CHAPTER 1-NATURE, OBJECTIVE AND SCOPE OF AUDIT

MEANING OF AUDIT

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.

Auditor should check following to ensure that financial statements are not misleading:

- No entry is omitted from books of account.
- Accounts are drawn from entries in the books of account.
- Entries are adequately supported by SAAE.
- Information in the financial statements is clear & unambiguous.
- Financial statements presents a true and fair picture of the results & assets and liabilities.
- Financial statements are properly classified, described & disclosed as per Accounting Standards (AS).

INTERDISCIPLINARY NATURE OF AUDITING-RELATIONSHIP WITH DIVERSE SUBJECTS

Accounting	Auditor reviews financial statements which are nothing but results of accounting process.
Law	Auditor should have good knowledge of business law affecting entity.
Economics	Auditor to be familiar with the overall economic environment of the client.
Behavioural Science	Knowledge of human behaviour is essential for an auditor to effectively discharge his duty.
Statistics & Mathematics	Auditor to have knowledge of statistical sampling for meaningful conclusion and mathematics for verification of inventory.
Data Processing	EDP auditing in itself is developing as discipline in itself.
Financial Management	Knowledge about financial techniques such as: Working Capital Management, fund flow, etc.
Production	Understand the business functions of client such as: Production, cost system, marketing, etc.

SA 200 – OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND THE CONDUCT OF AUDIT AS PER STANDARDS OF AUDITING

OVERALL OBJECTIVES OF THE AUDITOR

- To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatements and express opinion whether financial statements are prepared in accordance with AFRF.
- To report on the Financial Statements as required by SA.

SCOPE OF AUDIT

INCLUSIONS:

- Coverage of all aspects of entity relevant to the financial statements being audited.
- Reliability and sufficiency of financial information by making study and assessment of accounting and internal control system.
- Proper disclosure of financial information by ensuring financial statements properly summarize events and transactions and adequate disclosure of accounting policies and accounting estimates.

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- **EXCLUSIONS:**
  - Responsibility of preparation and presentation of financial statements.
  - Duties outside scope of competence of auditor.
  - Expertise in authentication of documents.
  - Investigation.

- **INHERENT LIMITATION OF AUDIT**
  - **Nature Of Financial Reporting:** Preparation of financial statements involve judgement of management which is subjective decisions or assessments or degree of uncertainty. Check reasonableness of estimates & qualitative aspects of Accounting Practices.
  - **Nature Of Audit Procedure:** Management may not provide information intentionally or unintentionally. Fraud involves sophisticated & carefully organized schemes.
  - Audit is not an official investigation & no legal power to search.
  - **Timeliness and Cost & Benefit:** Matters may be omitted involving difficulty, time or cost. Appropriate planning helps in sufficient time & resource available during audit.
  - **Future events:** Future adverse events may seriously affect ability of an entity to continue its Business.

BENEFITS OF AUDIT: WHY AUDIT IS NEEDED?

- Provides high quality information.
- Safeguards financial interest of persons who are not associated with the management.
- Acts as a moral check on the employees.
- Helpful in determining tax liabilities by government.
- Relied upon by banks or lenders.
- Help in the detection of frauds or errors.
- Helps in reviews of existence & operations of various controls in the organisations.

AUDIT-MANDATORY OR VOLUNTARY?

- **Audit required under law:** Audit conducted as per the provisions of the concerned law.
- **Voluntary Audit:** No legal requirements to conduct the audit.

WHO APPOINTS THE AUDITOR?

- Owners in case of most entities; or
- Comptroller & Auditor General in case of Government companies.

TO WHOM REPORT IS SUBMITTED?

To the person making the appointment.

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.

- **ELEMENTS OF AN ASSURANCE ENGAGEMENT**
  - **A three-party relationship involving a practitioner, a responsible party, and intended users.** ***Practitioner*** provides assurance; ***Responsible party*** prepares subject matter and ***intended users***, for whom report is prepared.

- **An appropriate subject matter:** Information to be examined by the practitioner.
- **Suitable Criteria:** Benchmarks used to evaluate the subject matter like standards, guidance, laws, rules and regulations.

- **An appropriate subject matter:** Information to be examined by the practitioner.
- **Suitable Criteria:** Benchmarks used to evaluate the subject matter like standards, guidance, laws, rules and regulations.
- Sufficient appropriate evidence: "Sufficient" relates to quantity of evidence obtained by auditor. "Appropriate" relates to quality of evidence obtained by auditor.
- **Written assurance report in appropriate form:** Outcome of an assurance engagement.

AUDIT *VS.* REVIEW

Audit	Review
Reasonable assurance engagement.	Limited assurance engagement.
Provides high level of assurance.	Provides lower level of assurance.
Elaborate extensive procedure to obtain evidence.	Fewer procedures to obtain evidence.
Obtain sufficient appropriate evidence to draw reasonable conclusion.	Obtains sufficient appropriate evidence to draw limited conclusion.

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.

AUDIT *VS.* INVESTIGATION:

Investigation is a critical examination of the accounts with a special purpose *vs.* Audit objective is to obtain reasonable assurance that financial statements are free from material misstatement & express an opinion thereon. Investigation may result from *prima facie* evidence of audit.

QUALITIES OF AUDITOR

Must have tact, caution, firmness, good temper, integrity, discretion industry, judgement, patience, clear headedness & reliability. Knowledge of law, all accounting principles & techniques. Highest level of integrity backed with independence. Both practical and theoretical education of finance & accounts, business, law etc.

ENGAGEMENT AND QUALITY CONTROL STANDARDS: AN OVERVIEW

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

➢ **STANDARDS ON AUDITING (SAs)** which apply in audit of historical financial information. Establish high quality benchmarks and are followed by auditors in conducting audit of financial statements.
***For example,* Audit of Annual financial statement of all companies**
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 500 Audit Evidence.
- Revised SA 700 forming an opinion and reporting on financial statements.

➢ **STANDARDS ON REVIEW ENGAGEMENTS (SREs)** which apply in review of historical financial information. Review is a limited assurance engagement and it provides assurance which is lower than that provided by audit. It is due to the fact that review involves fewer procedures as compared to audit.
***For example,* Review of Quarterly financial statements of Listed Companies**
Examples of Standards on Review engagements are:

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- SRE 2400 (Revised) Engagements to Review Historical Financial Statements.

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- SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity.

➢ **STANDARDS ON ASSURANCE ENGAGEMENTS (SAEs)** which apply in assurance engagements other than audits and review of historical financial information. Such assurance engagements do not include "audit" or "review" of historical financial information.
***For example,* Audit of Prospective financial statements and Audit of Internal Controls.**
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.

➢ **STANDARDS ON RELATED SERVICES (SRSs)** which apply in agreed upon procedures to information,compilation engagements and other related service engagements. An engagement in which practitioner may be called upon to assist management with the preparation and presentation of historical financial information without obtaining assurance on that information. Practitioner issues a report clearly stating that it is not an assurance engagement and no opinion is being expressed.
***For example,* Preparation of financial statements, Consolidation, etc.**
Examples of Standards on related services are:
- SRS 4400 Engagements to perform agreed-upon procedures regarding financial information.
- SRS 4410 (Revised) Compilation engagements.

➢ **STANDARDS ON QUALITY CONTROL**
Standards on Quality Control (SQCs) have been issued to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for the conduct of audit and review of historical financial information and for other assurance and related service engagements.
Why are Standards needed?
- Ensure carrying out of audit against established benchmark.
- Improve quality of financial reporting.
- Promote uniformity.
- Equip professional accountants with professional knowledge and skill.
- Ensure audit quality.

Duty of professional accountants to follow Standards. If not followed, reason for departure to be stated in reports.

