and borrowings and repayments during the year, and perform the following:

(a) Consider any evidence of additional debt obtained through examination of minutes of the board, significant contracts, confirmations of bank accounts, support for subsequent cash disbursements (when testing payables), and other documents.

(b) Test the summarization and trace the ending balances to the general ledger

→ For each lender (or, in some circumstances, selected lenders) with which the client had debt outstanding at the prior year end or during the current year, prepare, or have the client prepare, a confirmation request for the amount(s) owed to the lender

3.4 Presentation and Disclosure

→ It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013

→ Examine the due dates on loans for proper classification between long-term and current. Analyse relevant details of interest rates, amounts due (e.g. between current and non-current payables), dates and terms of redemption or conversion

→ Verify whether liabilities to bank towards bills discounted, bills negotiated, cheques discounted, etc. are correctly reflected and disclosed in the accounts

3.5 Other Aspects:

→ Verify that the company has not contravened the restrictions laid down by Section 180 of the Companies Act, on the borrowings of the company. Also, check compliance of section 185 and 186 of Companies Act, 2013.

→ Check compliance of Section 2(22)(e) of Income Tax Act,1961 and ensure that payment by way of advance or loan to a shareholder holding not less than 10% of voting power or any concern in which such shareholder is a member or a partner and in which he has substantial interest, shall be treated as dividend

→ Where the entity has accepted deposits, examine whether the directives issued by the Reserve Bank of India or other appropriate authority have been complied with.

4 TRADE RECEIVABLES

4.1 Existence

→ To ensure that trace receivables ledger reconciles to general ledger. Ask for a period-end accounts receivable aging report and trace the grand total to the amount in the accounts receivable account in the general ledger

- → Calculate the receivable report total. Add up the invoices on the accounts receivable aging report to verify that the total traced to the general ledger is correct.
- → Investigate reconciling items. If there are journal entries in the accounts receivable account in the general ledger, review the justification for larger amounts. This implies that these journal entries should be fully documented.
- → See whether realization is recorded invoice wise or not. If not, check that money received from debtors is adjusted chronologically invoice wise and on FIFO basis i.e. previous bill is adjusted first. If realization is made on account, verify if the Company has obtained confirmations from debtors.
- → A significant and important audit activity is to contact customers directly and ask them to confirm the amounts of unpaid accounts receivable as of the end of the reporting period under audit. This should necessarily be done for all significant account balances as at the period-end while certain random customers having smaller outstanding invoices should also be selected.
- → The trade receivables may be requested to confirm the balances either
  - (a) as at the date of the balance sheet, or
  - (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be decided by the auditor in consultation with the Company.
- → If there are any related party receivables, review them for collectability, as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.

4.2 Valuation

- → Assess the allowance for doubtful accounts. Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.
- → Obtain the ageing report of accounts receivable (both Dr/Cr balance), split between not currently due, 30 days old, 30-60 days old, 60- 180 days old, 180- 365 days old and more than 365 days old (refer screenshot below). Also, obtain the list of debtors under litigation and compare with previous year.

→ Assess bad debt write-offs. Prepare schedule of movements on Bad Debts – Provision Accounts and Debts written off and compare the proportion of bad debt expense to sales for the current year in comparison to prior years, to see if the current expense appears reasonable.

→ Check that write-offs or other reductions in the receivable balances have been approved by an appropriate and authorised member of senior management, for example the financial controller or finance director.

4.3 Completeness

→ The auditor needs to satisfy himself of correct and proper cut-offs. Without a correct cut-off , sales could be understated or overstated, hence, the need to perform the following cut-off tests:

(a) For the invoices issued during the last few days (say 5 days) closer to the reporting date/ cut-off date and which have been included in the debtors; the goods should have been dispatched and not lying with the Company and included in closing stock;

(b) All good dispatched prior to the period/ year-end have been invoiced and included in debtors;

(c) No goods dispatched after the year- end have been invoiced and included in debtors for the period under audit

→ Study the system of giving discounts and check the following:

(a) Whether the same is being given as per the Company policy/ general industry trends;

(b) Whether cash discount is given on the basis of date of realization of cheque or on the basis of date of receipt of cheque. If the same is on the basis of date of receipt of cheques, verify that the cheque has been realized within a reasonable time.

4.4 Presentation and Disclosure

→ It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013.

→ Verify that the split between more than 6 months and less than 6 months has been done from the due date instead of sales invoice date

5 CASH AND CASH EQUIVALENTS

5.1 Existence/Completeness/Valuation:

→ 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 other.

→ 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 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.

→ 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.

→ The auditor should also perform a cash sensitivity analysis by compiling a summary of total cash receipts and payments each month and analyse the trends to see if there have been variations in any specific month and request explanations from the management

→ In addition to the procedures performed above, the auditor should ensure that all bank account holding foreign currency have been restated at the closing exchange rates.

5.2 Presentation and Disclosure

→ It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013.

6 INVENTORIES

6.1 Existence

→ Review client's plan for performing inventory count. Plan should include procedures relating to shipments and receipts during count and should also allocate staff responsible for each class of inventory.

→ Ensure that consigned goods have been segregated

→ Evidence of appropriate supervision for those performing count should be examined.

→ Observe inventory being counted and personally perform test counts to verify counts. Test counts by auditor should include: {FURTHER CONSIDER SA 501}

6.2 Valuation

→ Depending on how the business operates, the management may value inventory using "first-in firstout," "last-in first-out," or a weighted average system. First-in first-out, called FIFO, values inventory at close to its current replacement cost. Last-in first-out, called LIFO, values inventory at close to its original purchase cost. A weighted average system values inventory according to an average cost of all inventory items bought during the period.

→ Ascertain what elements of cost are included e.g. carriage in, duties etc

→ If standard costs are used, enquire into basis of standards, how these are compared with actual costs and how variances are analyzed and accounted for/ treated in accounting records.

→ Follow up valuation of all damaged or obsolete inventories noted during observance of physical counting with a view to establishing a realistic net realizable value.

→ Ascertain how the various stages of production/ value add are measured and in case estimates are made, understand the basis for such estimates.

→ Ascertain what elements of cost are included. If overheads are included, ascertain the basis on which they are included and compare such basis with the available costing and financial data/ information maintained by the entity.

→ Ensure that material costs exclude any abnormal wastage factors

→ Enquire into what costs are included, how these have been established and ensure that the overheads included have been determined based on normal costs and appear reasonable in relation to the information disclosed in the draft financial statements

→ Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. For the purpose, request the client to provide inventory ageing split between less than 30 days, 30-60 days old, 60- 90 days old, 90- 180 days old, 180- 385 days old and more than 365 days old.

6.3 Rights and Obligation

→ Evaluate the consigned goods. Examine client correspondence, sales and receivables records, purchase documents.

→ Determine existence of collateral agreements

→ For instances of inventory held by third party, the auditor should insist on obtaining declaration from the third party on its business letterhead and signed by an authorized personnel of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit

6.4 Completeness

→ Perform purchase and sales cut-off tests. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after yearend.

→ Reconcile physical inventory amounts with perpetual records.

6.5 Presentation and Disclosure

→ It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013.

7 FIXED ASSETS (PROPERTY, PLANT AND EQUIPMENT)

7.1 Existence

→ Review client's plan for performing physical verification of PPE i.e. whether performed by own staff or by a third party and the policy regarding periodicity i.e. whether physical verification shall be done on annual basis or once in two years/ three years.

→ Evidence of appropriate supervision of those performing physical verification of PPE should be examined.

- → Assess if all items of PPE are properly tagged and carry identification marks/ numbers and physical verification work papers do capture the asset identification numbers for assets physically verified
- → Verify the discrepancies noted, based on physical verification undertaken and the manner in which such discrepancies have been dealt with in the entity's books and financial statements, for example any identified shortages/ assets not in working condition and/ or active use should be accounted for as deletions in the books of account post approvals by the entity's management

7.2 Valuation

- → It is a common understanding that the value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained and the values of PPE would be shown at higher amounts.
- → Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non- depreciating like freehold land
- → Verify that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity
- → The auditor should also verify if the management has undertaken an impairment assessment to determine whether an item of property, plant and equipment is impaired.

7.3 Rights and Obligation

- → In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity.
- → For all additions to land, building in particular, the auditor should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.
- → The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date

→ In addition, the auditor should also verify the register of charges, available with the entity to assess the PPE that has been given as security to any third parties

7.4 Completeness

→ Verify the movement in the PPE schedule (asset class wise like building, P&M etc.) compiled by the management i.e. Opening + Additions - Deletions= Closing and tally the closing balance to the entity's books of account.

→ Check the arithmetical accuracy of the movement in PPE schedule; tally the opening balances to the previous year audited financial statements.

7.5 Presentation and Disclosure

It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013.

8 INTANGIBLE ASSET

8.1 Existence

→ Since an Intangible Asset is an identifiable non-monetary asset, without physical substance, for establishing the existence of such assets, the auditor should verify whether such intangible asset is in active use in the production or supply of goods or services, for rental to others, or for administrative purposes.

→ In case any intangible asset is not in active use, deletion should have been recorded in the books of account post approvals by the entity's management and amortization charge should have ceased to be charged beyond the date of deletion.

8.2 Valuation

→ Verify the movement in the Intangible assets schedule (asset class wise like software, designs/ drawings, goodwill etc.) compiled by the management i.e. Opening + Additions - Deletions= Closing and tally the closing balance to the entity's books of account.

→ Check the arithmetical accuracy of the movement in intangible asset schedule, tally the opening balances to the previous year audited financial statements.

→ For all material additions, verify if such expenditure meets the criterion for recognition of an intangible asset.

- → The value of intangible assets may diminish due to efflux of time, use and/ or obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period.
- → Unless this cost in the form of amortization is charged to the accounts, the profit or loss would not be correctly ascertained and the values of intangible asset would be shown at higher amounts.
- → Verify that the amortization method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity

8.3 Rights and Obligation

an intangible asset shall be recognised if, and only if:

(a) the said asset is identifiable;

(b) the entity controls the asset i.e. the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits;

(c) it is probable that future economic benefits associated with the asset will flow to the entity;

(d) the cost of the item can be measured reliably.

To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

(a) research phase; and

(b) a development phase

8.4 Presentation and Disclosure

It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013.

9 TRADE PAYABLES AND CURRENT LIABILITIES

9.1 Existence

- → Check whether there are controls in place to ensure that the same purchase/ expense invoice cannot be recorded more than once and payable balances are automatically recorded in the general ledger at the time of recording of expense
- → To ensure that trade payable ledger reconciles to general ledger, ask for a period-end accounts payable aging report and trace the grand total to the amount in the accounts payable account in the general ledger.

→ Calculate the accounts payable report total. Add up the expense/ liability items on the accounts payable aging report to verify that the total traced to the general ledger is correct.

→ Investigate reconciling items. If there are journal entries in the accounts payable account in the general ledger, review the justification for larger amounts. This implies that these journal entries should be fully documented.

→ An important audit activity is to contact vendors directly and ask them to confirm the amounts of accounts payable as of the end of the reporting period under audit. This should necessarily be done for all significant account payable balances as at the period- end and for parties from whom material purchases have been made during the period under audit even if period- end balance of such parties is not significant.

→ The trade creditors may be requested to confirm the balances either

(a) as at the date of the balance sheet, or

(b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be decided by the auditor in consultation with the Company.

9.2 Valuation

→ Obtain the ageing of payable balances, split between current, less than 30 days old, 30-60 days old, 60-180 days old, 180- 365 days old and more than 365 days old (refer screenshot below). Also, obtain the list of vendors with whom the Company has disputes and any claims from customers, under litigation and compare with previous year.

→ Check that write backs in the liability balances assessed as no longer payable have been approved by an appropriate and authorised member of senior management, for example the financial controller or finance director.

→ Check that the restatement of foreign currency trade payables has been done properly

9.3 Completeness

→ For the invoices received/ recorded during the last few days (say 5 days) closer to the reporting date/ cut off date and which have been included in the trade payables; the goods should have been received/ risk and rewards of ownership in goods should have been transferred in favour of the entity

- → All good received prior to the period/ yearend should have been booked in the form of purchases and included in trade creditors
- → No goods received/ risk and rewards of ownership in goods transferred in favour of the entity after the year- end should have been recorded as purchases and included in trade creditors for the period under audit.

9.4 Presentation and Disclosure

It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013.

10 LOANS AND ADVANCES

10.1 Existence

- → For establishing existence of loans and advances, direct confirmation procedures, similar to those performed for "Accounts receivable" balances are undertaken with the only difference that while undertaking circularisation of direct confirmations, in addition to the principal amount, interest received/ receivable, if any, as per the agreed terms between the parties, may also be included as part of the balance to be confirmed.

10.2 Valuation

- → Assess the allowance for doubtful accounts. Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment
- → Obtain the ageing report of loans and advances, split between not currently due, 30 days old, 30-60 days old, 60- 180 days old, 180- 365 days old and more than 365 days old. Also, obtain the list of loans and advances under litigation and compare with previous year.
- → Assess bad loans/ advances write-off. Prepare schedule of movements on Bad loans/ advances – Provision Accounts and loans/ advances written off.
- → Check that the restatement of foreign currency loans and advances/ other current assets has been done properly.

10.3 Completeness

- → Obtain a list of all advances and other current assets and compare them with balances in the ledger
- → Inspect loan agreements and acknowledgements of parties in respect of outstanding loans
- → Inspect the minutes of meeting of board of directors to confirm if all material loans and advances were approved by the board of directors
- → Further, the auditor should obtain copies of statutory returns filed with the authorities like excise returns/ VAT returns etc. and verify whether the amount recorded as per books of account tallies with the claim made with the authorities

10.4 Presentation and Disclosure

It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013.

11 PROVISIONS AND CONTINGENT LIABILITY

11.1 Existence/Completeness/Valuation

- → Obtain a list of all provisions and compare them with balances in the ledger
- → Inspect the underlying arrangements like appointment agreement with employees to understand the entity's commitment towards defined benefits, agreement with customers to assess warranty commitments, any legal and other claims on the entity i.e. litigations
- → Obtain the underlying working and the basis for each of the provisions made, from the management and verify whether the same is complete and accurate.
- → Wherever required, obtain experts report, calculation and underlying working for the provision amount, example for employee defined benefit provision, the auditor may request the management to share the actuarial valuation report and in case of any matter under legal dispute.

11.2 Presentation and Disclosure

It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013.

12 SALE OF PRODUCTS AND SERVICES

12.1 Occurrence:

→ Check whether a single sales invoice is recorded twice or a cancelled sales invoice could also be recorded

→ Whether any shipments were done without the consent and agreement of the customer.

→ Vouch from the sales journal to the supporting documents

→ Check the sales return with sales invoice, challan, credit note, stock register, reversal of excise duty and sales tax etc.

12.2 Measurement:

→ If there are any export sales, consider calculating/reviewing “Exchange gain/ loss” arising from the sales

→ Recalculate prices and extensions on sales invoice

→ Trace a few transactions from inception to completion

→ Auditor must understand client’s operations and related GAAP issues e.g. point of sale revenue recognition vs. percentage of completion

→ Compare the rate of sales affected with related parties and review them for collectability, as well as whether they were properly authorized and the value of such transactions were reasonable and at arm’s length

12.3 Completeness

→ Perform cut-off test to ensure that revenues are recognised in the current accounting period and sales were not tampered towards the period end

→ Auditors will also have to see “Credit notes” issued after the accounting period. Sometimes sales team or sales personnel can make fictitious/ ghost sales before the year-end to meet performance target and cancel out the sale with a post year end credit note.

12.4 Presentation and Disclosure

→ It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013.

13 OTHER INCOME COMPRISING INTEREST INCOME, DIVIDEND INCOME, GAIN/ LOSS ON SALE OF INVESTMENTS ETC.

13.1 Occurrence/Completeness/Measurement

→ For verifying interest income on Fixed deposit:

(a) Obtain a listing of fixed deposits opened during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period. Verify the arithmetical accuracy of the interest calculation made by the entity by multiplying the deposit amount with the applicable rate and number of days during the period under audit.

(b) For deposits still outstanding as at the period- end, trace the same to the direct confirmation obtained from the respective bank/ financial institution

(c) Obtain a confirmation of interest income from the bank and verify that the interest income as per bank reconciles to the calculation shared by the entity

(d) Also, obtain a copy of Form 26AS (TDS withholding by the bank/ financial institution) and reconcile the interest reflected therein to the calculation shared by client

→ For Dividends, verify that the same are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established, provided it is probable that the economic benefits associated with the dividend will flow to the entity and the amount of the dividend can be measured reliably.

→ Verify that Gain/(loss) on sale of investment in mutual funds is recorded as other income only on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments. For the purpose, obtain the mutual fund statement and trace the gain / loss as recorded in the books of account to the gain/ loss as reflected in the statement.

13.2 Presentation and Disclosure

→ It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013

14 PURCHASES

14.1 Occurrence:

→ Whether any fictitious vendor and purchase has been recorded by reviewing the vendor selection process followed by the entity and also doing a search on web for ascertaining the existence of the vendor.

→ Whether the goods were received at the factory gate and whether there exists an entry in the security gate inward register

→ Whether quality inspection of goods was done

→ Whether a goods receipt note was prepared and signed by an appropriate client personnel

→ Whether stock record has been updated by the stores personnel

14.2 Measurement/Completeness:

→ Perform cut-off test to ensure that purchases are recognised in the correct accounting period. For the purpose, the auditor should examine material inward records for few days say last 5 days prior to closing date to check that all corresponding invoices have been duly entered in the Purchases book and none have been omitted.

→ Ensure correct accounting treatment of goods – in – transit as per the agreed terms with the vendor regarding transfer of risk and reward of ownership in goods.

→ Perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price which may include:

(a) Consumption Analysis: Auditor should scrutinize raw material consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from Management If any significant variations found.

(b) Stock Composition Analysis: Auditor to collect the reports from management for composition of stock i.e. raw materials as a percentage of total stock and compare the same with previous year and ask for reasons from management in case of significant variations.

(c) Ratios: Auditor should compare the creditors turnover ratios and stock turnover ratios of the current year with previous years.

(d) Auditor should review quantitative reconciliation of closing stocks with opening stock, purchases and consumption

14.3 Presentation and Disclosure

→ It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013

15 EMPLOYEE BENEFIT EXPENSE

15.1 Occurrence/Completeness/Measurement:

→ Understanding of entity's process of capturing employee attendance.

→ There is always a risk that an entity could record expense for fictitious employees.

→ To address this risk, the auditor may choose to be physically present at the entry gate at any given date and himself count the employees entering the premises and also, understand the manner of recording/ capturing their time

→ Obtain a list of employees as at the period- end along with a monthly movement split between new hires, leavers and continuing employees

→ For a sample (selected randomly) of resigned employees, obtain their full and final computation and verify whether all their dues including post-retirement benefits like gratuity, leave encashment have been paid and whether the respective employee's acknowledgement on final computation has been obtained.

→ Obtain the monthly salary registers for all 12 months. Compile monthly payroll reasonability by calculating the average salary per employee per month and compare with the previous year and preceding month and analyse the reasons for variance which could be attributable to annual increments, an employee at senior level joining/ leaving the entity, bonus pay-out etc.

→ In case provident fund (PF), employee state insurance (ESI) are applicable to the entity, compile a reasonability by applying the rate to the basic wages and comparing to the amount recorded in books and analyse reasons for variance, if any. Also, obtain monthly deposit challans to verify if the month on month liability was subsequently deposited with the authorities and within the defined timelines.

15.2 Presentation and Disclosure

→ It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013

16 DEPRECIATION AND AMORTISATION

16.1 Occurrence/Completeness/Measurement

→ Obtain an understanding of entity's process of charging depreciation and amortization.

→ Obtain the fixed asset register maintained by the entity.

→ There is always a risk that an entity could capitalize expense of revenue nature to increase its profit or charge capital expenditure directly in income and expense statement to reduce its profit.

→ Obtain a list of all additions/ deletions along with their proper approval from the authorised person for the same.

→ Select the sample of assets from the Fixed Assets Register, on materiality considerations and verify the rates of depreciation, depreciation calculation.