Question Solver Points:
1. Objective of Audit is to obtain reasonable assurance and give opinion. Basic objective does not change with nature, size or form. **(PP Book-C/I- Q.7)**
2. Auditor is not an Insurer, cannot be expected to reduce audit risk to zero. **(PP Book-C/I- Q.3)**
3. Auditor can give only reasonable assurance due to inherent limitations of Audit. **(PP Book-C/I- Q.13)**
4. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. **(PP Book-C/I- Q.12)**
5. Responsibility of management to prepare financial statement and establish IC.
6. Scope of Audit is to examine all aspects of entity's operations.
7. Audit is closely related to Accounting and Law. **(PP Book- Q11 and 12)**
8. An audit is distinct from investigation. However, it is quite possible that sometimes investigation results from the *prima facie* findings of the auditor. **(PP Book- Q18)**
9. Assurance is provided by audit by means of written audit report.
10. 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.

11. Assurance engagement consists of five elements consisting of– a three party relationship, an appropriate subject matter, suitable criteria, sufficient appropriate evidence and a written assurance report in appropriate form.
12. Audit is a reasonable assurance engagement. Review is a limited assurance engagement. **(PP Book-C/I- Q.9)**
13. Assurance engagements consist of reasonable assurance engagements limited assurance

11.	Assurance engagement consists of five elements consisting of– a three party relationship, an appropriate subject matter, suitable criteria, sufficient appropriate evidence and a written assurance report in appropriate form.
12.	Audit is a reasonable assurance engagement. Review is a limited assurance engagement. **(PP Book-C/1- Q.9)**
13.	Assurance engagements consist of reasonable assurance engagements, limited assurance engagements and assurance engagements dealing with matters other than historical financial information. **(PP Book Q. 14)**
14.	SA, SRE, SAE and SRS are 4 engagement standards. It applies on a particular engagement.
15.	SQC is a firm level standard which applies on all engagement.
16.	Audit does not provide assurance to investor in shares regarding safety of his money.

PERFECT REVISION QUESTIONS

Q. No.	Questions and Answers
1.	**Explain the meaning of Auditing. How would you, as an auditor, perform an audit?**
Ans.	An **Audit** is an independent examination of financial information of any entity, whether profit-oriented or not, and irrespective of its size and legal form, when such an examination is conducted with a view to expressing an opinion thereon. **As an auditor, we should ensure the following things:** **(a)** The accounts have been drawn up with reference to entries in the books. **(b)** The entries in the books are adequately supported by sufficient and appropriate evidence. **(c)** No entries are omitted from the books of accounts, and no extra entries are done in the process of making the financial statements. **(d)** The information conveyed by the financial statements is clear and unambiguous. **(e)** The accounts present a true and fair picture of the assets and liabilities. **(f)** The amounts in the financial statements are properly classified, described and disclosed as per Accounting Standards.
2.	**RAG is a proprietorship firm engaged in the manufacturing of textile and handloom products. It sells its finished products both in the domestic as well as in the international market. The company is making a total turnover of ₹30 crores. It has also availed a cash credit limit of ₹5 crores from Canara Bank. In the year 2017-18, the proprietor of the firm is worried about the financial position of the company and is under the impression that since he is out of India, therefore firm might run into losses. He approaches a CA about the advantages of getting his accounts audited throughout the year so that he may not suffer due to accounting weaknesses. Advice regarding the advantages of getting accounts audited.**
Ans.	***Advantages of getting the accounts audited:*** **(a) It safeguards the financial interest** of persons who are not associated with the management of the entity, whether they are partners or shareholders, bankers, Financial Institutions, public at large, etc. **(b) It acts as a moral check** on the employees from committing defalcations or embezzlement. **(c)** Audited financial statements are **helpful in settling liability** for taxes, negotiating loans and determining the purchase consideration for a business. **(d)** These are also useful for settling trade disputes for higher wages or bonuses as well as claims in respect of damage suffered by the property, by fire or some other calamity. **(e)** An audit can also help in the detection of wastages and losses by showing the different ways by which these might be checked, especially those that occur due to the absence or inadequacy of internal checks or internal control measures.

	(f) Audit ascertains whether the necessary books of account and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respect. **(g)** As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies, etc., in them. **(h)** Audited accounts are of great help in the settlement of accounts at the time of admission

	(f) Audit ascertains whether the necessary books of account and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respect. (g) As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies, etc., in them. (h) Audited accounts are of great help in the settlement of accounts at the time of admission or death of a partner. Government may require audited and certified financial statements before it gives assistance or issues a license for a particular trade.
3.	**Choosing of appropriate accounting policies in relation to accounting issues is responsibility of management". Do you agree? Discuss duty of auditor, *if any*, in relation to accounting policies.**
Ans.	Choosing of appropriate accounting policies is responsibility of management. The role of auditor lies in evaluating selection and consistent application of accounting policies by management. **The scope of audit includes:** • Coverage of all aspects of entity. • Reliability and sufficiency of financial information. • Proper disclosure of financial information. The management is responsible for preparation and presentation of financial statements and makes many judgments in this process of preparing and presenting financial statements. *For example*, choosing of appropriate accounting policies in relation to various accounting issues like choosing method of charging depreciation on fixed assets or choosing appropriate method for valuation of inventories. 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.
4.	**An assurance engagement involves a three-party relationship. Discuss meaning of three parties in such an engagement.**
Ans.	A three-party relationship involving a practitioner, a responsible party, and intended users. An assurance engagement involves above said three parties. 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. A ***responsible party*** is the party responsible for preparation of subject matter. ***Intended users*** are the persons for whom an assurance report is prepared. These persons may use the report in making decisions.
5.	**Assurance engagements are not restricted to audit of financial statements alone. Discuss.**
Ans.	***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. 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.

Examples & Types of assurance engagements:

Examples of Assurance Engagement	Types of Assurance Engagement
Audit of financial statements	Reasonable Assurance Engagement
Review of financial statements	Limited Assurance Engagement
Examination of prospective financial	Provide assurance regarding reasonability of

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Examples of Assurance Engagement	Types of Assurance Engagement
Audit of financial statements	Reasonable Assurance Engagement
Review of financial statements	Limited Assurance Engagement
Examination of prospective financial information	Provide assurance regarding reasonability of assumptions forming basis of projections and related matters.

6. An audit does not provide absolute assurance. Discuss how nature of audit procedures itself is one of the reasons due to which audit cannot provide absolute assurance.

Ans. 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.

One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with applicable financial reporting framework and for devising suitable internal controls. However, such controls may not have operated to produce reliable financial information due to their own limitations.

7. Explain the qualities of the Auditor.

Ans. Qualities of an auditor are that auditor have 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.

8. Both accounting and auditing are closely related to each other. Explain.

Ans. **(a)** Both accounting and auditing are closely related to each other. Auditing reviews the financial statements, which are nothing but an overall accounting process. The auditor shall have a thorough knowledge of accounting principles for reviewing the financial statements.

(b) The knowledge of accounting is essential in the field of auditing as the auditor is required to communicate and express his opinions on the financial statements through his reports.

(c) If there are no financial statements, then there can be no auditing.

9. An audit does not provide absolute assurance. Discuss how nature of audit procedures itself is one of the reasons due to which audit cannot provide absolute assurance.

Ans. 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. There is no way by which auditor can force management to provide complete information as may be

requested by auditor. In case he is not provided with required information, he can only report.

The management may consist of dishonest and unscrupulous people and may be, itself, involved in fraud. It may be engaged in concealing fraud by designing sophisticated and carefully organized schemes which may be hard to detect by the auditor.

requested by auditor. In case he is not provided with required information, he can only report.
The management may consist of dishonest and unscrupulous people and may be, itself, involved in fraud. It may be engaged in concealing fraud by designing sophisticated and carefully organized schemes which may be hard to detect by the auditor.
It may produce fabricated documents before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine.
Due to above factors, nature of audit procedures itself is one of the reasons due to which audit cannot provide absolute assurance.

CHAPTER 2-AUDIT STRATEGY, AUDIT PLANNING & AUDIT PROGRAMME

SA 300 - PLANNING AN AUDIT OF FINANCIAL STATEMENT

- **RESPONSIBILITY OF AUDITOR:** Plan work to conduct an effective audit in an efficient and timely manner.
- **BENEFITS OF PLANNING:**
  - Devote attention to important areas.
  - Identify and resolve potential problems.
  - Organize & manage audit in effective & efficient manner.
  - Helps in selection of engagement team & allocation of work.
  - Facilitating direction, supervision and review of engagement team.
  - Coordination of work done by other auditors.
- **NATURE OF AUDIT PLANNING – A CONTINUOUS PROCESS:**

  Planning is not a discrete phase of an audit, but rather a continual and iterative process.
  It begins **after the completion of the previous audit** & **continues** till **completion of current audit** engagement. It includes audit procedures that need to be completed prior to the performance of further audit procedures.
  Includes consideration of matters such as obtaining knowledge about legal framework, determination of material or significant matter and performance of risk assessment procedures.
  The engagement partner and other key members of the engagement team shall be involved in planning the audit.

PLANNING PROCESS: ELEMENTS OF PLANNING

Elements of planning are:

I. Preliminary Engagement Activities
II. Planning Activities

I. PRELIMINARY ENGAGEMENT ACTIVITIES INCLUDE:

- **Performing procedures regarding the continuance of the client relationship:** Appropriate procedure regarding acceptance and continuance of client relationship and audit engagement.
- **Evaluating compliance with ethical requirements, including independence:** Engagement partner shall obtain information to identify threats, breaches of independence and take action to eliminate them.
- **Establishing an understanding of terms of engagement:** Auditor to send written engagement letter to management to avoid misunderstanding.

II. PLANNING ACTIVITIES

Planning involves:

(A) Establishing the overall audit strategy &
(B) Developing an audit plan.

(A) Establishing the Overall Audit Strategy: Sets scope, timing and direction of the audit and that guides thedevelopment of the audit plan.

- **Assists auditor in determining:**
  - Which resources to deploy to specific audit areas.
  - Amount of resources to be allocated.
  - When these resources are deployed.
  - How such resources are managed, directed and supervised.

➢ **Factors Consideration For Establishment of Overall Audit Strategy:**

- **Identify characteristics that define scope of engagement:** Applicable financial reporting framework, nature of the business segments (any specialization), use of audit evidence from previous audit (risk assessment procedures, TOCs, etc.).
- **Reporting objectives to ascertain timing & nature of communication of audit:**
  (i) Reporting timetable (Final/Interim).
  (ii) Meetings with management & those charged with governance for nature, extent & timing of audit.
  (iii) Management & those charged with governance discussion on time & type of report.
  (iv) Management discussion expected communication on status of audit work.
- **Consider factors significant in directing the engagement team's efforts:**
  Direct efforts towards matters which are significant such as relying on Internal Control where volume is high, new reporting requirements, change in FRF, significant change in legal environment.
- **Consider preliminary engagement activities results & knowledge gained:** (1) Area having high risk of material misstatement. (2) Previous audit results (including Internal Control effectiveness). (3) Volume of transactions to determine it is more efficient to rely on Internal Control.
- **Ascertain nature, extent and timing of resources necessary to perform audit:**
  (1) Selection of engagement team & work assignment
  (2) Engagement budgeting (including setting aside time for high risk of material misstatement areas).

(B) Developing an 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:

- The nature, timing and extent of planned risk assessment procedures.
- The nature, timing and extent of planned further audit procedures at assertion level.

✍ **Relationship between Audit Strategy & Audit Plan:** Plan is made based on overall audit strategy. Plan is made after overall audit strategy. Not discrete processes. Closely inter-related. Change in one result changes in other.

✍ **Change of Plan in during audit:** Due to unexpected events and overall audit strategy, plan needs to be updated. Accordingly, nature, extent and timing of further audit procedures will be revised.

➢ **Planning, supervision and review:** Nature, extent and timing of planning, supervision and review of engagement team may vary due to:
(a) The size & complexity of entity;
(b) Area of audit;
(c) Assessed Risk of Material Misstatement;
(d) Capabilities & competence of the individual team members performing the audit work.

✍ **Documentation**

The auditor shall document:
(a) Overall Audit Strategy;
(b) Audit plan;
(c) Any significant changes made and reasons of such change.

Audit strategy is a record of the key considered to plan an audit. Audit plan Documentation is a record

Audit strategy is a record of the key considered to plan an audit. Audit plan Documentation is a record of planned nature, extent and timing of risk assessment procedure and further audit procedure at the assertion level in response to the assessed risks. Serves as a record of the proper planning of the Audit Programme that can be reviewed & approved prior to their performance.

- **Audit Programme:** Series of verification procedures to be applied to the financial statements & accounts for the purpose of obtaining SAAE to enable the auditor to express an opinion on such financial statements.
  - **One audit programme – Not practicable to other:** Nature, size & composition, efficiency & operation of Internal Control and nature of the service may vary from assignment to assignment.
  - **Assistant to keep an open mind:** Assistant to keep an open mind beyond the programme. Note & report significant matters to his senior or engagement partner. Programme may be altered to take care of situations which were left out but are found relevant for the particular concern.
  - **Periodic Review of the Programme:** Periodically check whether programme is adequate.If any change in client's policy & obsolete programme continuous, it will result in audit conducted negligently & auditor may face legal consequences. To remove inadequacies or redundancies, periodic review should be done of programme along with client's operations & Internal Control.
  - **Construction of Audit Programme:**
    - Stay within the scope & limitation of the assignment.
    - Prepare written audit programme by setting procedure need to implement audit plan.
    - Determine evidence reasonably available & identify best evidence.
    - Apply those steps & procedures which are useful in verification purpose.
    - Include audit objectives for each area.
    - Consider all possibilities of error.
    - Coordinate the procedures to be applied to related items.

- **Audit programme- Designed to provide audit evidence:**
  (a) Documentary examination;
  (b) Physical examination;
  (c) Statements & explanation of management, officials & employees;
  (d) Statements & explanations of third parties;
  (e) Arithmetical calculations by the auditor;
  (f) State of Internal Controls & internal checks;
  (g) Inter-relationship of various accounting data;
  (h) Subsidiary and memorandum records;
  (i) Minutes;
  (j) Subsequent action by the client and by others.

- **Advantages of Audit programme:**
  (a) **Assistants** perform audit with clear set of instruction,
  (b) Total perspective ***(focus)*** of the work to be performed,
  (c) **Selection of assistants for job,**
  (d) Significantly less danger of ignoring/overlooking records,
  (e) Signature on programme fix responsibility of engagement team,
  (f) Guide for future audits,
  (g) Control progress of various audits in hand,
  (h) Serves as evidence.

- **Disadvantages of Audit Programme:**
  a) Work may become mechanical & may carry out without understanding object,
  b) Rigid & inflexible programme,
  c) Inefficient assistants may take shelterbehind the programme,
  d) Hard & fast programme may kill initiative of efficient & enterprising assistants.

Question Solver Points:

1. SA-300 states that objective of the auditor is to plan the audit so that it will be performed in an effective manner.

Question Solver Points:

1. SA-300 states that objective of the auditor is to plan the audit so that it will be performed in an effective manner.
2. Planning is not a discrete phase of an audit, but rather a continual and iterative process. **(PP book C/I- Q-4)**
3. Elements of planning include preliminary engagement activities and planning activities.
4. Preliminary engagement activities include performing procedures regarding continuance of client relationship, evaluating compliance with ethical requirements including independence and establishing an understanding of terms of engagement with the client so that there are no misunderstandings.
5. Planning activities include establishing overall audit strategy and developing audit plan.
6. Audit strategy sets scope, timing and direction of audit. **(PP book C/I- Q-7)**
7. Audit plan addresses various matters identified in overall audit strategy.
8. Audit plan includes nature, timing and extent of planned risk assessment procedures, planned further audit procedures and planned other audit procedures in accordance with SAs.
9. 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. **(PP book C/I- Q-8)**
10. Overall audit strategy, audit plan and changes made shall be documented by auditor.
11. 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.