→ Obtain the list of all the components identified by the management

→ Ensure Intangible assets like patents, goodwill, copy rights have been properly amortized over the period

→ Ensure depreciation is charged on the assets from the date when it is ready to use

→ Ensure depreciation on revalued amount has been properly accounted from revaluation reserve

→ Depreciation computation as per Income tax Act, 1961- Ensure that additions are tallying with the additions as per Companies Act and the opening WDV to the Tax audit schedule for the assessment year preceding the previous year under audit.

16.2 Presentation and Disclosure

→ It should be as per AS/IND AS as applicable to the entity and in accordance with Schedule III of Companies Act, 2013

17 OTHER EXPENSES LIKE POWER AND FUEL, RENT, REPAIR TO BUILDING, PLANT AND MACHINERY, INSURANCE, TRAVELLING, LEGAL AND PROFESSIONAL, MISCELLANEOUS EXPENSES

17.1 Occurrence/Completeness/Measurement

→ Rent expense- Obtain a month wise expense schedule along with the rent agreements. Verify if expense has been recorded for all 12 months and whether the rent amount is as per the underlying agreement. Specific consideration should be given to escalation clause in the agreement to verify if the rent was to be increased/ adjusted during the period under audit. Also, verify if the agreement is in the name of the entity and whether the expense pertains to premises used for running business operations of the entity

→ Power and fuel expense- Obtain a month wise expense schedule along with the power bills. Verify if expense has been recorded for all 12 months. Also, compile a month wise summary of power units consumed and the applicable rate and check the arithmetical accuracy of the bill raised on monthly basis. In relation to the units consumed, analyse the monthly power units consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends

→ Insurance expense- Obtain a summary of insurance policies taken along with their validity period. Verify if the expense has been correctly classified between prepaid and expense for the period based on number of days.

→ Legal and professional expenses- Obtain a month wise and consultant wise summary. In case of monthly retainer ship agreements, verify if the expenditure for all 12 months has been recorded correctly. For non-recurring expenses, select a sample and vouch for the attributes discussed above. The auditor should be cautious while vouching for legal expenses as the same may highlight a dispute for which the entity may not have made any provision and the matter may also not have been discussed/ highlighted to the auditor for his specific consideration.

→ Travel, repair and maintenance, printing and stationery, miscellaneous expenses – The auditor should select a sample and vouch for the attributes discussed above. Wherever possible, the auditor and try and prepare a summary of expenditure on monthly basis and then analytically compare the trends

→ Perform analytical procedures to obtain audit evidence as to overall reasonableness of other expense which may include expenditure per unit produced analysis. Auditor should analyse expense per unit produced and compare the same with previous years and prevent industry trends and ask for the reasons from Management If any significant variations are found.

17.2 Presentation and Disclosure

→ Ensure other expenses have been classified as follows in accordance with AS/IND AS as applicable to the entity and Schedule III of Companies Act, 2013:

(a) Rent.
(b) Insurance.
(c) Power and fuel.
(d) Repairs and maintenance- Building, Plant and machinery, others.
(e) Legal and professional.
(f) Printing and stationary.
(g) Travel expenses.
(h) Miscellaneous expenses

OTHER ACCOUNTING AND COMPANY LAW CONCEPTS WHICH CAN BE QUESTIONED IN EXAM

1) Share issued at premium:

→ In case a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account and state the means in which the amount in the account can be applied

→ The 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 of the preliminary expenses of the Company;
(c) In writing of the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
(d) In providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
(e) For the purchase of its own shares or other securities under section 68. The auditor needs to verify whether the premium received on shares, if any, has been transferred to a "securities premium account" and whether the application of any amount out of the said "securities premium account" is only for the purposes mentioned above.

2) Shares Issued at discount:

According to Section 53 of the Companies Act, 2013,

(1) 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.

(2) any share issued by a company at a discounted price shall be void. (2A) Notwithstanding anything contained in sub-sections (1) and (2), a company may issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.

(3) Where any company fails to comply with the provisions of this section, such company and every officer who is in default shall be liable to a penalty which may extend to an amount equal to the amount raised through the issue of shares at a discount or five lakh rupees, whichever is less, and the company shall also be liable to refund all monies received with interest at the rate of twelve per cent. per annum from the date of issue of such shares to the persons to whom such shares have been issued.

The auditor needs to check

(i) the movement in share capital during the year and wherever there is any issue,

(ii) he should verify that the Company has not issued any of its shares at a discount by reading the minutes of meeting of its directors and shareholders authorizing issue of share capital and the issue price.

(iii) Further, auditor should also verify that whether the company has issued shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.

3) Issue of Sweat Equity Shares:

→ According to section 54 of the Companies Act, 2013, the employees may be compensated in the form of 'Sweat Equity Shares".

→ "Sweat Equity Shares" 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 needs to verify that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions have been complied with:

(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) Omitted

(d) Where the equity shares of the company are listed on a recognised stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

(e) The rights, limitations, restrictions and provisions as applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank pari passu with other equity shareholders.

4) Reduction of Capital

For verifying reduction of capital, the auditor needs to undertake the following procedures:

(i) Verify that the meeting of the shareholder held to pass the special resolution was properly convened and that the proposal was circularised in advance among all the shareholders;

(ii) Verify that the Articles of Association authorises reduction of capital;

(iii) Examine the order of the Tribunal confirming the reduction and verify that a copy of the order and the minutes have been registered and filed with the Registrar of Companies;

(iv) Inspect the Registrar's Certificate as regards to reduction of capital;

(v) Vouch the accounting entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also check whether the requirements of Schedule III, Part I, have been complied with;

(vi) Confirm whether the revaluation of assets has been properly disclosed in the Balance Sheet;

(vii) Verify the adjustment made in the members' accounts in the Register of Members and confirm that either the paid up amount shown on the old share certificates have been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled;

(viii) Confirm that the words "and reduced", if required by the order of the Tribunal, have been added to the name of the company in the Balance Sheet.

(ix) Verify that the Memorandum of Association of the company has been suitably amended.

5) Distinguish between reserves and provisions

→ Reserves are amounts appropriated out of profits that are not intended to meet any liability, contingency, commitment or diminution in the value of assets known to exist as at the date of the Balance Sheet

→ On the contrary, provisions are amounts charged against revenue to provide for:

(i) Renewal or diminution in the value of assets; or

(ii) a known liability, the amount whereof could only be estimated and cannot be determined with accuracy; or

(iii) a claim which is disputed.

→ Provisions are normally charged to the Statement of Profit and Loss before arriving at the amount of profit. Reserves are appropriations out of profits.

6) Revenue and Capital Reserve

→ Revenue reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose.

→ Capital Reserve, on the other hand represents a reserve which does not include any amount regarded as free for distribution through the Statement of Profit and Loss.

7) Difference between Revenue and Capital Expenditure

→ Revenue Expenditure

An expenditure, the benefits of which shall get expended or exhausted in the process of earning revenue within a short span of time, maximum period being one year, for example on purchase of goods for sale, on their movement from one place to another, on maintenance of assets, etc

→ Capital Expenditure

An expenditure incurred for the below mentioned purposes:

(i) Acquiring fixed assets, i.e., assets of a permanent or a semi-permanent nature, which are held not for resale but for use within the business with a view to earning profits and the benefit whereof is expected to last for more than one year;

(ii) Making additions/ enhancements to the existing fixed assets with the intent to increasing earning capacity of the business;

(iii) Minimising the cost of production;

(iv) Acquiring a benefit of enduring nature in the form of a valuable right like patent, trademarks etc.

8) 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.

Examples of such 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 incurred during the eligible period as defined under AS 16 i.e. during the period of construction of the asset.

9) Note on other income

(a) Dividend Income:

Dividends are recognised in the statement of profit and loss only when:

(i) The entity's right to receive payment of the dividend is established;

(ii) It is probable that the economic benefits associated with the dividend will flow to the entity; and

(iii) The amount of the dividend can be measured reliably.

(b) Gain/(loss) on sale of investment in mutual funds is recorded as other income on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.

10) Auditor needs to consider some attributes while verifying for depreciation and amortisation expenses. List them.

- Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- Ensure the Company policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act, applicable accounting standards.
- Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- Whether depreciation and amortisation charges are valid.
- Whether depreciation and amortisation charges are accurately calculated and recorded.
- Whether all depreciation and amortisation charges are recorded in the appropriate period.
- Ensure the parts (components) of each item of property, plant and equipment that are to be depreciated separately has been properly identified.
- Whether the most appropriate depreciation method for each separately depreciable component has been used.

11) While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel, an auditor generally prefers to vouch for other expenses to verify certain attributes. List them.

→ Whether the expenditure pertained to current period under audit

→ Whether the expenditure qualified as a revenue and not capital expenditure

→ Whether the expenditure had a valid supporting like travel tickets, insurance policy, third party invoice etc.

→ Whether the expenditure has been classified under the correct expense head

→ Whether the expenditure was authorised as per the delegation of authority matrix.

→ Whether the expenditure was in relation to the entity's business and not a personal expenditure.

AMENDMENTS

1. Corporate Social Responsibility (CSR)

Where the company covered under section 135 of the companies act, the following shall be disclosed with regard to CSR activities:

(a) amount required to be spent by the company during the year,

(b) amount of expenditure incurred,

(c) shortfall at the end of the year,

(d) total of previous years shortfall,

(e) reason for shortfall,

(f) nature of CSR activities,

(g) details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per relevant Accounting Standard,

(h) where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year should be shown separately.

2. (i) Depending upon the Total Income of the company, the figures appearing in the Financial Statements shall be rounded off as given below:

	Total Income	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 should be used uniformly in the Financial Statements.

3. Details of Benami Property held

Where any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, the company shall disclose the following:

(a) Details of such property, including year of acquisition,

(b) Amount thereof,

(c) Details of Beneficiaries,

(d) If property is in the books, then reference to the item in the Balance Sheet,

(e) If property is not in the books, then the fact shall be stated with reasons,

(f) Where there are proceedings against the company under this law as an abetter of the transaction or as the transferor then the details shall be provided,

(g) Nature of proceedings, status of same and company's view on same.

4. Relationship with Struck off Companies

Where the company has any transactions with companies struck off under section 248 of the Companies Act, 2013 or section 560 of Companies Act, 1956, the Company shall disclose the following details:

Name of struck off Company	Nature of transactions with struck off Company	Balance outstanding	Relationship with the Struck off company, if any, to be disclosed
	Investments in securities		
	Receivables		
	Payables		
	Shares held by stuck off company		
	Other outstanding balances (to be specified)		

5. Following Ratios to be disclosed:

(a) Current Ratio,

(b) Debt-Equity Ratio,

(c) Debt Service Coverage Ratio,

(d) Return on Equity Ratio,

(e) Inventory turnover ratio,

(f) Trade Receivables turnover ratio,

(g) Trade payables turnover ratio,

(h) Net capital turnover ratio,

(i) Net profit ratio,

(j) Return on Capital employed,

(k) Return on investment.

The company shall explain the items included in numerator and denominator for computing the above ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

6. Details of Crypto Currency or Virtual Currency

Where the Company has traded or invested in Crypto currency or Virtual Currency during the financial year, the following shall be disclosed:

(a) profit or loss on transactions involving Crypto currency or Virtual Currency

(b) amount of currency held as at the reporting date,

(c) deposits or advances from any person for the purpose of trading or investing in Crypto Currency/ virtual currency.

6 AUDIT DOCUMENTATION

1. AUDIT DOCUMENTATION

SA 230 on "Audit Documentation", deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements.

1.1 Definition of Audit Documentation:

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

1.2 Objective of the Auditor:

The objective of the auditor is to prepare documentation that provides:

(a) A sufficient and appropriate record of the basis for the auditor's report; and

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

1.3 Nature of Audit Documentation:

Audit documentation 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.

1.4 Purpose of Audit Documentation

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

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

1.5 Form, Content and Extent of Audit Documentation:

- The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:
  - (a) The nature, timing and extent of the audit procedures performed.
  - (b) The results of the audit procedures performed and the audit evidence obtained and
  - (c) Significant matters arising during the audit and the conclusions reached thereon and significant professional judgements made in reaching those conclusions.

- Further 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.
  - (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.

- 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.

- 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

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

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed.
3. The identified risks of material misstatement.
4. The significance of the audit evidence obtained.

5. The nature and extent of exceptions identified.
6. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
7. The audit methodology and tools used.

1.6 Examples of Audit Documentation:

Example

Audit Documentation include:

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

The auditor 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.

1.7 Timely Preparation of Audit Documentation:

The auditor shall prepare audit documentation on a timely basis. 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.

1.8 Audit File:

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

1.9 Assembly of the Final Audit File:

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

- SQC 1 requires firms to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

- Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

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

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

- SQC 1 requires the retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

1.10 Documentation of Significant Matters and Related Significant Professional Judgements:

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

Examples of significant matters include:

Matters that give rise to significant risks.

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

- → Documentation of the professional judgements made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgement.

- → **Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgement include, where the matters and judgements 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 judgements (for example, the reasonableness of significant accounting estimates).

- → The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

1.11 Completion Memorandum or Audit Documentation Summary:

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

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

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

1.12 Ownership of Audit Documentation:

- ➢ Standard on Quality Control (SQC) 1 provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor.

- He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

7 COMPLETION AND REVIEW

1. 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 are known as subsequent events.

Example :

(a) Consider case of a company which may have planned an agreement to merge between the date of the financial statements and the date of the auditor's report.

(b) a fire claim amount of an entity receivable from insurance company as on date of financial statements may have been settled at a reduced amount before date of auditor's report.

Such Events Could be :

(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.

1.1 SA 560 Subsequent Events:

SA 560 deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements.

1.2 Objectives of auditor in accordance with SA 560:

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.

1.3 Audit procedures relating to events occurring between the date of the financial statements and the date of the auditor's report:

(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(d) Reading the entity's latest subsequent interim financial statements, if any.

When, as a result of the procedures performed, 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.

The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation

Meaning of "Date the financial statements are issued"

It reflects the date that the auditor's report and audited financial statements are made available to third parties. 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.

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

→ 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 a uditor's report, the auditor shall:

(a) Discuss the matter with management and, where appropriate, those charged with governance.

(b) Determine whether the financial statements need amendment and, if so,

(c) Inquire how management intends to address the matter in the financial statements.

→ 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 succeeding para apply: -

(i) Extend the audit procedures, already referred, 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.

→ 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 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

(b) Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph or Other Matter(s) paragraph 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.

→ 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: -

(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 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.

1.5 Facts which become known to the auditor after the financial statements have been issued

→ When, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall: -

(a) Discuss the matter with management and, where appropriate, those charged with governance.

(b) Determine whether the financial statements need amendment and, if so,

(c) Inquire how management intends to address the matter in the financial statements.

→ If the management amends the financial statements, the auditor shall: -

(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 such circumstances 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 apply: -

(i) Extend the audit procedures, already referred, 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 are such that 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, amend the auditor's report, or provide a new auditor's report as already discussed.

→ 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.

→ 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 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.

2. MEANING OF GOING CONCERN AND ITS SIGNIFICANCE

Going concern is one of the fundamental accounting assumptions.

It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

The significance of **Going Concern** is due to its effect on preparation of financial statements.

2.1 SA 570 Going Concern

SA 570 Going Concern deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.

2.2 Responsibility for assessment of the entity's ability to continue as a going concern

The preparation of the financial statements requires management to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so. Management's assessment involves making a judgment, 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
- ❖ 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
- ❖ Any judgment about the future is based on information available at the time at which the judgment is made.

2.4 Objectives of auditor in accordance with SA 570

The objectives of the auditor are: -

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

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

(c) To report in accordance with this SA.

2.5 Risk assessment procedures and related activities

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

(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, new management's plans to address them or

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

Examples of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern

Financial events or conditions

- 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 events or conditions

- 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 events or conditions

- Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy

2.6 Evaluating management's assessment

→ The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern.

→ 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 may not prevent the auditor from concluding whether management's use of the going concern basis of accounting is appropriate in the circumstances.

For example, when there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis. In this case, the auditor's evaluation of the appropriateness of management's assessment may be made without performing detailed evaluation procedures if the auditor's other audit procedures are sufficient to enable the auditor to conclude whether management's use of the going concern basis of accounting in the preparation of the financial statements is appropriate in the circumstances.

→ In other circumstances, evaluating management's assessment of the entity's ability to continue as a going concern, 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.

→ 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, the auditor shall request management to extend its assessment period to at least twelve months from that date.

2.7 Additional audit procedures when events or conditions are identified

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

(b) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.

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

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

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

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

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

Other events or conditions

Examples of audit procedures when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as going concern

- 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

2.8 Auditor's conclusions

2.9 Adequacy of disclosures when events or conditions have been identified and a material uncertainty exists

If the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements: -

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

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

2.10 Adequacy of disclosures when events or conditions have been identified but no material uncertainty exists

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists, the auditor shall

evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions.

2.11 Implications for the auditor's report

(I) If use of Going concern basis of accounting is inappropriate

If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the **auditor shall express an adverse opinion.**

(II) If use of going concern basis of accounting is appropriate but a material uncertainty exists

(A) Adequate Disclosure of a Material Uncertainty is made in the Financial Statements

If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express **an unmodified opinion** and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to: -

(a) Draw attention to the note in the financial statements that discloses such matters.

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

(B) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements

If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:

(a) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705.

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

(III) Management unwilling to make or extend its assessment

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. In such a situation, **a qualified opinion or a disclaimer of opinion** in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements.

3. EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

Before forming an opinion on the financial statements, the auditor evaluates effects of identified misstatements on the audit and of uncorrected misstatements on financial statements after consideration of materiality. Uncorrected misstatements refer to those misstatements that the auditor has accumulated after than those that are cliare trivia during the audit and that have not been corrected.

3.2 Objectives of auditor in accordance with SA 450

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.

3.4 Consideration of identified misstatements as the audit progresses

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

(b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320.

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.

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.

3.5 Communication and correction of misstatements

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. The auditor shall request management to correct those misstatements.

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.

3.6 Evaluating the effect of uncorrected misstatements

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

(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.

3.7 Communication with those charged with governance

The auditor shall communicate with those charged with governance regarding 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.

3.8 Written Representation from management regarding effects of uncorrected statements

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.

3.9 Documentation regarding misstatements identified during audit

The audit documentation shall include: -

(a) The amount below which misstatements would be regarded as clearly trivial;

(b) All misstatements accumulated during the audit and whether they have been corrected; and

(c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

4. WRITTEN REPRESENTATIONS [SA 580]

A written representation is 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.

4.1 Written representations as audit evidence

→ Written representations are an important source of audit evidence. If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist. Further, a request for written, rather than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

→ 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 fulfilment of management's responsibilities, or about specific assertions.

4.3 Objectives of auditor in accordance with SA 580

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.

4.4 From whom Written representations are requested by auditor?

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

4.5 Written representations about management's responsibilities

Written representation about management's responsibilities involves confirmation of fulfilment of management's responsibilities in following areas: -

(I) Preparation of the financial statements

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.

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 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.

(II) Information provided and completeness of transactions

(a) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement and

(b) All transactions have been recorded and are reflected in the financial statements.

4.6 Why Written representations about management responsibilities are necessary?

→ 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.

→ 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.

→ In addition to the written representation about management's responsibilities regarding preparation of financial statements, 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 relating to management's responsibilities regarding preparation of financial statements. They may include representations about the following: -

- Whether the selection and application of accounting policies are appropriate; and
- Whether matters such as the following, 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.

4.9 Additional Written representations about information provided to the auditor

In addition to the written representation required by auditor regarding management responsibility about information provided to auditor, 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.

4.10 Written representations about specific assertions

→ **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.

→ 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.

4.11 Date of and Period(s) covered by Written Representations

→ 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. because the auditor is concerned with events occurring up to the date of the auditor's report.

→ 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.

→ Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

4.11 Form of Written representations

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 regarding management responsibilities, the relevant matters covered by such statements need not be included in the representation letter.

Illustrative Written representation letter

On the letterhead of the entity

To
PJ Shrimali & Co. 15th July, 2022
Chartered Accountants
Dear Sir,
This representation letter is provided in connection with your audit of the financial statements of XXXX Limited for the year ended March 31, 2022 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view in accordance with the applicable accounting standards in India.

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated 17th August 2021, for the preparation of the financial statements in accordance with financial reporting Standards, in particular, the financial statements 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.
- 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)

- 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)

Information provided

- We have provided you with: -
  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.
- 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.

- 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.
- 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)

Chief Financial Officer

4.13 Doubt as to the reliability of Written representations

(a) 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 and audit evidence in general.

(b) 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 and audit evidence in general.

(c) 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, having regard to the requirement of disclaimer of opinion.

4.14 Requested Written representations not provided

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 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 of disclaimer of opinion.

4.15 Disclaimer of opinion in case of non-reliability of Written Representations about management's responsibilities or failure to provide such Written Representations

The auditor shall disclaim an opinion on the financial statements in accordance with SA 705 if:

(a) The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations about management fulfilling its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions are not reliable; or

(b) Management does not provide the written representations relating to fulfilling its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions.

5. SIGNIFICANCE OF COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

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

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

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

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

5.1 Who are "Those charged with governance"?

The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

5.2 Scope of SA 260- Communication with Those Charged with Governance

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

5.3 Objectives of auditor in accordance with SA 260

The objectives of the auditor are: -

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

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

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

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

5.4 Determining appropriate persons with whom to communicate

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

5.5 Matters to be communicated by auditor

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

- ✓ The auditor is responsible for forming and expressing an opinion on the financial statements
- ✓ The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

(b) **Planned scope and timing of the audit**

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

(c) **Significant findings from the audit**

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

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

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

(ii) Written representations the auditor is requesting

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

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

5.6 Communication of auditor's independence in case of listed entities

In the case of listed entities, the auditor shall communicate with those charged with governance: -

(a) A statement that the engagement team and others in the firm 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.

5.9 Documentation

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

6. WHY COMMUNICATION OF SIGNIFICANT DEFICIENCIES IN INTERNAL CONTROL IS NECESSARY?

Reflects the importance of these matters and assists those charged with governance in fulfilling their oversight responsibilities.

6.1 Scope of SA 265- Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement. 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.

6.2 Objective of auditor in accordance with SA 265

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.

6.3 Meaning of "Deficiency in internal control" and "significant deficiency in internal control"

(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

(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.

Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency

- 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.

Examples of indicators of significant deficiencies in 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.
- Evidence of management's inability to oversee the preparation of the financial statements.

6.5 Communication of significant deficiencies in internal control to those charged with governance

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.

8 AUDIT REPORT

1. FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS

SA 700 (Revised)- "Forming an Opinion and Reporting on Financial Statements", deals with the auditor's responsibility to form an opinion on the financial statements.

1.1 Objective of the Auditor

The objectives of the auditor as per SA 700 (Revised) are:

(a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and

(b) To express clearly that opinion through a written report.

1.2 To Form Opinion – Auditor to Obtain Reasonable Assurance

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.

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

That conclusion shall take into account:

(a) Whether sufficient appropriate audit evidence has been obtained;

(b) Whether uncorrected misstatements are material, individually or in aggregate;

(c) The evaluations.

1.3 Evaluations by the Auditor

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.

1.3.1 Qualitative Aspects of the Entity's Accounting Practices

1. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that the cumulative effect of 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 include the following:
   (i) The selective correction of misstatements brought to management's attention during the audit.

   Example

   Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.

   (ii) Possible management bias in the making of accounting estimates.
2. SA 540 addresses possible management bias in making accounting estimates.

1.4 Specific Evaluations by the Auditor

In particular, the auditor shall evaluate whether:

(a) The financial statements adequately disclose the significant accounting policies selected and applied;

(b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

(c) The accounting estimates made by management are reasonable;

(d) The information presented in the financial statements is relevant, reliable, comparable, and understandable;

(e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and

(f) The terminology used in the financial statements, including the title of ach financial statement, is appropriate.

Further, when the financial statements are prepared in accordance with a fair presentation framework, the evaluation shall also include an evaluation 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.

1.5 Definitions

(a) **General purpose financial statements** – Financial statements prepared inaccordance with a general purpose framework.

(b) **General purpose framework** – A financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.

The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

(i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or

(ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

2. FORM OF OPINION

Unmodified Opinion: The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Modified Opinion: If the auditor:

(a) concludes that, based on the audit evidence obtained, tha 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 whole are free from material misstatement

the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

3. AUDITOR'S REPORT

3.1 Auditor's Report for Audits Conducted in Accordance with Standards on Auditing

Basic Elements of an Audit Report are given below:

1. **Title:** The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.

   For example, "Independent Auditor's Report," distinguishes the independent auditor's report from reports issued by others.

2. **Addressee:** The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed.

   The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited. In case of a company, the report is addressed to the shareholders of the company.

3. **Auditor's Opinion:** The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

   The Opinion section of the auditor's report shall also:

   - Identify the entity whose financial statements have been audited;
   - State that the financial statements have been audited;
   - Identify the title of each statement comprising the financial statements;
   - Refer to the notes, including the summary of significant accounting policies; and
   - Specify the date of, or period covered by, each financial statement comprising the financial statements.

   Unmodified Opinion:

   When expressing an unmodified opinion use one of the following phrases,

(a) In our opinion, the accompanying financial statements present fairly, in all material respects, [....] in accordance with [the applicable financial reporting framework]; or

(b) In our opinion, the accompanying financial statements give a true and fair view of [......] in accordance with [the applicable financial reporting framework].

4. **Basis for Opinion:** The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

1. States that the audit was conducted in accordance with Standards on Auditing;
2. Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
3. Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.
4. States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

5. **Going Concern:** Where applicable, the auditor shall report in accordance with SA 570 (Revised).

6. **Key Audit Matters: SA 701.**

7. **Responsibilities for the Financial Statements:** The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."

This section of the auditor's report shall describe management's responsibility for:

(a) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

(b) Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern.

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.

Oversight of the financial reporting process: This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from Management. In this case, the heading of this section shall also refer to "Those Charged with Governance" or such term that is appropriate in the context of the legal framework applicable to the entity.

8. **Auditor's Responsibilities for the Audit of the Financial Statements:** The auditor's report shall include a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements."

I. **This section of the auditor's report shall state:**

(a) **That the objectives of the auditor are to:**

(i) Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and

(ii) Issue an auditor's report that includes the auditor's opinion.

(b) **That reasonable assurance is a high level of assurance, but is not a guarantee** that an audit conducted in accordance with SAs will always detect a material misstatement when it exists; and

(c) That misstatements can arise from fraud or error, and either:

(i) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or

(ii) Provide a definition or description of materiality in accordance with the applicable financial reporting framework.

II. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further:

(a) State that, as part of an audit in accordance with SAs, the auditor exercises professional judgement and maintains professional skepticism throughout the audit; and

(b) Describe an audit by stating that the auditor's responsibilities are:

(i) To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

(ii) To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances.

(iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

(iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

(v) When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

(c) When SA 600 applies, further describe the auditor's responsibilities in a group audit engagement by stating:

The division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components is audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions /branches/subsidiaries or other components audited by other auditors.

III. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall:

(a) State that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;

(b) For audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and where applicable, related safeguards; and

(c) For audits of financial statements of listed entities and any other entities for which key audit matters are communicated in accordance with SA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters.

9. **Location of the description of the auditor's responsibilities for the audit of the financial statements**: The description of the auditor's responsibilities for the audit of the financial statements shall be included:

(1) Within the body of the auditor's report

(2) Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix or

(3) By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so.

10. **Other Reporting Responsibilities:**

- If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the SAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled.

  "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the SAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the SAs.

  In that case, the auditor's report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the SAs.

11. **Signature of the Auditor:** The auditor's report shall be signed. The report is signed by the auditor (i.e. the engagement partner) in his personal name. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm.

    The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India.

    They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

12. **Place of Signature:** The auditor's report shall name specific location, which is ordinarily the city where the audit report is signed.

13. **Date of the Auditor's Report:** The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements.

    The date of the auditor's report informs the user of the auditor's report that he auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date.

UDIN

It was noticed that financial documents/ certificates attested by third person misrepresenting themselves as CA Members were misleading the Authorities and Stakeholders. ICAI also received number of complaints of signatures of CAs being forged by non CAs. To curb the malpractices, the Professional Development Committee of ICAI implemented in phased manner an innovative concept of UDIN i.e. Unique Document Identification Number. All Certificates were made mandatory with effect from 1st February, 2019 as per the Council decision taken at its 379th Meeting held on 17th – 18th December, 2018. Chartered Accountants having full-time Certificate of Practice can register on UDIN Portal and generate UDIN by registering the certificates attested/certified by them.

Accordingly, an auditor is required to mention the UDIN with respect to each audit report being signed by him, along with his membership number while signing an audit report.

4. AUDITOR'S REPORT PRESCRIBED BY LAW OR REGULATION

SA 200 explains that the auditor may be required to comply with legal or regulatory requirements in addition to SAs. When the differences between the legal or regulatory requirements and SAs relate only to the layout and wording of the auditor's report, the requirements stated below in points (a)–(m) set out the minimum elements to be included in the auditor's report to enable a reference to the Standards on Auditing. In those circumstances, the requirements stated in earler need not be applied.

For example, the required ordering of the Opinion and the Basis of Opinion sections need not be applied.

If the auditor is required by law or regulation to use a specific layout, or wo rding of the auditor's report, the auditor's report shall refer to Standards on Auditing only if the auditor's report includes, at a minimum, each of the following elements:

(a) A title.

(b) An addressee, as required by the circumstances of the engagement.

(c) An Opinion section containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements.

(d) An identification of the entity's financial statements that have been audited.

(e) A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI.

(f) Where applicable, a section that addresses, and is not inconsistent with, the reporting requirements relating to going concern as per SA 570 (Revised).

(g) Where applicable, a Basis for Qualified (or Adverse) Opinion section that addresses, and is not inconsistent with, the reporting requirements relating to going concern as per SA 570 (Revised).

(h) Where applicable, a section that includes the information required by SA 701, or additional information about the audit that is prescribed by law or regulation and that addresses, and is not inconsistent with, the reporting requirements in that SA.

(i) A description of management's responsibilities for the preparation of the financial statements and an identification of those responsible for the oversight of the financial reporting process that addresses, and is not inconsistent with, the requirements as contained in this SA 700.

(j) A reference to Standards on Auditing and the law or regulation, and a description of the auditor's responsibilities for an audit of the financial statements that addresses, and is not inconsistent with, the requirements as contained in this SA 700.

(k) The auditor's signature.

(l) The Place of signature.

(m) The date of the auditor's report.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements 1

Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at 31st March 20XX, and the statement of Profit and Loss, (statement of changes in equity)2 and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information [in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)].

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

Basis for Opinion

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

Key Audit Matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. [Description of each key audit matter in accordance with SA 701.]

Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act")4 with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (changes in equity)5 and cash flows of the Company in accordance with6 the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate implementation and maintenance of accounting policies; making judgements and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those Board of Directors are also responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 40(b) of this SA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or applicable auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with SAs, we exercise professional judgement and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances. Under section 143(3)(i) of the Companies Act, 2013, we are also responsible for expressing our opinion on whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

  We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards. From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Other Matter

We did not audit the financial statements/ information of............... . (number) branches included in the stand alone financial statements of the Company whose financial statements/financial information reflect total assets of ₹ .... as at 31st March 20XX and the total revenue of ₹ .... for the year ended on that date, as considered in the standalone financial statements/information of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of branches, is based solely on the report of such branch auditors. Our opinion is not modified in respect of these matters.

Report on Other Legal and Regulatory Requirements

As required by the Companies (Auditor's Report) Order, 2020 ("the Order"), issued by the Central Government of India in terms of sub-section (11) of section 143 ofthe 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.

[For detailed discussion on CARO 2020, refer Chapter 10, The Company Audit]

As required by Section 143(3) of the Act, we report that:

(a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.

(b) In our opinion, proper books of account as required by law have been kept by the Company so far as it appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from the branches not visited by us]

(c) [The reports on the accounts of the branch offices of the Company audited under Section 143(8) of the Act by branch auditors have been sent to us and have been properly dealt with by us in preparing this report.]

(d) The Balance Sheet, the Statement of Profit and Loss, and the Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from the branches not visited by us].

(e) In our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014.

(f) We do not have any observation or comment on the financial statements or matters which have any adverse effect on the functioning of the company.

(g) On the basis of the written representations received from the directors as on 31st

March, 20XX taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164 (2) of the Act.

(h) We do not have any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected herewith.

(i) With respect to the adequacy of the internal financial controls over financial reporting of the Company and the operating effectiveness of such controls, refer to our separate Report in "Annexure A".

(j) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:

(1) The Company has disclosed the impact of pending litigations on its financial position in its financial statements – Refer Note XX to the financial statements; [or the Company does not have any pending litigations which would impact its financial position]

(2) The Company has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on longterm contracts including derivative contracts – Refer Note XX to the financial statements; [or the Company did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.]

(3) There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company [or, following are the instances of delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Company].

(4) (i) The management has represented that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;

(ii) The management has represented, that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and

(iii) Based on such audit procedures that we have considered reasonable and appropriate in the circumstances, nothing has come to our notice that has caused us to believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.

(5) The dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.

(6) The company has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and the same has been operated throughout the year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention.

For Manish & Co
Chartered Accountants
(Firm's Registration No.)
Signature
(Name of the Member Signing the Audit Report)
(Designation13)
(Membership No. XXXXX)
UDIN: 21233720AAAAAH1234
Place of Signature:

Date:

5. MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT(SA 705)

5.1 Circumstances When a Modification to the Auditor's Opinion Is Required

The auditor shall modify the opinion in the auditor's report in the following circumstances:

(1) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(2) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

5.3 Types of Modified Opinions:

A. Qualified Opinion

The auditor shall express a qualified opinion when:

(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

B. 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.

B.1 Definition of Pervasive:

A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

B.2 Pervasive effects on the financial statements are those that, in the auditor's judgement:

(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.

C. **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.

5.4 Which type of opinion is appropriate?

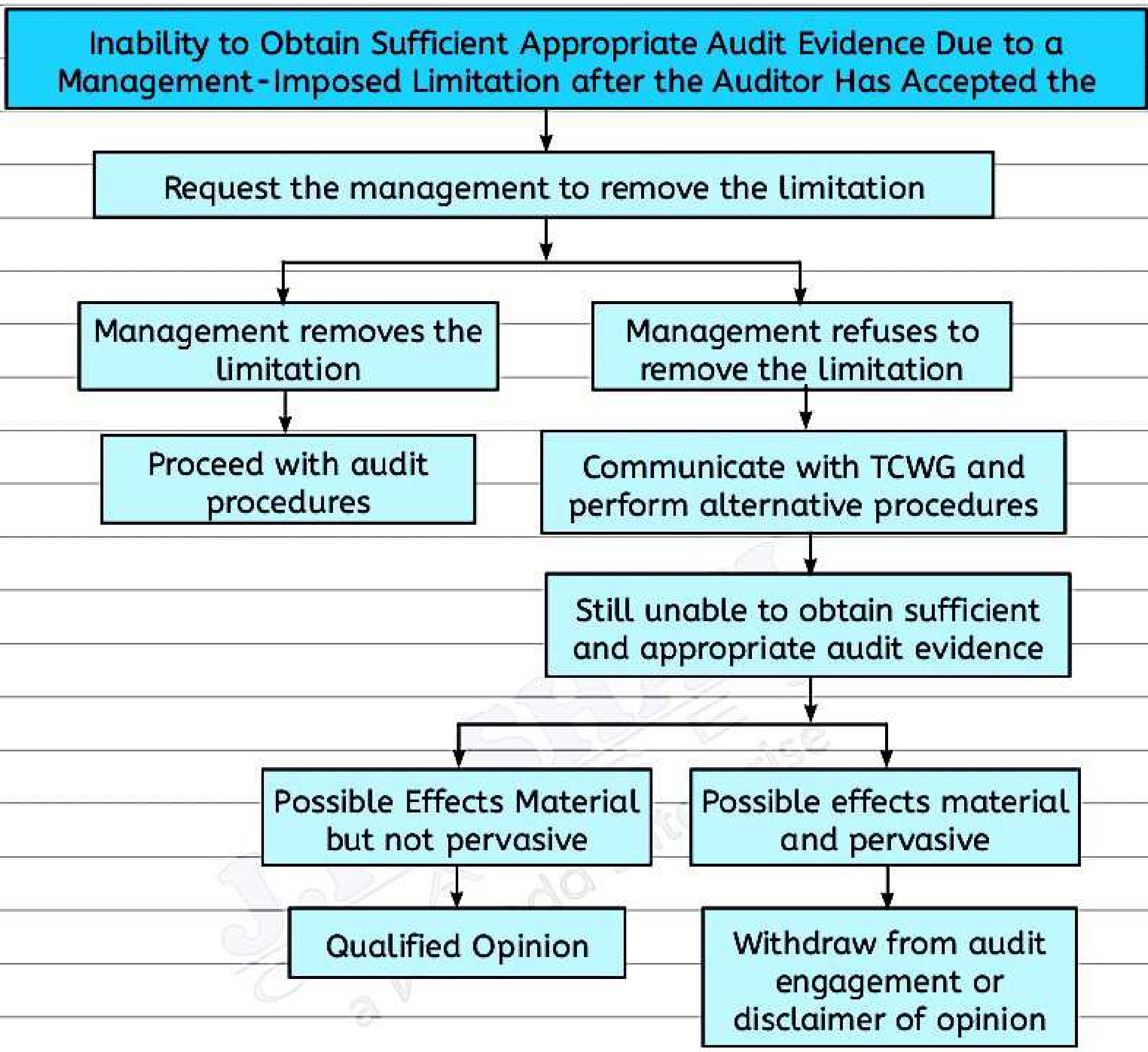
The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

(b) The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Nature of Matter Giving Rise to the Modification	Auditor's Judgement 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

5.5 Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management- Imposed Limitation after the Auditor Has Accepted the Engagement



5.6 Form and Content of the Auditor's Report When the Opinion is Modified

→ **Auditor's Opinion:**

When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section.

→ **Qualified Opinion:**

When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion section,

(a) When reporting in accordance with a fair presentation framework, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or

(b) When reporting in accordance with a compliance framework, the accompanying financial statements have been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter(s) ..." for the modified opinion.

→ **Adverse Opinion:**

When the auditor expresses an adverse opinion, the auditor shall state that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion section,

(a) When reporting in accordance with a fair presentation framework, the accompanying financial statements do not present fairly (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or

(b) When reporting in accordance with a compliance framework, the accompanying financial statements have not been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

→ **Disclaimer of Opinion:**

When the auditor disclaims an opinion due to an inability to obtain sufficientappropriate audit evidence, the auditor shall:

(a) State that the auditor does not express an opinion on the accompanying financial statements;

(b) State that, because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

(c) Amend the statement required by SA 700 (Revised), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.

5.7 Basis for Opinion

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised):

(a) Amend the heading "Basis for Opinion" required by SA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or"Basis for Disclaimer of Opinion," as appropriate; and

(b) Within this section, include a description of the matter giving rise to the modification.

- If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures in the notes to the financial statements), the auditor shall include in the Basis for Opinion section a description and quantification of the financial effects of the misstatement, unless impracticable.

- If it is not practicable to quantify the financial effects, the auditor shall so state in this section.

- If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the Basis for Opinion section an explanation of how the disclosures are misstated.

- If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:
  (a) Discuss the non-disclosure with those charged with governance;
  (b) Describe in the Basis for Opinion section the nature of the omitted information; and
  (c) Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

- If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.

- When the auditor expresses a qualified or adverse opinion, the auditor shall amend the statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion required by SA 700 (Revised) to include the word "qualified" or "adverse", as appropriate.