PERFECT REVISION QUESTIONS

Q. No.	Questions and Answers

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Q. No.	Questions and Answers
1. Ans.	**An adequate planning benefits the audit of financial statements. Discuss.** Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following: **(a)** Helping the auditor to devote appropriate attention to important areas of the audit. **(b)** Helping the auditor identify and resolve potential problems on a timely basis. **(c)** Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner. **(d)** Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks and the proper assignment of work to them. **(e)** Facilitating the direction and supervision of engagement team members and the review of their work. **(f)** Assisting, where applicable, in the coordination of work done by auditors of components and experts.
2. Ans.	**Describe how the process of establishing the overall audit strategy assists the auditor in marshalling his human resources?** The process of establishing the overall audit strategy assists the auditor in marshalling his human resources in the following ways: **(a)** 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. **(b)** 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. **(c)** When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates. **(d)** 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, and whether to complete engagement quality control reviews.
3. Ans.	**"The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors." Explain.** The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. **The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:** **(a)** The size and complexity of the entity. **(b)** The area of the audit. **(c)** The assessed risks of material misstatement. **(d)** The capabilities and competence of the individual team members performing the audit work.
4.	**In establishing the overall audit strategy, the auditor shall ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required. Elaborate whether those cases by which the auditor can ascertain the reporting objectives of the engagement?**

Ans.	**Cases by which the auditor can <u>ascertain the reporting objectives</u> of the engagement:** **(a)** The <u>entity's timetable</u> for reporting, such as at interim and final stages. **(b)** The organization of <u>meetings with management</u> and those charged with governance to <u>discuss</u> the nature, timing and extent of the audit work. **(c)** The <u>discussion with management</u> and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance. **(d)** The <u>discussion with management</u> regarding the expected communications on the status of audit work throughout the engagement.
5.	**"Planning is not a discrete phase of an audit but rather a continual and iterative process." Discuss.**
Ans.	**(a)** As per <u>SA 300</u>, "Planning an Audit of Financial Statements", planning is a <u>continual process</u> that often begins shortly <u>after</u> the completion of the previous audit and continues <u>until</u> the completion of the current audit engagement. **(b)** Planning includes <u>consideration</u> of the <u>timing</u> of <u>certain activities</u> and <u>audit procedures</u> that need to be completed <u>prior</u> to the performance of further audit procedures. **(c)** *For <u>example</u>*, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as: • The <u>analytical procedures</u> are to be applied as risk assessment procedures. • Obtaining a <u>general understanding</u> of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework. • The determination of <u>materiality</u>. • The involvement of <u>experts</u>. • The performance of <u>other risk assessment procedures</u>.
6.	**Discuss how performing preliminary engagement activities as part of planning an audit assists auditor.**
Ans.	Performing preliminary engagement activities assists the auditor in identifying and evaluating events or circumstances that may affect auditor's ability to plan and perform audit engagement. **Following is included in Preliminary engagement activities:** **(a)** Preforming procedures regarding the continuance of client relationship. **(b)** Evaluating Compliance with ethical requirements including independence. **(c)** Establishing an understanding of terms of engagement with the client to ensure there are no misunderstandings.
7.	**Discuss how an engagement partner ensures that firm complies with relevant ethical requirements including independence in relation to client.**
Ans.	The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. **In doing so, the engagement partner shall:** **(a)** Obtain relevant information from the firm to identify and evaluate circumstances and relationships that create threats to independence; **(b)** Evaluate information on identified breaches, *if any*, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and **(c)** Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

8.	**An auditor of a company fails to document audit strategy and audit plan. Briefly outline consequences of such failure.**
Ans.	The auditor shall document: **(a)** the overall audit strategy; **(b)** the audit plan; and **(c)** any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team. The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances. Failure to document the overall audit strategy and audit plan. Auditor shall be hold negligent in performing the audit and will face legal consequences also.
9.	**Write *a* short note on the disadvantages of the use of an audit programme.**
Ans.	**The disadvantages of an audit programme 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. Also, 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.
10.	**Discuss the points to be considered by the auditor for constructing an audit programme.**
Ans.	**(a)** Stay within the scope and the limitation of the assignment. **(b)** Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction. **(c)** Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation. **(d)** Consider all possibilities of errors and coordinate the procedures to be applied to related items.

CHAPTER 3-RISK ASSESSMENT & INTERNAL CONTROL

✍ **AUDIT RISK:** Auditor gives inappropriate audit opinion when financial statements are materially misstated. Expresses an unmodified opinion when financial statements are materially misstated.

➢ **RISK OF MATERIAL MISSTATEMENT:** Risk that the financial statements are materially misstated prior to audit.
Risk of material misstatement at two levels:
(1) Overall financial statements level – which relates pervasively to the financial statements as a whole.
(2) Assertion level for classes of transactions, account balances & disclosures- assessed to determine nature, timing and extent of further audit procedures and obtain sufficient appropriate audit evidence.
Risk of Material Misstatement = Inherent Risk × Control Risk

➢ **COMPONENTS OF RISK OF MATERIAL MISSTATEMENT**

- **Inherent risk:** Susceptibility of an assertion about a class of transactions, account balance or disclosure to misstatement that could be material before consideration of any related controls. It can be higher for some assertions. External circumstances & entity and its environment may influence inherent risk. Important to consider reason for each inherent risk while designing test of controls & substantive procedures.
- **Control risk:** Risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, will not be prevented or detected and corrected, on a timely basis by the entity's internal control.

✍ **AUDIT RISK = RISK OF MATERIAL MISSTATEMENT × DETECTION RISK**

➢ **DETECTION RISK:** Procedures performed to reduce audit risk to acceptably low level will not detect a misstatement that exists & that could be material. **Detection risk may be reduced by increasing area of checking, testing larger samples and by including competent and experienced persons in the engagement team.**

➢ **AUDIT RISK-WHAT IS NOT INCLUDED?**

- Audit risk is a technical term. Does not include auditor's business risk.
- Does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not.

➢ **The assessment of risks is a matter of professional judgement, rather than a matter capable of precise measurement.**

- **Combined Assessment of the Risk of Material Misstatement**
SA do not refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments.

➢ **SA 315 - IDENTIFYING AND ASSESSING THE RISK OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT**

- **Identify and assess the risk of material misstatement:** At financial statement level & assertion level for classes of transactions, account balances and disclosures to provide a basis for designing and performing further audit procedure.
- **For this purpose:** (1) Identify risk by obtaining an understanding of the entity and its environment. (2) Assess identified risk. (3) Relate identified risks to what can go wrong at assertion level. (4)Consider likelihood & magnitude of misstatement.

- Information may be used by the auditor as audit evidence to support assessments of Risk of material misstatement. Perform substantive procedures or test of controls concurrently with risk assessment procedures because it is efficient to do so.

➢ **RISK ASSESSMENT PROCEDURES (RAP)**

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 RAP?**

A. **Inquiries of Management & Others Within the Entity:** Mostly, information obtained by the auditor's inquiries are obtained from management & those charged with governance. Other includes:
  - Those charged with governance: Help in understanding environment in which financial statements are prepared.
  - **Internal audit:** Information about design & effectiveness of the entity's internal control & whether management has satisfactorily responded to findings.
  - **Employees:** Initiating, processing or recording complex or unusual transactions mayhelp to evaluate appropriateness of selection & application of certain accounting policies.
  - **In-house legal counsel:** Matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity.
  - **Marketing/Sales personnel:** Changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
  - **Risk management function:** Operational & regulatory risks that may affect financial reporting.
  - **Information Systems Personnel:** System changes, system or control failures, or other information system- related risks.

B. **ANALYTICAL PROCEDURES:**
  - Identify aspects of entity of which auditor was unaware & may assist in assessing the Risk of material misstatement;
  - Include both financial & non-financial information;
  - Help identify existence of unusual transactions or events & amounts, ratios & trends that might indicate matters have audit implications.

C. **OBSERVATION & INSPECTION:** Support inquiries of management & others (Documents, records & internal control manuals, reports prepared by management & those charged with governance, entity premises & plant facilities).

SA - 320
MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

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 IN PLANNING AND PERFORMING AN AUDIT- AUDITOR'S RESPONSIBILITY**

- It deals with auditor's responsibly to apply materiality in planning & performing audit of financial statements. As per financial reporting framework:

A. Misstatements are material if expected to influence economic decisions of users taken on the basis of financial statements.