- When the auditor disclaims an opinion on the financial statements, the auditor's report shall not include the following elements required by SA 700 (Revised).
  (a) A reference to the section of the auditor's report where the auditor's responsibilities are described; and
  (b) A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

  Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the Basis for Opinion section the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof.

5.8 Description of Auditor's Responsibilities for the Audit of the Financial Statements When the Auditor Disclaims an Opinion on the Financial Statements

When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700 (Revised) to include only the following:

(a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;

(b) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

(c) The statement about auditor independence and other ethical responsibilities required by SA 700 (Revised).

5.9 Considerations When the Auditor Disclaims an Opinion on the Financial Statements

Unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with SA 701.

5.10 Communication with Those Charged with Governance

When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification.

6. EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT SA 706.

6.1 Objective of the Auditor as per SA 706

As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgement 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.

6.2 Emphasis of Matter Paragraphs in the Auditor's Report

The auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

(a) The auditor would not be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter; and

(b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

6.2.1 Separate section for Emphasis of Matter paragraph

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

(b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and

(c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Some examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph.

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

6.3 The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion

An Emphasis of Matter paragraph is not a substitute for:

(a) A modified opinion in accordance with SA 705 (Revised) when required by the circumstances of a specific audit engagement;

(b) Disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation; or

(c) Reporting in accordance with SA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

6.4 Other Matter Paragraphs in the Auditor's Report

The auditor's report, the auditor shall include an Other Matter paragraph in the auditor's report, provided:

(a) This is not prohibited by law or regulation; and

(b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

6.4.1 Separate section for Other Matter paragraph

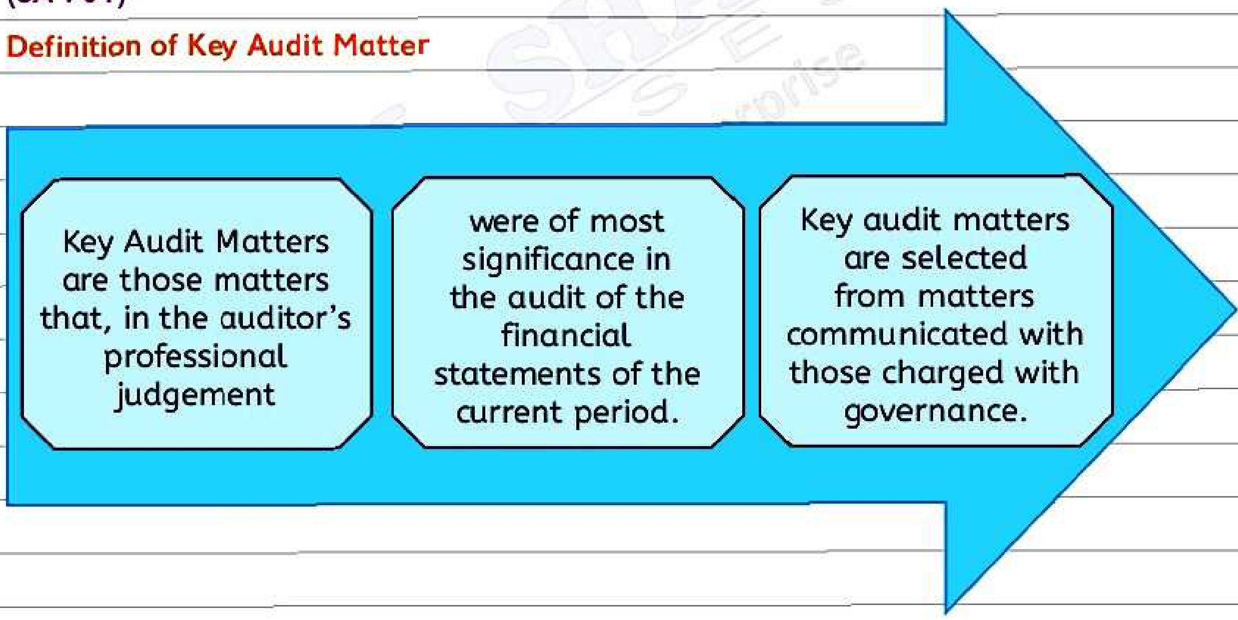
When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading.

6.5 Communication with Those Charged with Governance

If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph.

7. COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT (SA 701)

Definition of Key Audit Matter



7.1 Purpose of Communicating Key Audit Matters

(a) to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed.

(b) assist in understanding those matters that, in the auditor's professional judgement, were of most significance

(c) also assist intended users in understanding the entity and areas of significant management judgement in the audited financial statements.

7.2 Objectives of the Auditor regarding Key Audit Matters

The objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.

7.3 Determining Key Audit Matters

In making this determination, the auditor shall take into account the following:

(a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.

(b) Significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty.

(c) The effect on the audit of significant events or transactions that occurred during the period.

7.4 Communicating Key Audit Matters

The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters".

The introductory language in this section of the auditor's report shall state that:

(a) Key audit matters are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements [of the current period]; and

(b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

7.5 Communicating Key Audit Matters- not a substitute for disclosure in the Financial Statements etc.

Communicating key audit matters in the auditor's report is not:

(a) A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;

(b) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

(c) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or

(d) A separate opinion on individual matters.

7.6 Communication with Those Charged with Governance

The auditor shall communicate with those charged with governance:

(a) Those matters the auditor has determined to be the key audit matters; or

(b) If applicable, depending on the facts and circumstances of the entity and the audit, the auditor's determination that there are no key audit matters to communicate in the auditor's report.

Example:

Key Audit Matters: [Except for the matter described in the Basis for Qualified (Adverse) Opinion section or Material Uncertainty Related to Going Concern section,] We have determined that there are no [other] key audit matters to communicate in our report.

8. STANDARD ON AUDITING - 710, "COMPARATIVE INFORMATION - CORRESPONDING FIGURES AND COMPARATIVE FINANCIAL STATEMENTS"

8.1 The Nature of the Comparative Information

There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements.

The 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.

Objectives

As per SA 710, 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.

Definition of Comparative Information:

The amounts and disclosures included in the financial statements → in respect of one or more prior periods in accordance with the applicable financial reporting framework.

8.2 Audit Procedures regarding comparative information

- The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:
  - (a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and
  - (b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

- 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.

- As required by SA 580, the auditor shall request written representations for all periods referred to in the auditor's opinion.

8.3 Audit Reporting regarding Corresponding Figures

Definition of Corresponding figures:

Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements

and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures").

The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances:

1. **If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion** and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:
   (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
   (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

2. **If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements** on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion

in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein.

3. **Prior Period Financial Statements Not Audited-** If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

Prior Period Financial Statements Audited by a Predecessor Auditor

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.

8.4 Comparative Financial Statements

→ **Definition:** Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor 's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

→ **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.

→ **Prior Period Financial Statements Audited by a Predecessor Auditor**

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:

(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.

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.

→ **Prior Period Financial Statements Not Audited**

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.

9. AUDIT OF BRANCH OFFICE ACCOUNTS

(a) Senction 143(8) 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:

(b) 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.

(c) 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.

(d) **SA 600, "Using the Work of another Auditor"**.

Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component. Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

(a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as are as requiring special consideration, procedures for the identification of inter -component transactions that may require disclosure and the time-table for completion of audit; and

(b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them. The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor.

10. JOINT AUDIT

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.

Advantages

(i) Sharing of expertise.

(ii) Advantage of mutual consultation.

(iii) Lower workload.

(iv) Better quality of performance.

(v) Improved service to the client.

(vi) 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.

(vii) Lower staff development costs.

(viii) Lower costs to carry out the work.

(ix) A sense of healthy competition towards a better performance.

Disadvantages

(i) The fees being shared.

(ii) Psychological problem where firms of different standing are associated in the joint audit.

(iii) General superiority complex 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.

(SA) 299 (Revised), "Joint Audit of Financial Statements"

This Standard deals with the special considerations in carrying out audit by joint auditors. It requires that–

(i) the engagement partner and other key members of the engagement team from each of the joint auditors should be involved in planning the audit.

(ii) the joint auditors should jointly establish an overall audit strategy which sets the scope, timing and direction of the audit, and also guides the development of the audit plan.

(iii) before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:

   (a) identify division of audit areas and common audit areas;

   (b) ascertain the reporting objectives of the engagement;

   (c) consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;

   (d) consider the results of preliminary engagement activities, or similar engagements performed earlier.

   (e) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

(iv) each of the joint auditors should consider and assess the risks of material misstatement and communicate to other joint auditors.

(v) the joint auditors should discuss and document the nature, timing, and the extent of the audit procedures for (I) common and (II) specific allotted areas of audit to be performed.

(vi) the joint auditors should obtain common engagement letter and common management representation letter.

(vii) the work allocation document should be signed by all the joint auditors and communicated to those charged with governance.

Each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. On the other hand, all the joint auditors shall be jointly and severally responsible for:

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

(ii) decisions taken by all the joint auditors under audit planning in respect of common audit areas;

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

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

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

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

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

It may be noted that the joint auditors are required to issue common audit report. However, where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to each other's audit report(s).

11. REPORTING REQUIREMENTS UNDER THE COMPANIES ACT, 2013

(1) Reporting requirement relating to matters stated in section 143(1)

Under section 143(1), auditor shall inquire into following matters given as under:

(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.

However, 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.

(2) Reporting on accounts examined

Under provisions of Section 143(2), 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 thereunder or under any order made under subsection (11).

Further, auditor has to report whether to 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 prescribed under Rule 11 of the Companies (Audit and Auditors) Rules, 2014.

Further, in terms of section 143(3), the auditor's report shall also state

(a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

(b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books nd proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

(d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

(e) whether, in his opinion, the financial statements comply with the accounting standards;

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(g) whether any director is disqualified from being appointed as a director under sub- section (2) of the section 164;

(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(i) whether the company has adequate internal financial controls **with reference to financial statements** in place and the operating effectiveness of such controls;

However, it may be noted that the reporting requirement on adequacy of internal financial controls (IFCs) with reference to financial statements shall not be applicable to a private company which is a–

- (i) One person company; or
- (ii) Small company; or
- (iii) Company having turnover less than ₹ 50 crore as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial year less than ₹ 25 crore.

(j) such other matters as are prescribed in **Rule 11 of the Companies (Audit and Auditors) Rules, 2014** which are as under:

- (a) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
- (b) 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;
- (c) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.
- (d) (i) Whether the management has represented that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or

any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;

(ii) Whether the management has represented, that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties") with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and

(iii) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under subclause (1) and (2) contain any material misstatement.

(e) Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.

(f) Whether the company has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and the same has been operated throughout the year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention.

While reporting, 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 therefor in terms of Section 143(4). Further, every auditor shall comply with the auditing standards as required under section 143(9).

(3) Reporting on any other matter specified by Central Government:

As per section 143(11), 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.

(4) Reporting on frauds:

A. Reporting to the Central Government- As per section 143(12) of the Companies Act, 2013 read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 crore or above, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as prescribed.

B. Reporting to the Audit Committee or Board- In case of a fraud involving lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as prescribed.

Besides, auditor has also to report matters pertaining to fraud at point (xi) of paragraph 3 of CARO,2020 which is discussed subsequently.

12. REPORTING UNDER COMPANIES AUDITOR'S REPORT ORDER, 2020 [CARO, 2020]

Section	Particulars
1. What is CARO 2020?	➢ Additional Reporting Requirement prescribed by Ministry of Corporate affairs ➢ Prescribed Under Section 143(11) by MCA. ➢ Total Number of Clauses- 21 ➢ Auditor Must comment upon all clauses in cases where CARO 2020 is applicable. ➢ It is issued as an annexure to the Independent Auditor's Report
2. Applicability	It is applicable to all companies including foreign companies except for companies given below:

Companies Excluded:	CARO is NOT APPLICABLE TO: (a) banking company as defined under Banking Regulation Act, 1949 (b) an insurance company as defined under the Insurance Act, 1938 (c) a company licensed to operate under section 8 of the Companies Act, 2013 (d) a One person Company as defined under section 2(62) of the Companies Act, 2013 (e) a Small Company as defined under 2(85) of the Companies Act 2013 (f) a private limited company, not being a subsidiary or holding company of a public company, having: (i) a paid-up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and (ii) which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and (iii) Which does not have a total revenue (including revenue from discontinued operations) exceeding rupees ten crores during the financial year as per the financial statements.
2.1 Consolidated Financial Statement:	The Order specifically provides that it shall not apply to the auditor's report on consolidated financial statements. except clause (xxi) "whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports of the companies incn the consolidated financial statements, if yes, indicate the details of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks".
2.2 Branch Audit	The Order is also applicable to the audits of branch(es) of a company since sub-section 8 of section 143 of the Act read with Rule 12 of the Companies (Audit and Auditors) Rules, 2014 clearly specifies that a branch auditor has the same duties in respect of audit as the company's auditor. It is, therefore, necessary that the report submitted by the branch auditor contains a statement on all the matters specified in the Order, as applicable to the company.
2.3 Status of the Company:	The applicability of the Order would be based on the status of the company as at the balance sheet date for the financial year under audit.

3. Clause Reporting

Clause (i)

PROPERTY, PLANT, EQUIPMENT & INTANGIBLE ASSET

(a) (A) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of Property, Plant and Equipment;

(B) whether the company is maintaining proper records showing full particulars of intangible assets;

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

(c) whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company, if not, provide the details thereof in the format below:

Description of property	Gross carrying value	Held in name of	Whether promoter, director or their relative or employee	Period held – indicate range, where appropriate	Reason for not being held in name of company*
-	-	-	-	-	*also indicate if in dispute

(d) whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets;

(e) whether any proceedings have been initiated or are pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and rules made thereunder, if so, whether the company has appropriately disclosed the details in its financial statements;

Clause (ii)

INVERNTORY

(a) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account;

	(b) whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;
Clause (iii)	**Investments, Guarantee,Security & loans granted by co** whether during the year the company has made investments in, provided any guarantee or security or granted any loans or advances in the nature of loans, secured or unsecured, to companies, firms, Limited Liability Partnerships or any other parties, if so,- (a) whether during the year the company has provided loans or provided advances in the nature of loans, or stood guarantee, or provided security to any other entity [not applicable to companies whose principal business is to give loans], if so, indicate- (A) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to subsidiaries, joint ventures and associates (B) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to parties other than subsidiaries, joint ventures and associates; (b) whether the investments made, guarantees provided, security given and the terms and conditions of the grant of all loans and advances in the nature of loans and guarantees provided are not prejudicial to the company's interest; (c) in respect of loans and advances in the nature of loans, whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular; (d) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest; (e) whether any loan or advance in the nature of loan granted which has fallen due during the year, has been renewed or extended or fresh loans granted to settle the overdues of existing loans given to the same parties, if so, specify the aggregate amount of such dues renewed or extended or settled by fresh loans and the percentage of the aggregate to the total loans or advances in the nature of loans granted during the year [not applicable to companies whose principal business is to give loans];

	(f) whether the company has granted any loans or advances in the nature of loans either repayable on demand or without specifying any terms or period of repayment, if so, specify the aggregate amount, percentage thereof to the total loans granted, aggregate amount of loans granted to Promoters, related parties as defined in clause (76) of section 2 of the Companies Act, 2013;
Clause (iv)	**Compliance of sec 185 & 186** In respect of loans, investments, guarantees, and security, whether provisions of sections 185 and 86 of the Companies Act have been complied with, if not, provide the details thereof;
Clause (v)	**PUBLIC DEPOSIT(Including Deemed deposits)** In respect of deposits accepted by the company or amounts which are deemed to be 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 made thereunder, where applicable, have been complied with, if not, the nature of such contraventions be stated; if an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not;
Clause (vi)	**Cost records maintained as per sec 148** Whether maintenance of cost records has been specified by the Central Government under subsection (1) of section 148 of the Companies Act and whether such accounts and records have been so made and maintained;
Clause (vii)	**STATUTORY DUES (including GST)** (a) whether the company is regular in depositing undisputed statutory dues including Goods and Services Tax, provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated; (b) where statutory dues referred to in sub-clause (a) have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned (a mere representation to the concerned Department shall not be treated as a dispute);

<table>
<tr><td>Clause (viii)</td><td>Disclosure of transactions not recorded
whether any transactions not recorded in the books of account have been surrendered or disclosed as income during the year in the tax assessments under the Income Tax Act, 1961 (43 of 1961), if so, whether the previously unrecorded income has been properly recorded in the books of account during the year;</td></tr>
<tr><td>Clause (ix)</td><td>Default in repayment of loans or other borrowings
(a) whether the company has defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender, if yes, the period and the amount of default to be reported as per the format below:-
<table>
<tr><th>Nature of borrowing, including debt securities</th><th>Name of lender*</th><th>Amount not paid on due date</th><th>Whether principal or interest</th><th>No. of days delay or unpaid</th><th>Remarks, if any</th></tr>
<tr><td></td><td>*lender wise details to be provided in case of defaults to banks, financial institutions and Government.</td><td></td><td></td><td></td><td></td></tr>
</table>
(b) whether the company is a declared wilful defaulter by any bank or financial institution or other lender;
(c) whether term loans were applied for the purpose for which the loans were obtained; if not, the amount of loan so diverted and the purpose for which it is used may be reported;
(d) whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated;
(e) whether the company has taken any funds from any entity or person on account of or to meet the obligations of its subsidiaries, associates or joint ventures, if so, details thereof with nature of such transactions and the amount in each case;
(f) whether the company has raised loans during the year on the pledge of securities held in its subsidiaries, joint ventures or associate companies, if so, give details thereof and also report if the company has defaulted in repayment of such loans raised;</td></tr>
</table>

Clause (x)	**Money raised by IPO, FPO & preferential allotment/private placement of shares or convertible debentures** (a) whether moneys raised by way of initial public offer or further public offer (including debt instruments) during the year were applied for the purposes for which those are raised, if not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported; (b) whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of non-compliance;
Clause (xi)	**FRAUD** (a) whether any fraud by the company or any fraud on the company by officer or employee of the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated; (b) whether any report under sub-section (12) of section 143 of the Companies Act has been filed by the auditors in Form ADT-4 as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the Central Government; (c) whether the auditor has considered whistle-blower complaints, if any, received during the year by the company;
Clause (xii)	**NIDHI COMPANY** (a) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1: 20 to meet out the liability; (b) whether the Nidhi Company is maintaining ten per cent. unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability; (c) whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof;
Clause (xiii)	**RELATED PARTY** whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act where applicable and the details have been disclosed in the financial statements, etc., as required by the applicable accounting standards;

Clause (xiv)	**Internal Audit System** (a) whether the company has an internal audit system commensurate with the size and nature of its business; (b) whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor;
Clause (xv)	**NON CASH TRANSACTION** whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with;
Clause (xvi)	**SEC 45 IA OF RBI, ACT 1934** (a) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 (2 of 1934) and if so, whether the registration has been obtained; (b) whether the company has conducted any Non-Banking Financial or Housing Finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India as per the Reserve Bank of India Act, 1934; (c) whether the company is a Core Investment Company (CIC) as defined in the regulations made by the Reserve Bank of India, if so, whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria; (d) whether the Group has more than one CIC as part of the Group, if yes, indicate the number of CICs which are part of the Group;
Clause (xvii)	**Cash losses** whether the company has incurred cash losses in the financial year and in the immediately preceding financial year, if so, state the amount of cash losses;
Clause (xviii)	**Resignation of Statutory Auditor** whether there has been any resignation of the statutory auditors during the year, if so, whether the incoming auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors;

Clause (xix)	**Capability of Co meeting its liabilities existing at the BS date** on the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities, other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans, whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report that company is capable of meeting its liabilities existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date;
Clause (xx)	**Transfer amount remaining unspent u/s 135(5) to fund specified in Sch VII** (a) whether, in respect of other than ongoing projects, the company has transferred unspent amount to a Fund specified in Schedule VII to the Companies Act within a period of six months of the expiry of the financial year in compliance with second proviso to sub-section (5) of section 135 of the said Act; (b) whether any amount remaining unspent under sub-section (5) of section 135 of the Companies Act, pursuant to any ongoing project, has been transferred to special account in compliance with the provision of sub-section (6) of section 135 of the said Act;
Clause (xxi)	**Reporting on Consolidated Financial Statements** whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports of the companies included in the consolidated financial statements, if yes, indicate the details of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks.