B. Judgments about materiality are affected by the size or nature of a misstatement.

C. Judgments about materiality is based on a consideration of the needs of users of financial statements.

These judgments provide a basis for:
- Determining the nature, timing and extent of risk assessment procedures;
- Identifying and assessing the Risk of material misstatement; and
- Determining the nature, timing and extent of further assessment procedures.

➢ **DETERMINATION OF MATERIALITY- A MATTER OF PROFESSIONAL JUDGEMENT**

Auditor's determination of materiality is a matter of professional judgment & affected by the needs of the users & auditor. It is reasonable for the auditor to assume that:

A. Users have a reasonable knowledge of business, economic activities, accounting & a willingness to study the information in the financial statements;

B. Users understand that financial statements are prepared, presented and audited to levels of materiality;

C. Users recognize the uncertainties inherent in the measurement of amounts based on estimates & judgment;

D. Users make reasonable economic decisions on the basis of the information in the financial statements.

➢ **PERFORMANCE MATERIALITY:** Amount set by the auditor at less than materiality of financial statements as whole to reduce audit risk that the aggregate of uncorrected & undetected misstatements exceeds materiality for financial statements as a whole to an appropriately low level.

- Materiality is applied both in planning & performing the audit. It helps an auditor to evaluate whether financial statements reflect a true & fair view or not. Auditor should consider materiality & its relationship with audit risk while conducting an audit.
- Auditor determines materiality level for each particular class of transactions, account balances or disclosures.

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

Materiality Amount = Benchmark Amount × % of Benchmark

It is a matter of professional judgment. Factors affecting selection of an appropriate benchmark:

(1) Elements of the financial statements;

(2) Items on which attention of the users of financial statements are focused;

(3) Nature of the entity, its life cycle & industry & its economic environment;

(4) Relative volatility of the benchmark.

- **Examples of benchmark**- Profit before tax, revenue, gross profit & total expenses, total equity or net asset value etc.
- **Relevant Data for chosen Benchmark:** Prior periods amount or period to-date financial information or result, budgets or forecasts for current period adjusted for significant changes in the circumstances of the entity.
- **Determining** % to be applied to **benchmark** is a matter of **professional judgment**.

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

Factors which indicate existence of account balances, classes of transactions or disclosure where materiality of lower level is required:

(1) Whether law, regulations or financial reporting framework affect users' expectations regarding measurement or disclosure.

(2) Disclosures is key in relation to the industry in which entity operates.

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

- **REVISION IN MATERIALITY LEVEL:** Revision can be done due to: (1) Change in circumstances occurred during audit; (2) New information; (3) Change in the auditor's understanding of entity & its operations while performing further audit procedures. If auditor reduces materiality level, revise performance materiality & nature, timing and extent of further assessment procedures.

- **DOCUMENTING THE MATERIALITY:**
  A. Materiality for the financial statements as a whole;
  B. Materiality level for particular classes of transactions, account balances or disclosures;
  C. Performance materiality; &
  D. Any revision of inany of these reasons & revised amount.
- **MATERIALITY AND AUDIT RISK**
  As per **SA 320**, there is an **inverse relationship** between **materiality** and the degree of **audit risk.** Materiality and Audit Risk are considered throughout the audit in identifying and assessing risks of material misstatements, determining nature, timing and extent of further audit procedures and evaluating effect of uncorrected misstatements in forming the opinion.

UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

- **SA 315 IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT**
  - **The Required Understanding of the Entity and Its Environment, Including Entity's Internal Control:**
    A. **Relevant industry, regulatory, & other external factors including applicable financial reporting framework.**
       - Industry factors- competitive environment, supplier and customer relations etc.
       - Regulatory factors- Regulatory environment including applicable financial reporting framework.
       - External factors- interest rate, availability of finance, etc.
    B. **Nature of entity, including:**
       Its operations; its ownership & governance structures; types of investments made & plans to make; and how entity is structured & how it is financed.
    C. **Entity's selection & application of accounting policies, including reasons for changes.**
    D. **Entity's objectives & strategies & those related business risks that result in Risk of material misstatement.**
       Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time. An understanding of the business risks facing the entity increases the likelihood of identifying 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:
       - Industry developments
       - New products and services
       - Expansion of business
    E. **Measurement & review of entity's financial performance.**
       Assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud.
       Examples:
       - Key performance indicators.
       - Period-on-period financial performance analyses.
       - Budget, forecasts.
       - Credit rating agency reports.

- **UNDERSTANDING OF ENTITY- A CONTINUOUS PROCESS:** It is a continuous, dynamic process of gathering, updating & analyzing information throughout the audit. Understanding is required when:

(1) Assessing risks of material misstatement.
(2) Determining materiality.
(3) Considering appropriateness of selection & application of accounting policies.
(4) Identifying special audit consideration area.
(5) Developing expectations when performing analytical procedures.
(6) Evaluating sufficient appropriate audit evidence obtained.

INTERNAL CONTROL

- **ENTITY'S INTERNAL CONTROL:** Process designed, implemented & maintained by those charged with governance, management & other personnel, to provide reasonable assurance about the achievement of an entity's objectives regarding, reliability of financial reporting, effectiveness & efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations.
- **BENEFITS OF INTERNAL CONTROL:**
  Helps in: (1) Identifying types of potential misstatements; (2) Identifying factors that affect risks of material misstatement; and (3) Designing the nature, extent and timing of further audit procedures.
- **LIMITATIONS OF INTERNAL CONTROL:**
  A. **Internal control can provide only reasonable assurance:** No matter how effective, it can only provide reasonable assurance about achieving entity's financial reporting objectives.
  B. **Human judgment in decision-making:** Human judgment in decision-making can be faulty & breakdowns in **internal control** can occur because of it.
  C. **Lack of understanding the purpose:** Individual responsible for reviewing information does not understand its purpose or fails to take appropriate action.
  D. **Collusion among People:** Controls can be circumvented by the collusion of two or more people or inappropriate management override **of internal control.**
  E. **Judgements by Management:** Judgement on nature & extent of controls it chooses to implement & the nature & extent of risks it chooses to assume.
  F. **Limitations in case of Small Entities:** Have fewer employees due to which segregation of duties is not practicable. Owner-manager exercise more effective oversight & able to override controls.

- **COMPONENTS OF INTERNAL CONTROL:**
  A. Control Environment
  B. Entity's RAP
  C. Information system and communication
  D. Control activities
  E. Monitoring of controls

  A. **Control Environment:** Obtain understanding & evaluate whether: management has created & maintained culture of honesty & ethical behaviour; and strengths in control environment provide foundation for the other components of internal control.
     - **It includes:**
       (1) Governance & management functions.
       (2) Attitudes, awareness and actions of those charged with governance and management.
       (3) Sets the tone of an organization, influencing control consciousness of its people.
     - **Elements of control environment**
       1. **Communication & enforcement of integrity & ethical values:** Integrity and ethical behaviour are the product of the entity's ethical and behavioural standards, how they are communicated.
       2. **Commitment to competence:** Consideration of competence levels for jobs & how translate levels into requisite skills & knowledge.
       3. **Participation by those charged with governance:** Their independence from management; experience & stature; extent of involvement & information they receive; appropriateness of actions.

4. **Management's philosophy & operating style:** Approach of taking & managing business risks; attitudes & actions toward financial reporting; attitudes towards information processing & accounting functions and personnel.
5. **Organisational structure:** Framework for achieving its objectives.
6. **Assignment of authority & responsibility:** How reporting relationships & authorization hierarchies are established.
7. **HR policies & practices:** Policies and practices; recruitment, orientation, training, evaluation, counselling, etc.

B. Entity's risk assessment procedures: Obtain understanding of whether entity has a process for:
(1) Identifying business risks relevant to financial reporting objectives.
(2) Estimating significance of risks.
(3) Assessing likelihood of their occurrence; and
(4) Deciding about actions to address those risks.

C. Information system, including related business processes, relevant to financial reporting, and communication: Obtain understanding of information system, including related business processes, relevant to financial reporting including:
(a) Significant classes of transactions.
(b) Procedure by which those transactions is initiated, recorded and processed.
(c) Related accounting records and supporting information used.
(d) How information system captures all transactions.
(e) Financial reporting process.
(f) Controls surrounding journal entries.
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.

D. Control Activities: Obtain understanding of control activities, which considers necessary to assess the risk of material misstatement. Control activities are policies & procedures that help ensure that management directives are carried out. Control activities generally includes **Segregation of duties, Physical Controls, Authorization, Performance Review and Enterprise data processing/Information processing (SCARE).**

E. Monitoring of Controls- Obtain understanding of the major activities that uses to monitor internal control over financial reporting.
- Monitoring of controls defined: Assess effectiveness of internal control performance over time.
- Helps in assessing effectiveness of controls on a timely basis: Taking necessary remedial actions timely.
- Management accomplishes through ongoing activities, separate evaluations etc.: Through ongoing activities, separate evaluations or combination of two.
- Management's monitoring activities include using information from communications from external parties that indicate problems areas in need of improvement.

➢ **CONTROLS RELEVANT TO THE AUDIT:** Direct relationship between an entity's objectives and the control it implements to provide reasonable assurance about their achievement.

Factors relevant about whether a control is relevant are:
(1) Materiality.
(2) Significance of related risk.
(3) Size of entity.
(4) Nature of entity's business.
(5) Diversity & complexity of entity's operations.
(6) Applicable legal & regulatory requirements.
(7) Circumstances & applicable component of internal control.

(8) Nature & complexity of systems that are part of internal control.
(9) How specific control prevents, or detects and corrects, material misstatement.

- **Controls over the completeness and accuracy of information** produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures.
- **INTERNAL CONTROL OVER SAFEGUARDING OF ASSETS:**
  Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Auditor's consideration is limited to those relevant to the reliability of financial reporting.
- **NATURE & EXTENT OF UNDERSTANDING OF RELEVANT CONTROLS:**
  - Evaluating design of control & capable of effectively preventing or detecting & correcting, material misstatements.
  - Risk Assessment Procedures to obtain audit evidence about design & implementation:
    (a) Inquire entity personnel;
    (b) Observing application of specific controls;
    (c) Inspect document & reports; Tracing transactions through information system relevant to financial reporting.

  Obtaining an understanding of an entity's controls is not sufficient, unless there is automation that provides for the consistent operation of the controls.

RISKS THAT REQUIRE SPECIAL AUDIT CONSIDERATION

- As part of the Risk Assessment Procedures, determine whether any of risks identified is significant risk. **Consider at least the following:**
  A. Whether risk is a risk of fraud.
  B. Whether risk is related to recent significant economic, accounting, or other developments and requires specific attention.
  C. Complexity of transactions.
  D. Whether risk involves significant transactions with related parties.
  E. Degree of subjectivity in measurement of financial information related to the risk, and
  F. Whether risk involves significant transactions that are outside normal course of business.
- **IDENTIFYING SIGNIFICANT RISKS**
  - Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement.
  - Significant risks often relate to significant non-routine transactions or judgmental matters.
- **RISK OF MATERIAL MISSTATEMENT – GREATER FOR SIGNIFICANT NON - ROUTINE TRANSACTIONS**
  (1) Greater management intervention to accounting treatment.
  (2) Greater manual intervention for data collection & processing.
  (3) Complex calculations or accounting principles.
  (4) Nature, making it difficult to implement effective controls over risks.
- **RISK OF MATERIAL MISSTATEMENT– GREATER FOR SIGNIFICANT JUDGMENTAL MATTERS**
  (1) Accounting principles for accounting estimates or revenue recognition subject to different interpretation.
  (2) Required judgment may be subjective or complex, or require assumptions about the effects of future events, *for example*, judgment about fair value.

EVALUATION OF INTERNAL CONTROL SYSTEM

- **BENEFITS OF EVALUATION OF INTERNAL CONTROL:** Enable auditor to know:
  (1) Whether an adequate internal control system is in use;
  (2) Whether effective internal auditing department operating;

(3) Whether administrative control has a bearing on his work;
(4) Whether controls adequately safeguard the assets;
(5) Appropriate audit technique & audit procedure;
(6) Areas where control is weak;
(7) Worthwhile suggestions to improve control system.

- **FORMULATE AUDIT PROGRAM AFTER UNDERSTANDING INTERNAL CONTROL:**
  - Formulate entire audit programme only after satisfactory understanding of internal control systems & their actual operation. If understanding not taken, object of audit may be altogether lost in the mass of entries & vouchers.
  - If system is in operation post-installation, as generally there is no proper follow up is taken by management System in operation may be not altogether in operation or may at best operate only partially. Worst situation if not taken care.
  - Review of internal control system of client. It helps in understanding controls & implications in the framing of the audit programme. Weakness in the system & improvement can be suggested to management of company.
  - It can be concluded that extent & nature of audit programme is substantially influenced by internal control system in operation. In deciding upon a plan of test checking, existence & operation of internal control system is of great significance.

- **METHODS OF EVALUATION OF INTERNAL CONTROL:**

  A. Narrative Record: Complete & exhaustive description of system in operation. May be recommended in cases where no formal control system is in operation & suited to small business. Basic disadvantages are:
  (i) Understanding system in operation is difficult.
  (ii) difficult to identify gaps or weakness.
  (iii) incorporate changes is difficult.

  B. Check List: Series of instructions and/or questions which member of auditing staff must follow and/or answer. Answers to check list instructions are usually: Yes, No or Not Applicable.

  C. Questionnaire: Comprehensive series of questions concerning internal control. Collects information about existence, operation & efficiency of internal control. Usually issued to client & client is requested to getit filled. 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. 'Not Applicable' when not relevant to business.

  D. Flow Chart: Graphic presentation of each part of company's system of internal control. Minimises amount of narrative explanation, gives bird's eye view of system & flow of transactions.

TESTING OF INTERNAL CONTROL

Test of controls are performed to obtain audit evidence about the effectiveness of the design of the accounting and internal control system and operation of the internal control throughout the period.

- **Test of controls may include:**
  - Inspection of documents.
  - Inquiry and observation of internal control which leave no audit trail.
  - Re-performance of control.
  - Testing internal control over specific computerized application or overall IT function.
- Based on tests of controls results, evaluate whether internal control are designed & operating as contemplated in the preliminary assessment of control risk. Evaluation of deviations may result in concluding that assessed level of control risk needs to be revised. In such cases, modify the nature, timing & extent of planned substantive procedures.
- Before audit conclusion, consider whether assessment of control risk is confirmed. In case of deviations, make specific inquiries to consider their implications. Conclude that deviations are such that preliminary assessment of control risk is not supported & amend. If assessed control risk needs to revised, modify nature, extent and timing of planned substantive procedures.

AUDIT IN AN AUTOMATED ENVIRONMENT

WHAT IS AN AUTOMATED ENVIRONMENT?

An **automated environment** refers to a business environment where the processes, operations, accounting and even decisions are carried out by **using computer systems.**

➢ **FEATURES OF AN AUTOMATED ENVIRONMENT:**
- Enables faster business operations.
- Improved accuracy in data processing and computation.
- Increases ability to process large volume of transactions.
- Helps integration of business operations.
- Improves security and controls.
- Reduction in human error.
- Provides latest updates.
- Provides connectivity and networking capability.

➢ **UNDERSTANDING AND DOCUMENTING AUTOMATED ENVIRONMENT**

Points that an auditor should consider to obtain an understanding of the company's automated environment:

Information system being used, location, architecture, version, number of Information System, in house vs. packaged, outsourced activities and key personnel for understanding IT system.

➢ **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.

➢ **IMPACT OF IT RELATED RISKS**
- **IMPACT ON SUBSTANTIVE CHECKING-** Leads 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.
- **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.
- **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.