9 SPECIAL FEATURES OF AUDIT OF DIFFERENT TYPES OF ENTITIES

1. GOVERNMENT AUDIT

1.1 Background

The concept, content and scope of government audit 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. 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.

(As per Article 266, the Consolidated Fund of India consists of all the revenue received from direct and indirect taxes, all the loans taken by the Govt. of India and all the amount of repayment of loans received by the Govt. of India)

After the expenditure has been incurred and the accounts are closed, the Appropriation Accounts are prepared which are scrutinised by the Public Accounts Committee (The Public Accounts Committee (PAC) is a committee of selected members of parliament, constituted by the Parliament of India, for the purpose of auditing the revenue and the expenditure of the Government of India). Thus, Parliamentary or Legislative control is exercised before spending and after the expenditure is actually incurred.

The U.N. Handbook on Government Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:

Government auditing is

- the objective, systematic, professional and independent examination
- of financial, administrative and other operations
- of a public entity
- made subsequently to their execution
- for the purpose of evaluating and verifying them,
- presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions

- by the responsible officials
- and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

OBJECTIVES:

(a) **Accounting for Public Funds:** Government audit serves as a mechanism or process for public accounting of government funds.

(b) **Appraisal of Government policies:** 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.

(c) **Base for Corrective actions:** 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.

(d) **Administrative accountability:** 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.

1.2 Legal Framework and Comptroller & Auditor General

1. APPOINTMENT & REMOVAL

(a) 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.

(b) 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.

(c) 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.

(d) 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 thePresident after consultation with him.

2. TENURE

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. Tenure is 6 years or 65 years age whichever is earlier.

3. VARIOUS CONSTITUTIONAL PROVISIONS

(i) **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.

(ii) **Article 150** of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.

(iii) **Article 151** requires that the reports of the C&AG relating to the accounts of the Union/State shall be submitted to the President/ Governor who shall cause them to be laid before House of Parliament/ State Legislature.

1.3 Comptroller and Auditor General's — Duties and Powers

(A) 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 and shall submit those accounts to the President or the Governor of a State or Administrator of the Union Territory.

(ii) **General Provisions Relating to Audit -** It shall be the duty of the Comptroller and Auditor General–

(a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

(b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;

(c) to audit and report on all trading, manufacturing and profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

(iii) **Audit of Receipts and Expenditure-** Where anybody or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory, the Comptroller and Auditor General shall, audit and report all receipts and expenditure of that body or authority.

Note: **Meaning of Substantially financed:** 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 ₹ 25 lakhs and the amount of such grant or loan is not less than 75% of the total expenditure of that body or authority.

(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 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.

(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 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 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.

(B) Powers of C&AG

(a) To inspect any office of accounts under the control of the Union or a State Government including office responsible for the creation of the initial or subsidiary accounts.

(b) To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.

(c) To put such questions or make such observations as he may consider necessary to the person in charge of the office and to call for such information as he may require for the preparation of any account or report which is his duty to prepare.

(d) 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.

1.4 Expenditure Audit

(1) **Audit against Rules & 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.

(iii) Rules and orders regulating the conditions of service, pay and allowances, and pensions of government servants.

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.

(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. and also to satisfy that the authority sanctioning it is competent.

(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 ineffective expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.

e.g.: A building may be constructed for installing a telephone exchange but may not be used for the same purpose resulting in unproductive expenditure.

Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

(a) The expenditure should not be prima facie more than the occasion demands.

Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

(b) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

(c) Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

(i) the amount of expenditure involved is insignificant; or

(ii) a claim for the amount could be enforced in a Court of law; or

(iii) the expenditure is in pursuance of a recognised policy or custom; and

(iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

(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.

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 ,
- execution of audit, and
- reporting.

1.5 Audit of Receipts

The audit of receipts is neither all pervasive or as old as audit of expenditure but has come to stay in some countries. Such an audit provides for checking;

(i) whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities;

(ii) whether adequate regulations and procedures have been framed by the department/agency concerned to secure an effective check on assessment, collection and proper allocation of cases;

(iii) whether such regulations and procedures are actually being carried out;

(iv) whether adequate checks are imposed to ensure the prompt detection and investigation of irregularities, double refunds, fraudulent or forged refund vouchers.

(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.

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.

- to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.
- to verify that the purchases are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority.
- 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.
- to check the accounts of receipts, issues and balances 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.

  The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

1.7 Audit of Commercial Accounts

Public enterprises are required to maintain commercial accounts and are generally classified under three categories–

(a) **departmental enterprises** engaged in commercial and trading operations, which are subject to the same laws, financial and other regulations as other government departments and agencies;

(b) **statutory bodies, corporations,** created by specific statutes mostly financed by government in the form of loans, grants, etc.; and

(c) **government companies** set up under the Companies Act, 2013.

The audit of:

- **departmental concerns** is undertaken in the same manner as any department of government where commercial accounts are kept.
- **statutory bodies or corporations** depends on the nature and type of the satute governing the bodies or corporations.

- **government companies** is conducted by 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. 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.

(1) **Power to appoint Government Company Auditor: Section 143(5)** the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 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.

(2) **Power to conduct Supplementary Audit & comment thereupon:** 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

   (b) comment upon or supplement such audit report under section 143(6)(b). Any comments given or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements 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.

(3) **Test Audit:** the Comptroller and Auditor- General of India may, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company.

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.

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.

2. AUDIT OF LOCAL BODIES

2.1 Background

(1) 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 - 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.

(2) **Municipal government in India covers five distinct types of urban local 8; authorities-**

- the municipal corporations,
- the municipal councils,
- the notified area committees,
- the town area committees and
- the cantonment committees.

(3) **Municipal authorities are endowed with specific local functions covering**

(a) regulatory,

(b) maintenance and

(c) development activities.

(4) **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.

(5) **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.

(6) **Local bodies may receive different types of grants from the state administration as well. Broadly, the revenue grants are of three categories:**

(a) General purpose grants: These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.

(b) Specific purpose grants: These grants which are tied to the provision of certain services or performance of certain tasks.

(c) Statutory and compensatory grants: These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

2.2 Financial Administration

(a) **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.

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.

(b) **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.

(c) **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.

2.3 Objective of Audit of Local Bodies/ Auditor's Concern:

The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. However, 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.

2.4 Audit Programme for Local Bodies

(i) APPOINTMENT: 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) AUDITOR'S CONCERNS: 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) RULES & REGULATIONS: 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) AUTHORISATIONS: He should ensure that all types of sanctions, either special or general, accorded by the competent authority.

(v) PROVISIONING: 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) PERFORMANCE: The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.

3. AUDIT OF NON - GOVERNMENTAL ORGANISATION (NGO'S)

3.1 Background

(1) 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.

(2) Therefore, this definition of NGO would include religious organisations, voluntary health and welfare agencies, charitable organisations, hospitals, old age homes, research foundations etc. Example UNICEF.

(3) Non-Governmental Organisations are generally incorporated as societies under the Societies Registration Act, 1860 or as a trust under the India Trust Act, 1882 as a company under section 8 of the Companies Act, 2013.

Note:

(1) 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 Registration Act, 1908 read with

(2) Transfer of Property Act, 1882 must be complied with and the registration of trust becomes mandatory.

(3) In some states, such as the states of Maharashtra and Gujarat. All charitable trusts have to be registered under these specific Public Trusts Acts.

(4) Registration under the Income Tax Act, 1961 and the Foreign Contribution (Regulation) Act, 2010 would also be invoked in many cases.

(5) NGOs registered under the Companies Act, 2013 must maintain their books of account under the accrual basis. The NGOs which are not registered under the Companies Act, 2013 are allowed to maintain accounts either an accrual basis or cash basis.

3.2 Sources and Applications of Funds

(1) The main sources of funds include

(a) 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.

(b) 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.

(c) 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 rules and regulations laid down

(d) 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.

(e) Many a times NGOs receive contributions in kind. These contributions include assets such as land, buildings, vehicles and articles related to programmes / projects such as food, books, building materials, clothes.

(2) The areas of application of funds for an NGO include Establishment Costs, Office and Administrative Expenses, Maintenance Expenses, Programme / Project Expenses, Charity, Donations and Contributions given, etc.

3.3 Provisions Relating to Audit

The auditors of an NGO registered under the Societies Registration Act, 1860 or 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 2010, 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.

For Example, The Foreign Contribution (Regulation) Act 2010 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

(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 nd 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 Cwith special reference to the letters from the donor(s).

(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:** (Earmarking refers to a fund allocation practice in which an entity, a government, or an individual sets aside a determined amount of funds to use for a specific goal). Check requirements of donors institutions, board resolution of NGO, rules and regulations of the schemes of the earmarked 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. 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.

(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, 2010

(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.

4. AUDIT OF SOLE TRADER

A sole trader is under no legal obligation to have his accounts audited. However, many such individuals get their financial statement audited due to regulatory requirements, or on a specific instructions of the bank for approval of loans, etc.

Appointment of Auditor: by the sole proprietor himself. and he can determine the scope of the audit as well as the conditions under which it will be carried out.

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.

The advantages and audit procedure discussed in following paragraphs of audit in case of partnership firm would be similar in case of proprietorship.

5. AUDIT OF FIRM

(A) Matters to be considered before starting audit:

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.

(B) Advantages of Audit of a Partnership Firm -

(1) Disputes: 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.

(2) Dissolution: 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) Reliable: Audited statement of accounts are relied upon by the banks when advancing loans, as well as by prospective purchasers of the business, as evidence of the profitability of the concern and its financial position.

(4) Admission: Audited statements of account can be helpful in the negotiations to admit a person as a partner, especially when they are available for a number of past years.

(5) Control: 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.

(C) Matters which should be specially considered in the audit of accounts of a partnership:

(i) **Letter of Appointment**: 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) **Partnership Documents:** 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) **Objects of Partnership:** 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) **Books of Account:** 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) **Mutual Interest:** 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) **Provision for Taxes:** 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) **Division of Profits:** Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

5.1 Basics of Limited Liability Partnerships (LLP) Audit

(A) LLP is governed by Limited Liability Partnership Act, 2008.

A Small Limited Liability Partnership to denote any LLP:

(a) the Contribution of which, does not exceed twenty-five lakh rupees (INR 25,00,000) or such higher amount, not exceeding five crore rupees, as may be prescribed; and

(b) the Turnover of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, does not exceed forty lakh rupees (INR 40,00,000) or such higher amount, not exceeding fifty crore rupees, as may be prescribed;

(B) Whether LLP is required to maintain Books of Accounts:

LLP's are required to maintain books of accounts which shall contain-

1. Particulars of all sums of money received and expended by the LLP and the matters in respect of which the receipt and expenditure takes place,
2. A record of the assets and liabilities of the LLP,
3. Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold,
4. Any other particulars which the partners may decide.

(C) **Audit of the Accounts of an LLP:**

The accounts of every LLP shall be audited in accordance with Rule 24 of LLP, Rules 2009. Such rules, inter-alia, provides that any LLP, whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty five lakh rupees, is not required to get its accounts audited. However, if the partners of such limited liability partnership decide to get the accounts of such LLP audited, the accounts shall be audited only in accordance with such rule.

(D) Advantages / Purpose / Need of Audit:

1. **Detection of Errors:** Auditing the accounts of a LLP helps in detecting errors & frauds & verification of financial statements.
2. **Disputes:** Disputes, if any between any partners in the matter of accounts can be settled with the help of audited accounts.
3. **Reliability:** Banks & financial institutions lend money to the firms only on the basis of audited accounts.
4. **Better Compliance and Management:** Periodical visits & suggestions by the auditor will be helpful in improving the management of the LLP.
5. **Reconstitution:** For settling accounts between partners at the time of admission, death, retirement, insolvency, insanity, etc. audited accounts are accepted by those concerned who have dealings with the LLP.

(E) Returns to be maintained and filed by an LLP:

- Every LLP would be required to file annual return in Form 11 with ROC within 60 days of closer of financial year. The annual return will be available for public inspection on payment of prescribed fees to Registrar.
- Every LLP is also required to submit Statement of Account and Solvency in Form 8 which shall be filed within a period of thirty days from the end of six months the financial year to which the Statement of Account and Solvency relates.

(F) Appointment of Auditor:

The auditor may be appointed by the designated partners of the LLP-

1. At any time for the first financial year but before the end of first financial year,
2. At least thirty days prior to the end of each financial year (other than the first financial year),
3. To fill the casual vacancy in the office of auditor,
4. To fill the casual vacancy caused by removal of auditor.

The partners may appoint the auditors if the designated partners have failed to appoint them.

(G) Auditor's Duty Regarding Audit of LLP:

1. **Engagement Letter:** The auditor should get definite instructions in writing as to the work to be performed by him.
2. **Minutes Book:** If partners maintain minute book he shall refer it for any resolution passed regarding the accounts
3. **LLP Agreement:** The auditor should read the LLP agreement & note the following provisions
   (a) Nature of the business of the LLP.
   (b) Amount of capital contributed by each partner.
   (c) Interest – in respect of additional capital contributed.
   (d) Duration of partnership.
   (e) Drawings allowed to the partners.
   (f) Salaries, commission etc. payable to partners.
   (g) Borrowing powers of the LLP.
   (h) Rights & duties of partners.
   (i) Method of settlement of accounts between partners at the time of admission, retirement, admission etc.
   (j) Any loans advanced by the partners.
   (k) Profit sharing ratio
4. **Reporting:** The auditor should mention
   (a) Whether the records of the firm appear to be correct & reliable.
   (b) Whether he was able to obtain all information & explanation necessary for his work.
   (c) Whether any restriction was imposed upon him.

6. AUDIT OF CHARITABLE INSTITUTION

(1) General

(i) Studying the constitution under which the charitable institution has been set up.

(ii) Verifying whether the institution is being managed in the manner contemplated by the law under which it has been set up.

(iii) Examining the system of internal check, especially as regards accounting of amounts collected.

(iv) Verifying in detail the income and confirming that the amounts received have been deposited in the bank regularly and promptly.

(v) Examine the Trust Deed or the Regulations as laid down.

(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 with the correspondence and the official receipts issued; paying special attention to the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and

(f) verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.

(3) Legacies: Verifying the amounts received by reference to correspondence with any figures and other available information.

(4) Grants

(i) Vouching the amount received with the relevant correspondence, receipts and minute books.

(ii) Obtaining a certificate from a responsible official showing the amount of grants received.

(5) Investments Income

(i) Vouching the amounts received with the dividend and interest counterfoils.

(ii) Checking the calculations of interest received on securities bearing fixed rates of interest.

(iii) Checking that the appropriate dividend has been received where any investment has been sold ex-dividend or purchased cum-dividend.

(iv) Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.

(6) **Rent**

(i) Examining the rent roll and inspecting tenancy agreements, noting in each case:

(a) the amounts of the rent, and

(b) the due dates.

(ii) Vouching the rent on to the rent roll from the counterfoils of receipt books and checking the totals of the cash book.

(7) **Special function, etc. -** Vouching gross receipts and outgoings in respect of any special functions, e.g. concerts, dramatic performance, etc., held in aid of the charity with such vouchers and cash statements as are necessary.

(8) **Income Tax Refunds -** Where income-tax has been deducted at source 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.

(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 payments.

(iv) Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.

7. AUDIT OF EDUCATIONAL INSTITUTIONS (SCHOOL, COLLEGE OR UNIVERSITY)

(A) General:

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.

(B) Fee from Students:

1. 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.
2. 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.
3. 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.
4. 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.
5. 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.
6. Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.
7. Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.

(C) Other Receipts/Grants & Donations:

1. Verify rental income from landed property with the rent rolls, etc.
2. Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.
3. 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.

(D) Expenditure:

1. Verify that the Provident Fund money of the staff has been invested in appropriate securities.

2. 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.
3. Vouch, all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.
4. 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.
5. See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

(E) Assets & Liabilities:

1. Report any old heavy arrears on account of fees, dormitory rents, etc. to the Managing Committee.
2. 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.
3. 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.
4. 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.
5. 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.

(F) Compliances:

1. 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.

2. Finally, verify the annual statements of account and, while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of staff, etc.

8. AUDIT OF HOSPITAL

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 with reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities have been collected.
4. **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
5. **Reconciliation of Subscriptions:** Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).
6. **Authorisation and Sanctions:** Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.
7. **Grants and TDS:** Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.
8. **Budgets:** Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.
9. **Internal Check:** Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.

10. **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.
11. **Registers:** Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.
12. **Inventories:** Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.
13. **Management Representation and Certificate:** Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

9. AUDIT OF CLUB

(1) **Entrance Fee:** 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) **Subscriptions:** 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) **Arrears of Subscriptions:** 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) **Arithmetical accuracy:** Check totals of various columns of the Register of members and tally them across.

(5) **Irrecoverable Member Dues:** 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) **Pricing:** 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) **Member Accounts:** 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) **Purchases:** Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective inventory registers.

(9) **Margins earned:** 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) **Inventories:** 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) **Investments:** 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) **Management Powers**: Examine the financial powers of the secretary and, if these have been exceeded, report specific case for confirmation by the Managing Committee.

10. AUDIT OF CINEMA

(1) Verify the internal control mechanism-

(a) that entrance to the cinema-hall during show is only through printed tickets;

(b) that they are serially numbered and bound into books;

(c) that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;

(d) that for advance booking a separate series of tickets is issued; and

(e) that the inventory of tickets is kept in the custody of a responsible official.

(2) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.

(3) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.

(4) Reconcile the amount of Tax collected with the total number of tickets issued for each class and vouch and verify the tax returns filed each month.

(5) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.

(6) Verify the charges collected for advertisement slides and shorts by reference to the Register of Slides and Shorts Exhibited kept at the cinema as well with the agreements, entered into with advertisers in this regard.

(7) Vouch the expenditure incurred on advertisement, repairs and maintenance. No part of such expenditure should be capitalized.

(8) Confirm that depreciation on machinery and furniture has been charged at an appropriate rate.

(9) Vouch payments on account of film hire with bills of distributors and in the process, the agreements concerned should be referred to.

(10) Examine unadjusted balance out of advance paid to the distributors against film hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquired as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.

(11) The arrangement for collection of the share in the restaurant income should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually. In case the restaurant is run by the Cinema, its accounts should be checked. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cold drink, etc. as in the case of club.

11. AUDIT OF HIRE PURCHASE AND LEASING COMPANIES

(A) HIRE - PURCHASE:

(1) A 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.

(2) While checking the hire- purchase transaction, the auditor may examine the following:

(i) Hire purchase agreement is in writing and is signed by all parties.

(ii) Hire purchase agreement specifies clearly-

(a) The hire-purchase price of the goods to which the agreement relates;

(b) The cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash;

(c) The date on which the agreement shall be deemed to have commenced;

(d) The number of instalments by which the hire- purchase price is to be paid, the amount of each of those instalments, and the date, or the mode of determining the date, upon which it is payable, and the person to whom and the place where it is payable; and

(e) The goods to which the agreement relates, in a manner sufficient to identify them.

(iii) Ensure that instalment payments are being received regularly as per the agreement.

(B) LEASES:

(1) 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').

(2) Auditor's Procedures: 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.

(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.

12. AUDIT OF HOTELS

12.1 Internal Controls:

(a) It is the responsibility of management to introduce controls which will minimise the leakage/pilferage as far as possible.

(b) 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 examine them and obtain explanations for any apparent deviations.

(c) 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 inorder.

(d) The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities.

(e) 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, the scope of his audit tests will necessarily be increased and, in the event of a material discrepancy being unexplained, he will have to consider qualifying his audit report.

12.2 Room Sales & Hall Bookings:

(a) The charge for room sales is normally posted to guest bills by the receptionist/ front office or in the case of large hotels by the night auditor.

(b) 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.

(c) 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.

(d) 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.

(e) The auditor should ensure that proper valuation of occupancyin- progress at the balance sheet date is made and included in the accounts.

(f) The auditor should ensure that proper records are maintained for booking of halls and other premises for special parties and recovered on the basis of the tariff.

12.3 Inventories:

(a) 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. The auditor should carry out tests to ensure that all such documentation is accurately processed.

(b) 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 . In particular, any movement of goods in or out of the stores should be checked.

(c) 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 by attending the physical inventory taking and carrying out certain pricing and calculation tests.

12.4 Fixed Assets:

(a) 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.

(b) 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.

(c) The auditor should see that costs of repairs and minor renovation and redecoration are treated as revenue expenditure, where as costs of major alterations and additions to the hotel building and facilities capitalised.

12.5 Casual Labour:

(a) The hotel trade operates to very large extent on casual labour. The records maintained of such wage payments are frequently inadequate.

(b) The auditor should ensure that defalcation on this account does not take place by suggesting proper controls to the management.

12.6 Travel Agents & Shops -

(a) 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.

(b) Commission, if any, paid to travel agents or booking agents should be checked by reference to the agreement on that behalf.

13. AUDIT OF CO-OPERATIVE SOCIETIES

13.1 Background

The Co-operative Societies Act, 1912, a Central Act, contains the fundamental law regarding the formation and working of the co-operative societies in India and is applicable in many states with or without amendments. In many states, viz., Maharashtra, West Bengal, Orissa, the co-operative societies are governed by specific state Acts.

Co-operative society is a business organisation with a special mode of doing business, by pulling together all the means of production co-operatively, elimination of middlemen and exploitation from outside forces.

13.2 Audit as per Section 17 of the Co-Operative Societies Act, 1912

1. **Qualifications of Auditors** - Apart from a chartered accountant within the meaning of the Chartered Accountants Act, 1949, some of the State Co-

operative Acts have permitted persons holding a government diploma in co-operative accounts or in co-operation and accountancy and also a person who has served as an auditor in the co-operative department of a government to act as an auditor.

2. **Appointment of the Auditor -** An auditor of a co-operative society is appointed by the Registrar of Co-operative Societies and the auditor so appointed conducts the audit on behalf of the Registrar and submits his report to him as also to the society. The audit fees are paid by the society on the basis of statutory scale of fees prescribed by the Registrar, according to the category of the society audited.

3. **Books, Accounts and other records of Co-operative Societies -** Under section 43(h) of the Central Act, a state government can frame rules prescribing the books nd accounts to be kept by a co-operative society.

4. **Restrictions on share holdings -** According to section 5 of the Central Act, in the case of a society where the liability of a member of the society is limited, no member of a society other than a registered society can hold such portion of the share capital of the society as would exceed a maximum of twenty percent of the total number of shares or of the value of shareholding to ₹ 1,000/-. The auditor of a co-operative society will be concerned with this provision so as to watch any breach relating to holding of shares. One should also watch whether any provision in the bye-laws of the society is not contrary to this statutory position. The State Acts may provide limits as to the shareholding, other than that provided in the Central Act.

5. **Restrictions on loans -** Section 29 of the Central Act puts restriction on loan. It states that a registered society shall not make a loan to any person other than a member. However, with the special sanction of the Registrar, a registered society may make a loan to another registered society.
   The State Government may further put such restrictions as it thinks fit on the loaning powers of the society to its members or to other societies in the interest of the society concerned and its members.

6. **Restrictions on borrowings** - Section 30 of the Central Act further puts restriction on borrowings. According to this section, a registered society shall accept loans and deposits from persons who are not members subject to the restrictions and limits of the bye-laws of the society. The auditor will have to examine the bye-laws in this respect.

7. **Investment of funds** - According to section 32 of the Central Act, a society may invest its funds in any one or more of the following:
   (a) In the Central or State Co-operative Bank.
   (b) In any of the securities specified in section 20 of the Indian Trusts Act, 1882.
   (c) In the shares, securities, bonds or debentures of any other society with limited liability.
   (d) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.
   (e) In any other moneys permitted by the Central or State Government.

8. **Appropriation of profits** - According to section 33 of the Central Act, a prescribed percentage of the profits should be transferred to Reserve Fund, before distribution as dividends or bonus to members.

9. **Contributions to Charitable Purposes** - According to section 34, a registered society may, with the sanction of the Registrar, contribute an amount not exceeding 10% of the net profits remaining after the compulsory transfer to the reserve fund for any charitable purpose as defined in section 2 of the Charitable Endowments Act, 1890.

10. **Investment of Reserve Fund outside the business or utilisation as working capital** - Some of the State Acts provide that a society may use the Reserve Fund:
    (a) in the business of a society, as working capital (subject to the rules made in this behalf).
    (b) may invest as per provisions of the Act.
    (c) may be used for some public purposes likely to promote the object of the society. The auditor should ensure strict compliance with the State Act and Rules in this regard.

11. **Contribution to Education Fund** - Some of the State Acts provide that every society shall contribute annually towards the Education Fund of the State Federal Society, at the appropriate rate as per the class of the society. Contribution to Education Fund is a charge on profits and not an appropriation.

13.3 Special Features of Co-Operative Audit:

(a) **Examination of overdue debts** - Overdue debts for a period from 6 months to 5 years and more than 5 years will have to be classified and shall have to be reported by an auditor. The auditor will have to ascertain whether proper provisions for doubtful debts are made and whether the same is satisfactory.

(b) **Overdue Interest** - Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.

(c) **Certification of Bad Debts** - A peculiar feature regarding the writing off of the bad debts as per Maharashtra State Co-operative Rules, 1961, is very interesting to note. As per the said rules, bad debts can be written off only when they are certified as bad by the auditor

(d) **Valuation of Assets and Liabilities** - Regarding valuation of assets there are no specific provisions or instructions under the Act and Rules and as such due regard shall be had to the general principles of accounting and auditing conventions and standards adopted.

(e) **Adherence to Co-operative Principles** - The auditor will have to ascertain in general, how far the objects, for which the co-operative organisation is set up, have been achieved in the course of its working

(f) **Observations of the Provisions of the Act and Rules** - An auditor of a cooperative society is required to point out the infringement with the provisions of Co-operative Societies Act and Rules and bye-laws.

13.4 Audit, Inquiry and Inspection of Multi-State Co-Operative Societies

The Multi-State Co-operative Societies Act, 2002, which came into force in August, 2002 applies to co-operative societies whose objects are not confined to one State.

Books of Accounts - As per Multi-State Co-operative Society Rules 2002, every Multi- State Co-operative society shall keep books of account with respect to

(a) all sum of money received and expended and matters in respect of which the receipt and expenditure take place;

(b) all sale and purchase of goods;

(c) the assets and liabilities;

(d) in the case of a Multi-State Co-operative society engaged in production, processing and manufacturing, particulars relating to utilization of materials or labour or other items of cost as may be specified in the bye-hours of such a society.

13.4.1 Audit of Multi-State Co-operative Society –

1. **Qualification of Auditors** - Section 72 of the Multi-State Co-operative Societies Act, 2002 states that a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can only be appointed as auditor of Multi-State co-operative society.

   However the following persons are not eligible for appointment as auditors of a Multi- State co-operative society-

   (a) A body corporate.

   (b) An officer or employee of the Multi-State co-operative society.

   (c) A person who is a member or who is in the employment, of an officer or employee of the Multi-State co-operative society.

   (d) A person who is indebted to the Multi-State co-operative society or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the Multi-State co-operative society for an amount exceeding one thousand rupees.

   If an auditor becomes subject, after his appointment, to any, of the disqualifications specified above, he shall be deemed to have vacated his office as such.

2. **Appointment of Auditors** - Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor or auditors of a Multi-State cooperative society shall be appointed by the board within one month of the date of registration of such society and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails to exercise its powers under this sub-section,

the Multi-State co-operative society in the general meeting may appoint the first auditor or auditors.

The subsequent auditor or auditors are appointed by Multi-State co-operative society, at each annual general meeting. The auditor or auditors so appointed shall hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

3. **Power and duties of Auditors –** Section 73 of the Multi-State Co-operative Societies Act, 2002 discusses the powers and duties of auditors. According to this, every auditor of a Multi-State co-operative society shall have a right of access at all times to the books accounts and vouchers of the Multi-State co-operative society, whether kept at the head office of the Multi-State co-operative society or elsewhere, and shall be entitled to require from the officers or other employees of the Multi- State co-operative society such information and explanation as the auditor may think necessary for the performance of his duties as an auditor.

   As per section 73(2), the auditor shall make following inquiries:

   (a) Whether loans and advances made by the Multi-State co-operative society on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the Multi-State co- operative society or its members,

   (b) Whether transactions of the Multi-State co-operative society which are represented merely by book entries are not prejudicial to the interests of the Multi-State co-operative society,

   (c) Whether personal expenses have been charged to revenue account, and

   (d) Where it is Stated in the books and papers of the Multi-State co-operative society that any shares have been allotted for cash, whether cash has actually, been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet as correct regular and not misleading.

4. **Content of Auditor's Report** - As per sub-section (3) & (4) of section 73 of Multi- state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss

account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co-operative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, and give a true and fair view:

(a) In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and

(b) In the case of the profit and loss account, of the profit or loss for its financial year. The auditor's report shall also state:

    (i) Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.

    (ii) Whether, in his opinion, proper books of account have been kept by the Multi-State co-operative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from branches or offices of the Multi-State cooperative society not visited by him.

    (iii) Whether the report on the accounts of any branch office audited by a person other than the Multi-State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.

    (iv) Whether the Multi-State co-operative society's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and return.

    Where any of the matters referred to in sub-section (3) or (4) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

5. **Power of Central Government to direct special audit in certain cases** - Under section 77 of the Multi-State Co-operative Societies Act, 2002, where the Central Government is of the opinion:

(a) that the affairs of any Multi-State co-operative society are not being managed in accordance with self-help and mutual deed and co-operative principles or prudent commercial practices or with sound business principles; or

(b) that any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains; or

(c) that the financial position of any Multi-State co-operative society is such as to endanger its solvency.

1. **Central Government's Order:** The Central Government may at any time by order direct that a special audit of the Multi-State co-operative society's accounts for such period or periods as may be specified in the order shall be conducted.

2. **Appointment of the Auditor:** It may appoint either a chartered accountant or the Multi-State co-operative society's auditor himself to conduct the special audit.

3. **Shareholding Restriction:** However, Central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty-one percent or more of the paid-up share capital in such Multi-State co-operative society.

4. **Special Auditor's Powers, Duties & Report:** The special auditor shall have the same powers and duties in relation to the special audit as an auditor of a Multi-State co-operative society has under section 73. However the special auditor shall instead of making his report to the members of the Multi-State co-operative society make the report to the Central Government. The report of the special auditor shall, include all the matters required to be included in the auditor's report under section 73 and any other matter as directed by the Central Government.

5. **Action by the Central Government:** On receipts of the report of the special auditor the Central Government may take such action on the report as it considers necessary in accordance with the provision of the Act or any law for the time being in force. However, if the Central Government does not take any action on the report within four months from the date of its receipt, that Government shall send to the Multi-State Co-operative society either a copy of, or relevant extract from, the report with its comments thereon and require the Multi-State Co-operative society either to circulate that copy or those extracts to the members or to have such copy or extracts read before the Multi-State Co-operative society at its next general meeting.

6. **Expenses pertaining to the Special Audit:** The expenses of, and incidental to, any special audit under this section (including the remuneration of the special auditor) shall be determined by the Central Government which determination shall be final and paid by the Multi-State Co-operative society and in default of such payment, shall be recoverable from the Multi-State Co-operative society as an arrear of land revenue.

13.4.2 Inquiry by Central Registrar under Section 78

1. **When:** The Central Registrar may, on a request from:
   - a federal co-operative to which a Multi- State Co-operative society is affiliated or
   - a creditor or not less than one-third of the members of the board or
   - not less than one-fifth of the total number of members of a Multi-state co-operative society,
2. **How:** hold an inquiry or direct some person authorized by him by order in writing in his behalf to hold an inquiry into the constitutions, working and financial condition of a Multi-State Co-operative society.
3. **Opportunity of being Heard:** However, before holding such inquiry fifteen days notice must be given to the Multi-State co-operative society.
4. **Powers given:** The Central Registrar or the person authorized by him shall have the following powers, namely:

   (a) he shall at all reasonable times have free access to the books, accounts, documents, securities, cash and other properties belonging to or in the custody of the Multi-State co-operative society and may summon any person in possession or responsible for the custody of any such books, accounts, documents securities, cash or other properties to produce the same at any place specified by him.

   (b) he may, notwithstanding any bye-law specifying the period of notice for a general meeting of the Multi-State co-operative society, require the officers of the society to call a general meeting of the society by giving notice of not less than seven days at such time and place at the head quarters of the society to consider such matters as may be directed to him, and where the officers of the society refuse or fail to call such a meeting, he shall have power to call it himself.

5. **Inspection Report:** A copy of the report of inspection under this section shall be communicated to the Multi-State Co-operative society within a period of three months from the date of completion of such inspection.

14. AUDIT OF TRUSTS & SOCIETIES

BOOKS OF ACCOUNT: The Auditor is required to report whether the Trust has maintained proper books of accounts, including the following, namely:

(i) cash book;

(ii) ledger;

(iii) journal;

(iv) copies of bills,

(v) original bills wherever issued to the person and receipts in respect of payments made by the person;

(vi) any other book that may be required to be maintained in order to give a true and fair view of the state of the affairs of the person and explain the transactions effected;

TRUSTS

The auditor has to ascertain:

(a) whether accounts are maintained regularly and in accordance with the provisions of the applicable Act and the rules;

(b) whether receipts and disbursements are properly and correctly shown in the accounts and money received in the form of donations is being applied as per the objects of the trust and as per the specific direction by the donor, if any.

(c) whether the cash balance and vouchers in the custody of the manager or trustee on the date of audit were in agreement with the accounts;

(d) whether all books, deeds, accounts, vouchers or other documents or records required by the auditor were produced before him;

(e) whether a register of movable and immovable properties is maintaine.

(f) whether the manager or trustee or any other person required by the auditor to appear before him did so and furnished the necessary information required by him;

(g) whether any property or funds of the Trust were applied for any object or purpose other than the object or purpose of the Trust;

(h) the amounts of outstanding for more than one year and the amounts written off, if any;

(i) whether any money of the public trust has been invested contrary to the provisions of applicable Act which have come to the notice of the Auditor

(j) all cases of irregular, illegal or improper expenditure, or failure or omission to recover monies or of loss or waste of money or other property thereof,

(k) whether the maximum and minimum number of the trustees is maintained;

(l) whether the meeting are held regularly as provided in such instrument

(m) whether the minute books of the proceedings of the meeting is maintained

(n) whether any of the trustees has any interest in the investment of the trust

(o) whether any of the trustees is a debtor or creditor of the trust.

(p) whether anonymous donations received are properly accounted for and donations in cash are not received by the Trust over and above the prescribed limit of accepting cash donations.

(q) whether the irregularities pointed out by the auditors in the accounts of the previous year have been duly complied with by the trustees during the period of audit

(r) any special matter which the auditor may think fit or necessary to bring to the notice of the Deputy or Assistant Charity Commissioner

SOCIETIES

The auditor's considerations:-

(a) The auditor should ascertain governing legislation of society i.e. Societies Registration act, 1860 or any applicable state law under which it has been registered.

(b) Object of society needs to be ascertained from its memorandum of association/ bye laws. Its activities may include charitable, social, cultural or educational activities.

(c) Ascertain whether society has obtained registration under Foreign Contribution (Regulation) Act, 2010 in case foreign contributions are received.

(d) Ascertain whether it is also registered under relevant provisions of Income Tax Act which may make it eligible for tax exemption on its income.

(e) Obtain an understanding of internal control to design audit procedures with special reference to donations and various expenditures incurred in relation to achievements of objects of society.

(f) Evaluate appropriateness of accounting policies with special reference to donations and grants. Also evaluate accounting policies in relation to specific grants.

(g) In case some expenses incurred by society are reimbursed by donors, ascertain how these are recognized in financial statements.

(h) Ascertain, if any inquiry has been held by Registrar under applicable law in the working or financial condition of society and its implications for auditor's opinion.

(i) Ascertain all cases of irregular, illegal or improper expenditure or failure or omission to recover monies or other property belonging to society or of loss or waste of money or other property thereof.

(j) Ascertain whether such expenditure or waste was caused in consequence of breach of trust or misapplication or any other misconduct on the part of governing body.

10 AUDIT OF BANKS

INTRODUCTION:

Types of Banks

There are different types of banking institutions prevailing in India which are as follows:

Commercial Banks	Regional Rural Banks
Co-operative Banks.	Payment Banks
Development Banks (more commonly known as 'Term-Lending Institutions').	Small Finance Banks

1. Commercial banks are the most wide spread banking institutions in India, that provide a number of products and services to general public and other segments of economy. Two of its main functions are:-
   (a) accepting deposits and
   (b) granting advances.

2. Regional Rural Banks known as RRBs are the banks that have been set up in rural areas in different states of the country to cater to the basic banking and financial needs of the rural communities
   Examples are: Punjab Gramin Bank , Tripura Gramin Bank , Allahabad UP Gramin Bank , Andhra Pradesh Grameen Vikas Bank, etc.

3. Co-operative Banks function like Commercial Banks only but are set up on the basis of Cooperative Principles and registered under the Cooperative Societies Act of the respective state or the Multistate Cooperative Societies Act and usually cater to the needs of the agricultural and rural sectors.
   Examples are: The Gujarat State Co-operative Bank Ltd., Chhatisgarh Rajya Sahakari Bank Maryadit, etc.

4. Payments Banks are a new type of banks which have been recently introduced by RBI. They are allowed to accept restricted deposits but they cannot issue loans and credit cards. However, customers can open Current & Savings accounts and also

avail the facility of ATM cum Debit cards, Internet-banking & Mobilebanking.
Examples are: Airtel Payments Bank , India Post Payments Bank, Paytm Payments Bank, etc.

5. **Development Banks** had been conceptualized to provide funds for infrastructural facilities important for the economic growth of the country.
Examples are: Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI) , etc.

6. **Small Finance Banks** have been set up by RBI to make available basic financial and banking facilities to the unserved and unorganised sectors like small marginal farmers, small & micro business units, etc.
Examples are: Equitas Small Finance Bank , AU Small Finance Bank , etc.

Reserve Bank of India: Regulating Body

The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country.

Important functions of RBI are :-

- issuance of currency;
- regulation of currency issue;
- acting as banker to the central and state governments; and
- acting as banker to commercial and other types of banks including term lending institutions.

Regulatory Framework

(a) Banking Regulation Act, 1949.
(b) State Bank of India Act, 1955.
(c) Companies Act, 2013.
(d) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.
(e) Regional Rural Banks Act, 1976.
(f) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.
(g) Information Technology Act, 2000. Prevention of Money Laundering Act, 2002.
(h) Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.
(i) Credit Information Companies Regulation Act, 2005.
(j) Payment and Settlement Systems Act, 2007.

Peculiarities involved:

- Huge volumes and complexity of transactions;
- Wide geographical spread of banks' network;
- Large range of products and services offered;
- Extensive use of technology;
- Strict vigilance by the banking regulator etc.

Types of Bank Audit Reports to be issued (generally):

Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:

(a) Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.

(b) Long Form Audit Report. (LFAR)

(c) Report on compliance with SLR requirements.

(d) Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.

(e) Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.

(f) Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.

(g) Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jilani Committee on internal control and inspection/ credit system.

(h) Report on instances of adverse credit-deposit ratio in the rural areas.

1. UNDERSTANDING OF ACCOUNTING SYSTEM IN BANKS

(a) In the computerized environment, it is imperative that the auditor is familiar with and satisfied that all the norms/parameters as per the latest applicable RBI guidelines are incorporated and built into the system that generates information/data having a bearing on the classification/ provisions and income recognition.

(b) The auditor should not go by the assumption that the system generated information is correct and can be relied upon without evidence that demonstrates that the system driven information is based on the required parameters.

(c) He should use Professional Skepticism and Prudence wherever he feels that something manually needs to be performed to check the authenticity and consistency of the information obtained from the systems and document the results of such activities performed.