➢ **TYPES OF CONTROLS IN AN AUTOMATED ENVIRONMENT**

Types of IT Controls are-

A. General IT controls
B. Application controls
C. IT Dependent controls

A. **General IT Controls (GITC)** are policies and procedures that relate to many applications and support **the effective functioning of application controls.** It maintains the integrity of information and security of data. It helps in mitigating risks that arise due to use of IT and information systems in business.

General controls include controls over the following:
- **Data center and network operations-**
  (i) Objective: Ensure systems are processed to meet FRO (financial reporting objectives).

(ii) Activity:
- **(a)** Overall Management
- **(b)** Managing - Batch jobs – preparing, scheduling and executing,
- **(c)** Backups – monitoring, storage & retention,
- **(d)** Performance monitoring of operating system, database and networks,
- **(e)** Recovery from Failures – BCP, DRP,
- **(f)** Help Desk Functions – recording, monitoring & tracking,
- **(g)** Service Level Agreements –monitoring & compliance,
- **(h)** Documentation – operations manuals, service reports.

- **Program change-**

(i) Objective: Ensure modified systems continue to meet financial reporting objectives.

(ii) Activity:
- **(a)** Change Management Process,
- **(b)** Making Changes in applications,
- **(c)** Test Changes,
- **(d)** Emergency & Minor Changes,
- **(e)** Documentation; and
- **(f)** User Training.

- **Access security-**

(i) Objective: Ensure access to programs & data is authenticated and authorized to meet financial reporting objectives.

(ii) Activity:
- **(a)** Organization & management,
- **(b)** Policies & procedures,
- **(c)** Application, data, operating system, network, physical security and
- **(d)** System administration & privileged accounts.

- **Application system acquisition, development, and maintenance-**

(i) Objective: Ensure systems are developed, configured and implemented to meet FRO.

(ii) Activity:
- **(a)** Overall management project activities,
- **(b)** Analysis & design construction,
- **(c)** Testing & quality assurance data conversion,
- **(d)** Go-Live decision; and
- **(e)** Documentation & training.

B. **Application Controls** operate at a business process level and are **embedded into IT applications** *viz.*, ERPs and helps in ensuring the **completeness, accuracy and integrity of data.** *Examples* are edit checks and validation of input data, sequence number checks, user limit checks, reasonableness checks, mandatory data fields, etc.

C. **IT dependent Controls are 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.

➢ **GENERAL IT CONTROLS VS. APPLICATION CONTROLS**

Both general control and application controls **are inter-related. Due to the inherent dependency on IT, application controls and IT dependent manual controls are effective and reliable only if General IT controls are effective.**

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.

➢ **TESTING METHODS IN AN AUTOMATED ENVIRONMENT**

Testing methods for the **audit in an automated environment:** Inquiry, observation, inspection and reperformance. **Inquiry is the most efficient** audit test, but it gives the **least audit evidence**. Therefore, **inquiry** should be used in **combination with other audit testing methods** to give the **most effective and efficient audit evidence**.

Inquiry in combination with inspection gives the most effective and efficient audit evidence.

- **Methods of audit in automated environment:**
  - Obtain an understanding of how an automated transaction is processed by doing a walk through 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.

CHARACTERISTICS OF MANUAL AND AUTOMATED ELEMENTS OF INTERNAL CONTROL RELEVANT TO THE AUDITOR'S RISK ASSESSMENT

Controls in IT systems consist of a combination of automated controls & manual controls.

- Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items.
- Controls in IT systems consist of a combination of automated controls 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.

➢ **MANUAL ELEMENTS VS. AUTOMATED ELEMENTS IN ENTITY'S INTERNAL CONTROL**

Manual elements in internal control may be more suitable where judgment and discretion are required such as: large, unusual, non-recurring transactions; where errors are difficult to define; in changing circumstances; or in monitoring automated controls.

- Less suitable in case of high volume or recurring transactions or where errors can be prevented or detected by automated controls.

AUDIT APPROACH IN AN ANTOMATED ENVIRONMENT

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

DATA ANALYTICS FOR AUDIT

Data Analytics means a combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information. Auditor can also use Data Analytics to analyse the data and improve audit efficiency **although not mandatory to use**.
The collection of computer-based tools and techniques that are used in an audit for analysing data in electronic form to obtain audit evidence are called CAATs (Computer Assisted Audit Techniques).
Even though **specialized audit tools are very useful**, such tools are not always required or necessary to carry out data analytics.
Data analytics can be used in the testing of electronic records and data residing in IT systems using spreadsheets and specialized audit tools *viz.*, IDEA and ACL. **These can be used for following:**

- Check completeness of data and population that is used in either test of controls or substantive audit tests.
- Selection of audit samples - random sampling, systematic sampling.
- Re-computation of balances – reconstruction of trial balance from transaction data.
- Reperformance of mathematical calculations - depreciation, bank interest calculation.
- Analysis of journal entries as required by SA 240.
- Fraud investigation.

DIGITAL AUDIT

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.

INTERNAL FINANCIAL CONTROLS AS PER REGULATORY REQUIREMENTS

- **Internal Finance Controls (IFC)**
  It 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.
- **Relevant provisions of Companies Act regarding internal financial controls:**

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 and such controls are adequate and operating effectively.
Section 143(3)(i)	• Auditor's report shall state adequacy and operating effectiveness of internal financial controls. • Applicability of Internal financial control under Companies Act- Internal financial control is applicable on all public company and on private company except One Person Company and private company with turnover of less than ₹50 crore as per latest audited **financial statements** or borrowing at any point of time during the year is less than ₹25 crores. **(Section 143(3)(i))**
Section 177(4)(vii)-	Functions of Audit committee to include **evaluation of internal financial controls and risk management systems.**
Section 149(8)-	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.

DOCUMENTING THE RISK

Discussion among engagement team & significant decisions reached; Key elements of understanding obtained of entity & its environment & internal control components; Identified & assessed risks of material misstatement at **financial statement** level & assertion level; and Risks identified & related controls about which the auditor has obtained an understanding.

ASSESS AND REPORT AUDIT FINDINGS

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 management and those charged with governance.
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.
- 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.

THE AUDITOR'S RESPONSES TO ASSESSED RISKS

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.

- **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 (*i.e.*, the inherent risk); and
  (ii) Whether the risk assessment takes into account the control risk so that auditor is able to determine whether or not to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures; and
  B. Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

- **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 intends to rely on the operating effectiveness of controls; or
  B. Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

➢ NATURE AND EXTENT OF TEST OF CONTROLS

- **In designing and performing test of controls, the auditor shall:**
  A. Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
  (i) How the controls were applied at relevant times during the period under audit.
  (ii) The consistency with which they were applied.
  (iii) By whom or by what means they were applied.

Inquiry alone is not sufficient to test the operating effectiveness of controls.
The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively.

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

- The frequency of the performance of the control.
- The length of time that the auditor is relying on control.
- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained.
- The extent to which audit evidence is obtained from tests of other controls.

➢ **TIMING OF TEST OF CONTROLS**

Audit evidence pertaining only to a point in time sufficient, *for example*, when testing controls over the entity's physical inventory counting at the period end. If 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.

➢ **USING AUDIT EVIDENCE OBTAINED IN PREVIOUS AUDITS**

The auditor shall consider the following:

A. The effectiveness of other elements of internal control.
B. The risks arising from the characteristics of the control, 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.
E. Whether the lack of a change in a particular control poses a risk due to changing circumstances.
F. The risks of material misstatement and the extent of reliance on the control.

➢ **SPECIFIC INQUIRIES BY AUDITOR WHEN DEVIATIONS FROM CONTROLS ARE DETECTED**

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

A. The test of controls that have been performed provide an appropriate basis for reliance on the controls;
B. Additional test of controls are necessary; or
C. The potential risks of misstatement need to be addressed using substantive procedures.

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.

SUBSTANTIVE PROCEDURES

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

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

➢ **TESTS OF DETAILS**

Tests of details are further classified into tests of transactions *i.e.*, vouching and tests of balances *i.e.*, verification.

➢ **Substantive analytical procedures**

Substantive analytical procedures refer to analytical procedures used as substantive procedures by auditor. The term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.