2. BANK AUDIT APPROACH

1. **Drawing an Audit Plan:** An audit plan should be drawn up based on:
   - the nature and level of operations,
   - nature of adverse features,
   - level of compliance based on previous reports and
   - audit risks based on inadequacy in or breach of internal controls and the familiarization exercise carried out,

2. **Control Environment at the Bank:** A bank should have appropriate controls to mitigate its risks, including
   (a) effective segregation of duties (particularly, between front and back offices),
   (b) accurate measurement and reporting of positions,
   (c) verification and approval of transactions,
   (d) reconciliation of positions and results,
   (e) setting up limits,
   (f) reporting and approval of exceptions,
   (g) physical security and contingency planning.

The following are certain common questions /steps, which have to be kept in mind while undertaking/ performing control activities:

Nature of Questions	Questions to be considered / answered
Who	• Who performs the control? • Does the above person have requisite knowledge and authority to perform the control?
What	• What evidence is available to demonstrate /prove that the control is performed?

When	• When and with what frequency is the control performed? • Is the frequency enough to prevent, detect and correct risk of material misstatements?
Where	• Where is the evidence of performance of the control retained? • For how long is the evidence retained? • Is the evidence accessible/ available for audit?
Why	• Why is the control being performed? • What type of errors are prevented or detected through the performance of the control?
How	• How is the control performed? • What are the control activities? • Can these activities be bypassed? • Can the bypass, if any, be detected? • How are exceptions / deviations resolved on identification? • What is the time frame for resolving the exceptions /deviations?

3. **Engagement Team Discussions:**

The engagement team discussion ordinarily includes a discussion of the following matters:

(a) Errors that may be more likely to occur;

(b) Errors which have been identified in prior years;

(c) Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;

(d) Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;

(e) Need to maintain professional skepticism throughout the audit engagement;

(f) Need to alert for information or other conditions that indicates that a material misstatement may have occurred.

Advantages of such a discussion:

➢ Specific emphasis should be provided to the susceptibility of the bank's financial statements to material misstatement due to fraud, that enables the engagement team to consider an appropriate response to fraud risks, including those related to engagement risk, pervasive risks, and specific risks.

➢ It further enables the audit engagement partner to delegate the work to the experienced engagement team members, and to determine the procedures to be followed when fraud is identified.

- Further, audit engagement partner may review the need to involve specialists to address the issues relating to fraud.

4. FORM AND CONTENT OF FINANCIAL STATEMENTS

Sub-sections (1) and (2) of Section 29 of the Banking Regulations Act, 1949 deal with the form and content of financial statements of a banking company and their authentication. These sub-sections are also applicable to nationalised banks, State Bank of India, and Regional Rural Banks.

Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

5. AUDIT OF ACCOUNTS

Balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies.

6. ELIGIBILITY, QUALIFICATIONS AND DISQUALIFICATIONS OF AUDITOR

Applicable as to a Company Auditor

7. APPOINTMENT OF AUDITOR

- The auditor of a banking company is to be appointed at the annual general meeting of the shareholders,
- The auditor of a nationalised bank is to be appointed by the bank concerned acting through its Board of Directors.

  (In either case, approval of the Reserve Bank of India is required before the appointment is made.)
- The auditors of regional rural banks are to be appointed by the bank concerned with the approval of the Central Government.

8. REMUNERATION OF AUDITOR

(a) The remuneration of auditor of a banking company is to be fixed in accordance with the provisions of Section 142 of the Companies Act, 2013.

(b) The remuneration of auditors of nationalised banks and State Bank of India is to be fixed by the Reserve Bank of India in consultation with the Central Government.

9. POWERS OF AUDITOR

same powers as those of a company's auditor.

10. AUDITOR'S REPORT

In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:

(a) whether, in his opinion, the financial statements present a true and fair view of the affairs of the bank and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;

(b) whether or not the transactions of the bank, which have come to his notice, have been made within the powers of that bank;

(c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit; and

(d) any other matter which he considers should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank.

10.1 Format of Report

The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of Standards on Auditing discussed in Chapter 8 on Audit Report.

10.2 Long Form Audit Report

The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India.

The Statutory Central Auditors are required to submit the LFAR to the banks latest by 30th June every year.

10.3 Reporting to RBI

1. The RBI issued a Circular relating to implementation of recommendations of Committee on Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks).

   "If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action".

2. Auditor should also consider the provisions of SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements".

3. SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" should does be considered.

11. CONDUCTING AN AUDIT

The audit of banks or their branches involves the following stages –

1. Initial consideration by the statutory auditor

(i) Declaration of Indebtedness: The RBI has advised that the banks, before appointing their statutory central/branch auditors, should obtain a declaration of indebtedness.

(ii) Internal Assignments in Banks by Statutory Auditors: The RBI decided that the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year, like Concurrent audits.

(iii) Planning: Standard on Auditing (SA) 300, "Planning an Audit of Financial Statements" requires that the auditor shall undertake the following activities prior to starting an initial audit:

(a) Performing procedures required by SA 220, "Quality Control for Audit Work" regarding the acceptance of the client relationship and the specific audit engagement; and

(b) Establish understanding of terms of engagement as per SA 210, "Agreeing the Terms of Audit Engagements".

(iv) Communication with Previous Auditor: As per Clause (8) of the Part I of the First Schedule to the chartered Accountants Act, 1949, a Chartered Accountant in practice cannot accept position as auditor previously held by another chartered accountant without first communicating with him in writing. He should get a NO Objection Certificate (NOC) from the previous auditor through this communication as to know whether he has any objections to such an appointment made, for any valid reasons.

(v) Terms of Audit Engagements: SA 210, "Terms of Audit Engagements" requires that for each period to be audited, the auditor should agree on the terms of the audit engagement with the bank before beginning significant portions of fieldwork.

(vi) Initial Engagements: The auditor needs to perform the audit procedures as mentioned in SA 510 "Initial Audit Engagements-Opening Balances".

(vii) Assessment of Engagement Risk

(viii) Establish the Engagement Team: The size and composition of the engagement team would depend on the size, nature and complexity of the bank's operations.

(ix) Understanding the Bank and its Environment: SA 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"

2. Identifying and Assessing the Risks of Material Misstatements: SA 315

3. Understanding the Bank and Its Environment including Internal Control: An understanding of the bank and its environment, including its internal control, enables the auditor:

- to identify and assess risk;
- to develop an audit plan so as to determine the operating effectiveness of the controls and to address the specific risks.

4. Understanding the Bank's Accounting Process.

5. Understanding the Risk Management Process:

An effective risk management system in a bank generally requires the following:

(a) Oversight and involvement in the control process by those charged with governance: Those charged with governance (Board of Directors/Managing Director) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.

(b) Identification, measurement and monitoring of risks: Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.

(c) Control activities: A bank should have appropriate controls to mitigate its risks including effective segregation of duties (particularly between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting up limits, reporting and approval of exceptions, physical security and contingency planning.

(d) **Monitoring activities:** Risk management models, methodologies and assumptions used to measure and mitigate risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.

(e) **Reliable information systems:** Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis.

6. **Engagement Team Discussions.**

7. **Establish the Overall Audit Strategy:** For this purpose, the audit engagement partner should:
   - ➢ establish the overall audit strategy, prior to the commencement of an audit; and
   - ➢ involve key engagement team members and other appropriate specialists while establishing the overall audit strategy, which depends on the characteristics of the audit engagement.

8. **Develop the Audit Plan: SA 300.**

9. **Audit Planning Memorandum:** The auditor should summarise the audit plan by preparing an audit planning memorandum in order to:
   - ➢ Describe the expected scope and extent of the audit procedures to be performed by the auditor.
   - ➢ Highlight all significant issues and risks identified during their planning and risk assessment activities, as well as the decisions concerning reliance on controls.
   - ➢ Provide evidence that they have planned the audit engagement appropriately and have responded to engagement risk, pervasive risks, specific risks, and other matters affecting the audit engagement.

10. Determine Audit Materiality: The auditor should consider the relationship between the audit materiality and audit risk when conducting an audit.

11. Consider Going Concern

12. Assess the Risk of Fraud including Money Laundering: As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objective is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately.
    The RBI has framed specific guidelines that deal with prevention of money laundering and "Know Your Customer (KYC)" norms. Requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

13. Assess Specific Risks: The auditors should identify and assess the risks of material misstatement at the financial statement level which refers to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions.

14. Risk Associated with Outsourcing of Activities.

15. Response to the Assessed Risks: SA 330 "The Auditor's Responses to Assessed Risks"

16. Stress Testing: Stress testing is a software testing activity that determines the robustness of software by testing beyond the limits of normal operation. Stress testing is particularly important for "mission critical" software, but is used for all types of software (Source – Wikipedia). RBI has required that all commercial banks shall put in place a Board approved 'Stress Testing framework' to suit their individual requirements which would integrate into their risk management systems.

17. BASEL III framework: Basel norms or accords are the International Banking regulations issued by the BCBS. The Basel Committee on Banking Supervision

(BCBS) and the Financial Stability Board (FSB) has undertaken an extensive review of the regulatory framework in the wake of the sub-prime crisis. In the document titled 'Basel III: A global regulatory framework for more resilient banks and banking systems', released by the BCBS in December 2010, it has inter alia proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital. The set of agreement by the BCBS, which mainly focuses on risks to banks and the financial system are called Basel accord.

18. Reliance on / review of other reports: The auditor should take into account the adverse comments, if any, on advances appearing in the following-
   - Previous year's audit reports.
   - Latest internal inspection reports of bank officials.
   - Reserve Bank's latest inspection report.
   - Concurrent / Internal audit report.
   - Report on verification of security.
   - Any other internal reports specially related to particular accounts.
   - Manager's charge-handing-over report when incumbent is changed.

12. ADVANCES

Advances are amount of money or credit, given as a loan from a bank to another party with an agreement that the money will be repaid.

Types of Advances: Funded Loans & Non-Funded Loans

- Funded loans are those loans where there is an actual transfer of funds from the bank to the borrower. Examples of funded loans are Term loans, Cash credits, Overdrafts, Demand Loans, Bills Discounted and Purchased, Participation on Risk Sharing basis, Interest-bearing Staff Loans.
- Non-funded facilities are those which do not involve such transfer. Examples of non-funded loans are Letters of credit, Bank guarantees, etc.

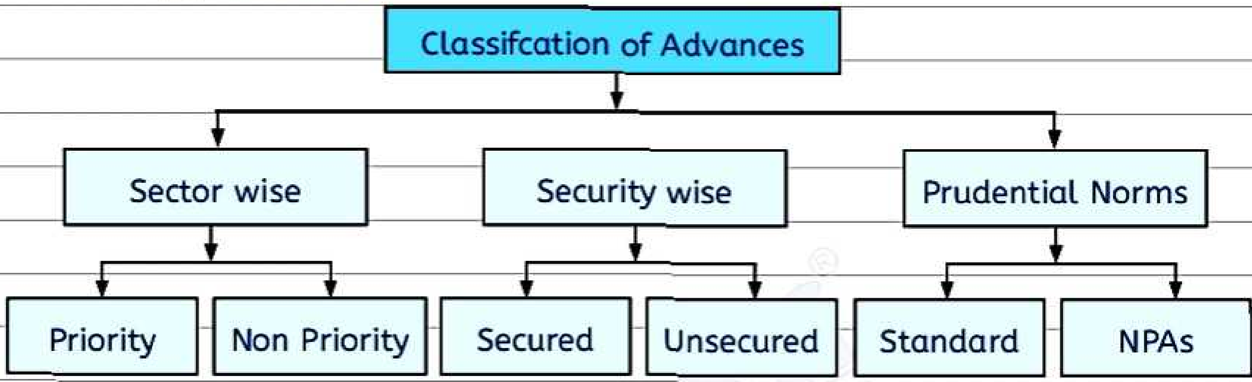
12.1 What do ADVANCES Comprise:

Advances comprise of funded amounts by way of:
- Term loans
- Cash credits, Overdrafts, Demand Loans
- Bills Discounted and Purchased
- Participation on Risk Sharing basis
- Interest-bearing Staff Loans

12.2 Legal requirements of Disclosure in the Balance Sheet:

A. (i) Bills purchased and discounted
   (ii) Cash credits, Overdrafts and loans repayable on demand
   (iii) Term Loans

B. (i) Secured by tangible assets
   (ii) Covered by Bank/Government guarantees
   (iii) Unsecured



C.I. Advances in India:	C. II. Advances outside India:
(i) Priority sectors (ii) Public sector (iii) Banks (iv) Others	(i) Due from Banks (ii) Due from Others: (a) Bills Purchased and discounted (b) Syndicated loans (c) Others

12.3 Classification of Advances

12.3.1 Sector Wise

Examples of Priority Sectors are Agriculture, MSME, Education, Housing, etc.

12.4 SECURITY WISE

Nature of Security

A. Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.

B. Collateral security is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of most common types of securities accepted by banks are the following:

- Personal Security of Guarantor
- Goods/Stocks/Debtors/Trade Receivables
- Gold Ornaments and Bullion
- Immovable Property
- Plantations (For Agricultural Advances)
- Third Party Guarantees
- Banker's General Lien
- Life Insurance Policies
- Stock Exchange Securities and Other Instruments

12.5 Mode of Creation of Security

(i) **Mortgage:** Mortgage are of several kinds but the most important are the Registered Mortgage and the Equitable Mortgage.

Registered Mortgage can be affected by a registered instrument called the 'Mortgage Deed' signed by the mortgagor. It registers the property to the mortgagee as a security.

Equitable mortgage, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

(ii) **Pledge:** A pledge thus involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods. The pledge of goods constitutes a specific (or fixed) charge.

(iii) **Hypothecation:** The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favor of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower. Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank.

The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

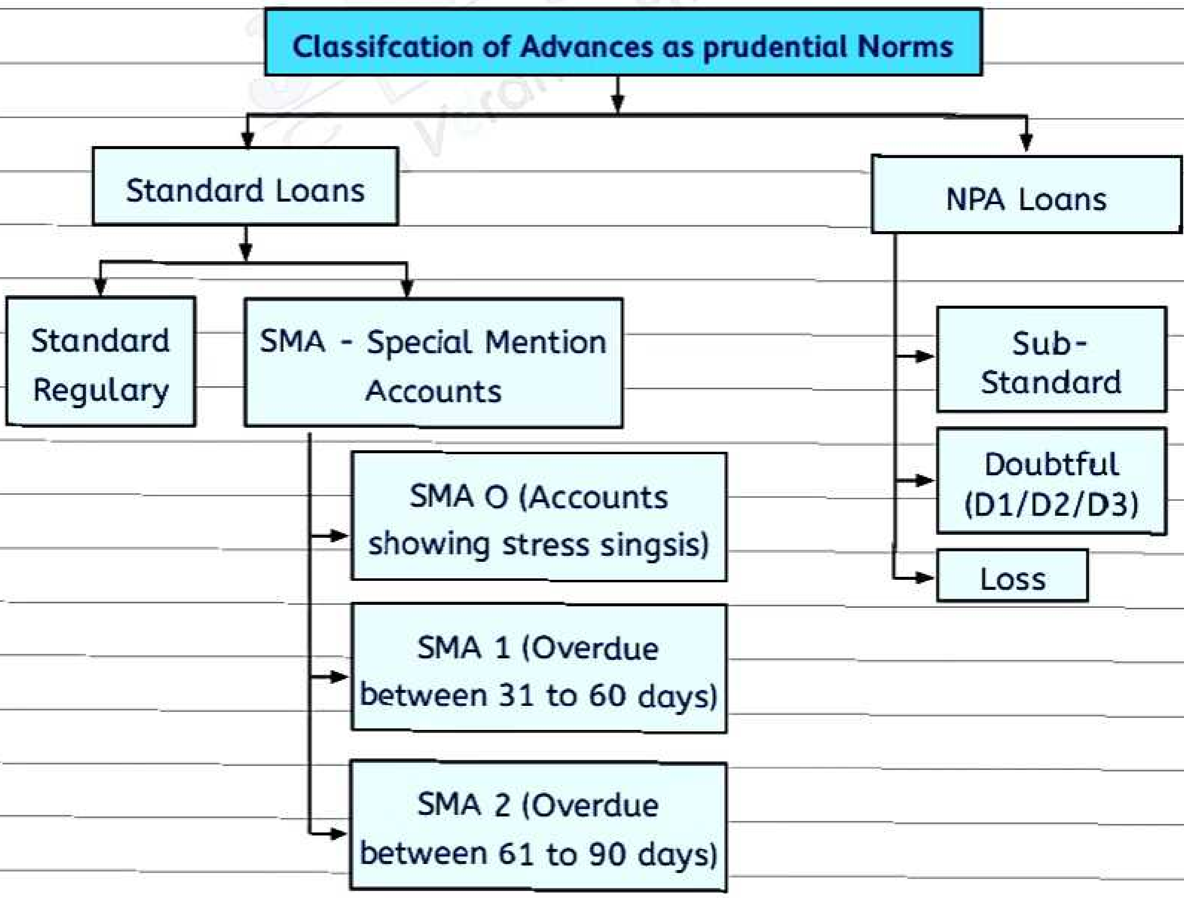
(iv) **Assignment:** Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favor of another person. Only action able claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.

(v) **Set-off:** Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor. The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right (i.e., the capacity of the account holder in both the accounts should be the same). For the purpose of set-off, all the branches of a bank are treated as one single entity. The right of set-off can be exercised in respect of time-barred debts also.

(vi) **Lien:** Lien is creation of a legal charge with consent of the owner, which gives lender a legal right to seize and dispose / liquidate the asset under lien.

12.6 Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances:

Classification of Advances as per RBI Prudential Norms



(i) Non-performing Assets: An asset becomes NPA when it ceases to generate income for the Bank.

A non-performing asset (NPA) is a loan or an advance where:

- interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a term loan;
- the account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/ CC);
- the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.

(ii) Out of Order: An account should be treated as 'out of order' if:

- the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or
- In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet ; or
- credits are there but are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

Example:

A Ltd. has been sanctioned a Cash Credit Facility by ADB Bank Ltd. for INR 50 lacs but as per the Stock Statements furnished for the last quarter, the Bank has calculated the Drawing power to be INR 42 Lakhs. In this case, the account would be termed as OUT OF ORDER if :-

- the outstanding balance remains continuously in excess of the INR 50 lacs/42 lacs whatever the case may be; or
- The outstanding balance in the account is less than INR 42 lacs but there are no credits or any payments deposited into this account continuously for 90 days as on the date of Balance Sheet; or
- credits are there upto say INR 2 lakhs but are not enough to cover the interest debited during the same period which is around INR 5 lakhs.

(iii) Overdue: Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

Source :- inventiva.co.in

Categories of Non-Performing Assets:	Provision required
• **Substandard Assets:** Would be one, which has remained NPA for a period less than or equal to 12 months.	
• **Doubtful Assets:** Would be one, which has remained in the substandard category for a period of 12 months. **Sub-categories:** Doubtful up to 1 Year (D1) Doubtful 1 to 3 Years (D2) Doubtful more than 3 Years (D3)	(Secured + Unsecured) 25% + 100% 40% + 100% 100% 100%
• **Loss Assets:** Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Note:

1. Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise.

2. Asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA.

Example:

Mr. Raman has availed two Loan facilities - a Car Loan as well as a Housing Loan from XYZ Bank Ltd. He is regular in depositing the Housing loan EMI but has not deposited the last 4 EMI's of the Car Loan due to paucity of funds. Hence, in this case, not only the Car loan but the Housing Loan would also be treated as an NPA, although it is going good and there are no irregularities because the NPA classification is Borrower wise (Mr. Raman) and not Facility wise (Car & Housing Loan individually).

(iv) Accounts regularized near the Balance Sheet Date: The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as NPA. The auditor should check for sample transactions immediately before the closing of the Financial Year and immediately after the closing of the Financial year to get a knowledge of the objective behind the transactions if they have any relation to each other in the Borrower accounts or if any/some transactions are being reversed during the first few days after closing which might show an arrangement to prevent the Borrower account(s) from slipping into the NPA category.

(v) Government Guaranteed advances:-

- Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.
- The situation would be different if the advance is guaranteed by State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.

(vi) Advances under Consortium:

Consortium advances mean advancing loans to a borrower by two or more Banks jointly by forming a Consortium. Usually, a Bank with a higher share will lead the consortium.

Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

12.7 Accounts where there is erosion in the value of security / frauds committed by borrowers

Erosion means the gradual destruction or diminution of something not prudent to follow stages of asset classification. It should be straight-away classified as doubtful or loss asset as appropriate as follows:

(i) Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straight-away classified under doubtful category and provisioning should be made as applicable to doubtful assets.

(ii) If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straight-away classified as loss asset. It may be either written off or fully provided for by the bank.

12.8 Advances Against Term Deposits, NSCs, KVPs/ IVPs, etc.

Advances against Term Deposits, NSCs eligible for surrender, KVP/IVP and life policies need not be treated as NPAs, provided adequate margin is available in the accounts.

12.9 Agricultural Advances Affected by Natural Calamities

Master Circular issued by the RBI deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities. Banks may decide on their own relief measures, viz., conversion of the short term production loan into a term loan or re-schedulement of the repayment period and the sanctioning of fresh short term loan, subject to the guidelines contained in RBI's latest Master Circular on Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances. In such cases, the NPA classification would be governed by such rescheduled terms.

12.10 Advances to Staff

Interest-bearing staff advances as a banker should be included as part of advances portfolio of the bank. In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of installment of principal or payment of interest on the respective due dates.

12.11 Agricultural Advances

As per the guidelines, Agricultural Advances are of two types:

(1) Agricultural Advances for "long duration" crops; and

(2) Agricultural Advances for "short duration" crops.

The "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops.

The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons; and

A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

13. COMPUTATION OF DRAWING POWER

1. Meaning:- Drawing Power generally addressed as "DP" is an important concept for Cash Credit (CC) facility availed from banks and financial institutions. Drawing power is the limit up to which a firm or company can withdraw from the working capital limit sanctioned.

2 Different from Sanctioned Limit:- The Sanctioned limit is the total exposure that a bank can take on a particular client for facilities like cash credit, overdraft, export packing credit, non-funded exposures etc. On the other hand, Drawing Power refers to the amount calculated based on primary security less margin as on a particular date.

3. Considerations:- All accounts should be kept within both the drawing power nd the sanctioned limit at all times. The accounts which exceed the sanctioned

limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head Office regularly.

4. Bank's Duties:- Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets. Drawing power is required to be arrived at based on current stock statement. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.

5. Auditor's Concern:- The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail.
The audited Annual Report submitted by the borrower should be scrutinized properly. The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.

6. Computation of DP:- It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

7. Stock Audit:- The stock audit should be carried out by the bank for all accounts having funded exposure of more than 5 crores. Auditors can also advise for stock audit in other cases if the situation warrants the same. Branches should obtain the stock audit reports from lead bank in the cases where the Bank is not leader of the consortium of working capital. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

Particulars of current assets DP			DP
(A) Stocks			
Stocks at realizable value		1000	
Less: Unpaid stocks:			
- Sundry creditors	300		
- Acceptances/LCs etc.	300	600	
Paid for stocks		400	
Margin @ 25%		100	100
(B) Debtors			
Total Debtors		1000	
Less: Ineligible debtors		200	
Eligible debtors		800	
Margin @ 40%		320	480
Total DP			**780**

14 AUDIT OF ADVANCES

Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted The audit of advances requires the major attention from the auditors.

14.1 In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

(a) Amounts included in balance sheet in respect of advances which are outstanding at the date of the balance sheet.

(b) Advances represent amount due to the bank.

(c) Amounts due to the bank are appropriately supported by loan documents and other documents as applicable to the nature of advances.

(d) There are no unrecorded advances.

(e) The stated basis of valuation of advances is appropriate and properly applied and the recoverability of advances is recognised in their valuation.

(f) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.

(g) Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

14.2 The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- examining the validity of the recorded amounts;
- examining loan documentation;
- reviewing the operation of the accounts;
- examining the existence, enforceability and valuation of the security;
- checking compliance with RBI norms including appropriate classification and provisioning; and
- carrying out appropriate analytical procedures.

14.3 Evaluation of Internal Controls over Advances: The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, inter alia, the following:

- The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.
- All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- The compliance with the terms of sanction and end use of funds should be ensured.
- Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.

- Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
- The accounts should be kept within both the drawing power and the sanctioned limit.
- All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- The operation of each advance account should be reviewed at least once a year and at more frequent intervals in the case of large advances.

15. AUDIT OF REVENUE ITEMS - PROFIT AND LOSS ACCOUNT

15.1 Income

15.1.1 Audit Approach and Procedures for Income earned by Bank

- Auditor's Concern:- In carrying out audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertained to the bank, there is no unrecorded income and the income is recorded at appropriate amount.

- RBI's Directions:- RBI has advised that in respect of any income which exceeds one percent of the total income of the bank if the income is reckoned on a gross basis or one percent of the net profit before taxes if the income is reckoned net of costs, should be considered on accrual as per Accounting Standard 9.

- Materiality:- If any item of income is not considered to be material as per the above norms, it may be recognised when received and the auditors need not qualify their report in that situation.

- Revenue Certainty:- Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection.

- **Revenue Uncertainty:-** In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on nonperforming assets until it is actually realised.

- **Advances against Securities:-** Interest on advances against Term Deposits, National Savings Certificates (NSCs), Indira Vikas Patras (IVPs), Kisan Vikas Patras (KVPs) and Life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.

- **Bills Purchased:-** In the case of bills purchased outstanding at the close of the year the discount received thereon should be properly apportioned between the two years.

- **Bills for Collection:-** In the case of bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected. The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its agents, etc. The commission of the branch becomes due only when the bill has been collected.

- **Renegotiations:-** Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.

- **Reversal of Income:**
  (a) If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.
  (b) In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

(c) Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).

(d) Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

15.1.2 On leased assets:

The component of finance income (as defined in AS 19 – Leases) on the leased asset which was accrued and credited to the income account before the asset became non-performing and remaining unrealised, should be reversed or provided for in the current accounting period.

15.1.3 On Take-out finance:

A takeout loan is a method of financing whereby a loan that is procured later is used to replace the initial loan. More specifically, a takeout loan, or takeout financing, is long-term financing that the lender promises to provide at a particular date or when particular criteria for completion of a project are met.

Takeout loans are commonly used in property development (Source: Investopedia). In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognize income unless realised from the borrower/taking-over institution (if the arrangement so provides).

15.1.4 On Partial Recoveries in NPAs:

In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner. The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/

derecognised or not recognised in the past should be accounted.

Interest partly/fully realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

15.1.5 Memorandum Account:

On an account turning NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account and stop further application of interest. However, banks may continue to record such accrued interest in a Memorandum account in their books for control purposes. For the purpose of computing Gross Advances, interest recorded in the Memorandum account should not be taken into account.

15.1.6 Income from Investments:

This includes all income derived from Government securities, bonds and debentures of corporates and other investments by way of interest and dividend, except income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India.

15.1.7 Profit on Sale of Investments:

Investments are dealt in the course of banking activity and hence the net profit or loss on sale of investments is taken to profit and loss account.

15.1.8 Profit/Loss on Revaluation of Investments:

In terms of guidelines issued by the RBI, investments are to be valued at periodical intervals and depreciation or appreciation in valuation should be recognised and taken to profit and loss account.

15.2 Expenses

Expenditure is to be shown under three broad heads:

(1) Interest expense

(2) Operating expense

(3) Provisions and contingencies.

15.2.1 Audit Approach and Procedures for Expense

(A) For Audit of Interest Expense

(i) In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense by analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. In modern day banking, the entries for interest expenses are automatically generated through a batch process in the CBS system.

(ii) The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.

(iii) The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.

(iv) The auditor should, on a test check basis, verify the calculation of interest and ensure that:

(a) Interest has been provided on all deposits upto the date of the balance sheet;

(b) Interest rates are in accordance with the bank's internal regulations, the RBI directives and agreements with the respective deposit holder;

(c) Interest on savings accounts are in accordance with the rules framed by the bank/RBI in this behalf.

(d) Interest on inter-branch balances has been provided at the rates prescribed by the head office/RBI.

(B) For audit of Operating expenses, the auditor should:-

- study and evaluate the system of internal control relating to expenses, including authorization procedures in order to determine the nature, timing and extent of his other audit procedures.
- should examine whether there are any divergent trends in respect of major items of expenses.
- perform substantive analytical procedures (preform a given

below for reference) in respect of these expenses. e.g. assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.

- verify expenses with reference to supporting documents and check the calculations wherever required.

(C) For audit of Provisions and contingencies the auditor should:

- ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
- obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. The auditor may verify the loan classification on a sample basis.
- obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
- obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation.
- examine the other provisions for expenses vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

15.3 Disclosure of the prior period items

Since the format of the profit and loss accounts of banks prescribed in Form B under Third Schedule to the Banking Regulation Act, 1949 does not specifically provide for disclosure of the impact of prior period items on the current year's profit and loss, such disclosures, wherever warranted, may be given.

11 ETHICS AND TERMS OF AUDIT ENGAGEMENTS

1. MEANING OF ETHICS – A STATE OF MIND

The term "Ethics" means moral principles which govern a person's behaviour or his conducting of an activity.

2. NEED FOR PROFESSIONAL ETHICS

Professional ethics seek to protect the interests of the profession as a whole and act as a shield that enables us to command respect.

A Chartered Accountant, either in practice or in service, has to abide by ethical behaviours. They are expected to follow the fundamental principles of professional ethics while performing their duties.

3. PRINCIPLES BASED APPROACH VS RULES BASED APPROACH TO ETHICS (ETHICAL OR LEGAL)

The essence of principles-based approach to ethics is that it requires compliance with spirit of ethics. It requires accountants to exercise professional judgment in every situation based upon their professional knowledge, skill and expertise.

However, rules-based approach to ethics strictly follows clearly established rules. It may lead to a narrow outlook and spirit of ethics may be overlooked while strictly adhering to rules. Further, rules- based approach is somewhat rigid as it may not be possible to deal with every practical situation relying upon rules.

Therefore, it is necessary that spirit of code is followed.

4. FUNDAMENTAL PRINCIPLES OF PROFESSIONAL ETHICS

1. Integrity

(a) A professional accountant shall comply with the principle of integrity, which Requires an accountant to be straightforward and honest in all professional And business relationships. Integrity implies fair dealing and truthfulness.

(b) A professional accountant shall not knowingly be associated with reports, Returns, communications or other information where the accountant believes That the information contains a materially false or misleading statement; Contains statements or information provided negligently or omits or obscures Required information where such omission or obscurity would be misleading.

2. **Objectivity**

The principle of objectivity requires an auditor not to compromise Professional judgment because of bias, conflict of interest or undue influence of others.

3. **Professional competence and due care**

It requires an accountant to attain and maintain professional knowledge and skill at the level required and act diligently and in accordance with applicable technical and professional standards.

4. **Confidentiality**

Confidentiality principle requires a professional accountant to respect the confidentiality of information acquired as a result of professional or business relationships. i.e. information will not be disclosed to a third party.

However, such confidential information may be disclosed, for example, when it is required by law, when it is permitted by law and is authorised by the client or employer or there is a professional duty or right to disclose.

5. **Professional Behaviour**

It requires an accountant to comply with relevant laws and regulations and avoid any conduct that the accountant knows or should know might discredit the profession.

5. INDEPENDENCE OF AUDITORS

Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him, or to his own self-interest.

Independence is a condition of mind as well as 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.

There are two interlinked perspectives of independence of auditors, one, independence of mind and two, independence in appearance.

Independence is:

(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; and

(b) Independence in appearance – the avoidance of facts and circumstances that a reasonable and informed third party, having knowledge of all relevant information, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised. Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

Independence is dependent on the state of mind and character of a person and is a very subjective matter. One person might be independent in a particular set of circumstances, while another person might feel he is not independent in similar circumstances. It is therefore the duty of every Chartered Accountant to determine for himself whether or not he can act independently in the given circumstances of a case and quite apart from legal rules, in no case to place himself in a position which would compromise his independence.

6. THREATS TO INDEPENDENCE

Following five types of threats to independence of auditors are discussed below:

1. Self-interest threats

Self-interest threats occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include

(i) direct financial interest or materially significant indirect financial interest in a client

(ii) loan or guarantee to or from the concerned client

(iii) undue dependence on a client's fees and, hence, concerns about losing the engagement

(iv) close business relationship with an audit client

(v) potential employment with the client and

(vi) contingent fees for the audit engagement

2. Self-review threats

Self-review threats occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client. Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements.

These include management services, internal audit, investment advisory service etc. Instances where such threats come into play are: -

(i) when an auditor having recently been a director or senior officer of the company.

(ii) when auditors perform services that are themselves subject matters of audit.

3. Advocacy threats

Advocacy threats occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, e.g., when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes. In such situations, auditor can be perceived as backing and championing causes of auditee client and it may lead to belief that auditor is not acting and working objectively.

4. Familiarity threats

Familiarity threats are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. This can occur in many ways including:

(i) close relative of the audit team working in a senior position in the client company

(ii) former partner of the audit firm being a director or senior employee of the client

(iii) long association between specific auditors and their specific client counterparts and

(iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.

Provisions in Companies Act, 2013 regarding rotation of auditors mainly address these very familiarity threats.

5. **Intimidation threats**

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

7. SAFEGUARDS TO INDEPENDENCE

The following guiding principles are to be applied: -

- For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.
- Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
- When such threats exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level. All such safeguards measures need to be recorded in a form that can serve as evidence of compliance with due process.
- If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

8. PROFESSIONAL SKEPTICISM

(A) Meaning:

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

(B) When to apply Professional skepticism:

- 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.

(C) Benefits:

Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

(D) General Point:

→ Professional skepticism is necessary to the critical assessment of audit evidence. The auditorc may accept records and documents as genuine unless the auditor has reason to believe the contrary.

→ In cases of doubt about the reliability of information or indications of possible fraud, the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

→ The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance.

→ Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism.

9. AGREEING THE TERMS OF AUDIT ENGAGEMENTS

SA 210 deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance.

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.

9A Preconditions for an audit

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

(a) Determine whether the financial reporting framework is acceptable and

(b) Obtain the agreement of management that it acknowledges and understands its responsibility:

(i) For the preparation of the financial statements in accordance with the applicable financial reporting framework including where relevant their fair representation;

(ii) For such internal control as management considers necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

(iii) To provide the auditor with:

- 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;
- Additional information that the auditor may request from management for the purpose of the audit; and
- Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

9B Agreement on audit engagement terms

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

The audit engagement letter is sent by the auditor to his client. Such a letter includes:-

(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.

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.

For ABC Co.
Chartered Accountants
Firm's Registration Number

(Signature)
(Name of the Member)
(Designation)

11. WHAT HAPPENS IF PRECONDITIONS FOR AN AUDIT ARE NOT PRESENT?

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.

12. 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.

13. ACCEPTANCE OF A CHANGE IN THE TERMS OF THE AUDIT ENGAGEMENT

The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so.

13.1 Request from Entity to change the Terms of Audit Engagement-When Reasonable Justification Exists?

A request from the entity for the auditor to change the terms of the audit engagement may result from

(a) a change in circumstances affecting the need for the service.

(b) a misunderstanding as to the nature of an audit as originally requested or

(c) a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances.

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.

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.

13.2 What should auditor consider before agreeing to change the audit engagement to the engagement providing lower level of assurance?

→ 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.

→ 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 also need to assess any legal or contractual implications of the change.

→ 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.

13.3 Recourse available to auditor in situation of nonagreement to a change in terms of engagement and lack of permission from management to continue original audit engagement

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.

14. TERMS OF ENGAGEMENT IN RECURRING AUDITS

Recurring audit is an audit which is performed by an auditor over years. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

The following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

(i) Any indication that the entity misunderstands the objective and scope of the audit.

(ii) Any revised or special terms of the audit engagement.

(iii) A recent change of senior management.

(iv) A significant change in ownership.

(v) A significant change in nature or size of the entity's business.

(vi) A change in legal or regulatory requirements.

(vii) A change in the financial reporting framework adopted in the preparation of the financial statements.

(viii) A change in other reporting requirements.

15. AUDIT QUALITY

The purpose of an independent audit is to provide confidence to users of audited financial statements.

SQC 1 and SA 220 both deal with quality control. Whereas SQC 1 deals with all engagements including audits, reviews and other assurance and related service engagements, SA 220 applies to audit engagements only.

Further, SQC 1 applies to entire firm. However, SA 220 applies to a particular audit engagement.

16. SQC 1 – "QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS AND REVIEWS OF HISTORICAL FINANCIAL INFORMATION, AND OTHER ASSURANCE AND RELATED SERVICES ENGAGEMENTS"

SQC 1 requires that 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 or engagement partners are appropriate in the circumstances.

Firm's system of quality control should consist of policies designed to achieve these objectives.

17. ELEMENTS OF SYSTEM OF QUALITY CONTROL

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

(A) Leadership responsibilities for quality within the firm
(B) Ethical requirements
(C) Acceptance and continuance of client relationships and specific engagements
(D) Human resources
(E) Engagement performance
(F) Monitoring

17A. Leadership responsibilities for quality within the firm

Such policies and procedures should require the firm's chief executive officer or the firm's managing partners to assume ultimate responsibility for the firm's system of quality control. Managing partners should have sufficient and appropriate experience, ability and the necessary authority to assume that responsibility.

17B. Ethical requirements

→ 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 contained in the Code of ethics issued by ICAI.

→ The Code establishes the fundamental principles of professional ethics which include integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

→ Observance of "Independence" in all engagements is the basic requirement. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and (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

(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.

17C. Acceptance and Continuance of Client Relationships and Specific Engagements

A firm before accepting an engagement should acquire vital information about the client. Such an information should help firm to decide about: -

- Integrity of Client
- Competence (including capabilities, time and resources) to perform engagement
- Compliance with ethical requirements

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.

If there is any conflict of interest between the firm and client, it should be properly resolved before accepting the engagement. Where the firm obtains information that would have caused it to decline an engagement if that information had been obtainable 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.

17D. Human resources

The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances. Such policies and procedures should address relevant HR issues including recruitment, compensation, training, career development, performance evaluation etc.

17F. Monitoring

The firm should ensure that 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.

18. SA 220- "QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS"

As per SA 220, 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.

SA 220 is modelled on lines of SQC 1. It describes responsibilities of engagement partner in relation to following matters:

(A) Leadership responsibilities for quality on audits

(B) Relevant ethical requirements

(C) Acceptance and continuance of client relationships and audit engagements

(D) Assignment of engagement teams

(E) Engagement performance

(F) Monitoring

18A. Leadership responsibilities for quality on audits

Leadership responsibility of an engagement partner is to take responsibility for the overall quality on each audit engagement. 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.

(b) The fact that quality is essential in performing audit engagements.

18B. Relevant ethical requirements

The responsibilities of an engagement partner in relation to ethical requirements in an audit engagement are as under: -

- Identifying a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level.

- Reporting by engagement partner to the relevant persons 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.

18C. Acceptance and Continuance of Client Relationships and audit Engagements

Information like integrity of principal owners, competence of engagement team and consideration of necessary capabilities including time and resources, compliance with relevant ethical requirements and significant matters arisen during current or previous audit engagement and their implications assist the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate.

18D. Assignment of engagement teams

It should be ensured by engagement partner 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 engagement in accordance with professional standards and regulatory and legal requirements.

18E. Engagement Performance

Engagement partner has the responsibility for direction, supervision and performance of audit engagement in accordance with professional standards and regulatory and legal requirements.

Engagement partner is also responsible for ensuring undertaking appropriate consultation on difficult or contentious matters by engagement team not only within the team but also with others at appropriate level within or outside the firm.

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.

(c) Not date the auditor's report until the completion of the engagement quality control review.

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.

18F. 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.

The engagement partner should document following matters pertaining to an audit engagement: -

(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.