- **NATURE AND EXTENT OF SUBSTANTIVE PROCEDURES**

  Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

  Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from test of controls are unsatisfactory.

Question Solver Points:

1. Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. **(PP Book Q.30)**
2. Risks of material misstatements consists of two components *i.e.*, inherent risk and control risk.
3. There is always a risk that before considering any existence of internal control in an entity, a particular transaction, balance of an account or a disclosure required to be made in the financial statements of an entity have a chance of being misstated and such misstatement can be material. This risk is known as inherent risk. **(PP book C/I-Q.2) (PP Book Q.24)**
4. Control risk is a risk that internal control existing and operating in an entity would not be efficient enough to stop from happening, or find and then rectify in an appropriate time, any material misstatement relating to a transaction, balance of an account or disclosure required to be made in the financial statements of that entity. **(PP Book Q.24)**
5. Detection risk is 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. It comprises of sampling and non-sampling risk.
6. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement. **(PP Book C/I-Q.37)**
7. 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.
8. 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.
9. There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and *vice versa*. **(PP book C/I-Q.1)**
10. Obtaining an understanding of the entity and its environment, including the entity's internal control is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. **(PP Book Q.28)**
11. Internal control is the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations.
12. The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls. **(PP book C/I-Q.19)**
13. Significant risks often relate to significant non-routine transactions or judgmental matters.
14. An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems. **(PP Book C/I-Q.28)**
15. 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.

16. Controls in an automated environment include general IT controls, application controls and IT-dependent controls.
17. Inquiry is the most efficient but least effective. Moreover, testing through inquiry alone is not sufficient. The inquiry should be corroborated by applying any one or a combination of observations, inspection or reperformance. **(PP Book C/I-Q.24)**
18. 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. **(PP Book C/I-Q.26)**
19. The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.
20. A proper understanding of the internal control system in its content andworking also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programme. **(PP Book C/I-Q.5)**
21. Inquiry alone is not sufficient to test the operating effectiveness of controls. In addition to inquiry, inspection, observation, confirmation, recalculation, reperformance, and analytical procedures are the audit procedures to test the operating effectiveness of controls. **(PP Book C/I-Q.11)**
22. Methods of evaluating internal control include narrative record, checklist, internal control questionnaire and flow chart. **(PP Book C/I-Q.12 and Q.16)**
23. Test of controls are performed to obtain audit evidence about the effectiveness of the design of the accounting and internal control system and operation of the internal control throughout the period. **(PP Book C/I-Q.3)**
24. The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.
25. Provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations.

PERFECT REVISION QUESTIONS

Q. No.	Questions and Answers
1.	**"The auditor shall obtain an understanding of the control environment." What is included in the control environment?**
Ans.	The auditor shall obtain an understanding of the control environment. **As part of obtaining this understanding, the auditor shall evaluate whether:** **(a)** Management has created and maintained a culture of honesty and ethical behaviour; and **(b)** The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control. **The control environment includes:** **(a)** The governance and management functions. **(b)** The attitude, awareness and actions of those charged with the governance. The control environment sets the tone of an organization, influencing the control consciousness of its people.
2.	**List any *six* points that an auditor should consider to obtain an understanding of the company's automated environment.**
Ans.	Given below are some of the points that an auditor should consider **to obtain an understanding of the company's automated environment:** **(a)** Information systems being used (one or more application systems and what they are). **(b)** Their purpose (financial and non-financial) **(c)** Location of IT systems - local *vs.* global **(d)** Architecture (desktop-based, client-server, web application, cloud-based) **(e)** Version (functions and risks could vary in different versions of the same application) **(f)** Interfaces within systems (in case multiple systems exist) **(g)** In-house *vs.* Packaged. **(h)** Outsourced activities (IT maintenance and support) **(i)** Key persons (CIO, CISO, Administrators)
3.	**The auditor should understand and consider the risks that may arise from the use of Information Technology (IT) Systems. Explain.**
Ans.	Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems. **Following are some risks that should be considered:** **(a)** Inaccurate processing of data, processing inaccurate data, or both. **(b)** Unauthorized access to data. **(c)** Direct data changes (backend changes). **(d)** Excessive access or Privileged access (super users). **(e)** Lack of adequate segregation of duties. **(f)** Unauthorized changes to systems or programs. **(g)** Failure to make necessary changes to systems or programs. **(h)** Loss of data.
4.	**Data analytics can be used in the testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL. Explain in detail, stating all relevant points.**
Ans.	**Data analytics** can be used in the testing of **electronic records** and **data residing** in IT systems using spreadsheets and specialised audit tools *viz.*, **IDEA and ACL to perform the following:**

PERFECT REVISION QUESTIONS

Q. No.	Questions and Answers
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2.	**List any *six* points that an auditor should consider to obtain an understanding of the company's automated environment.**
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18 of 22

	(a) Check completeness of data and population that is used in either test of controls or substantive audit tests. **(b)** Selection of audit samples – random sampling, systematic sampling. **(c)** Re-computation of balances – reconstruction of trial balance from transaction data. **(d)** Reperformance of mathematical calculations – depreciation, bank interest calculation. **(e)** Analysis of journal entries as required by SA 240. **(f)** Fraud investigation. **(g)** Evaluating the impact of control deficiencies.
5. **Ans.**	**Write *a* short note on the Knowledge of the Client's Business.** As per SA 315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment", without adequate knowledge of the client's business, a proper audit is not possible. **The auditor shall obtain an understanding of the following:** **(a)** Relevant industry, regulatory and other external factors, including the applicable financial reporting framework. **(b) The nature of the entity includes:** **(i)** Its operations; **(ii)** Its ownership and governance structures; **(iii)** The types of investments that the entity is making and plans to make, including investments in special-purpose entities; and **(iv)** The way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances and disclosures to be expected in the financial statements. **(c)** The entity's selection and application of accounting policies, including the reasons for changes thereto. **(d)** The entity's objectives and strategies and those related business risks may result in risks of material misstatement. **(e)** The measurement and review of the entity's financial performance.
6. **Ans.**	**The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. Analyze and explain.** 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. The control environment in itself does not prevent or detect and correct a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (*for example*, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.
7. **Ans.**	**"The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting." Explain.** The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting. **(a) Monitoring of controls:** Monitoring of controls is a process to assess the effectiveness of internal control performance over time.

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	(b) Helps in assessing the effectiveness of controls on a timely basis: It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. **(c) Management accomplishes through ongoing activities, separate evaluations etc.:** Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities. **(d) Management's monitoring activities include:** Management'smonitoring 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.
8.	**Factors relevant to the auditor's judgement about whether a control, individually or in combination with others, is relevant to the audit may include such matters as materiality, the significance of the related risks, etc. Explain in detail.**
Ans.	Factors relevant to the auditor's judgement about whether a control, individually or in combination with others, is relevant to the audit **may include the following matters:** **(a)** Materiality. **(b)** The significance of the related risk. **(c)** The size of the entity. **(d)** The nature of the entity's business, including its organisation and ownership characteristics. **(e)** The diversity and complexity of the entity's operations. **(f)** Applicable legal and regulatory requirements. **(g)** The circumstances and the applicable component of internal control. **(h)** The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations. **(i)** Whether, and how, a specific control, individually or in combination with others prevent, or detects and corrects, material misstatement.
9.	**The auditor of Sunshine Ltd. is of the view that due to greater management intervention to specify the accounting treatment, the risk of material misstatement is greater for non-routine transactions. Is the view of the auditor correct? Specify the other matters due to which the risk of material misstatement is greater for significant non-routine transactions.**
Ans.	***Yes.*** The auditor of Sunshine Ltd.'s view is correct that due to greater management intervention to specify the accounting treatment, the risk of material misstatement is greater for non-routine transactions. **Risks of material misstatement may be greater for significant non-routine transactions due to the following:** **(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 may make it difficult for the entity to implement effective controls over the risks.
10.	**Internal Controls over the safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain the objectives of Internal Controls.**
Ans.	**Internal Controls** over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting.

	Objectives of Internal Controls: **(a)** Transactions are executed in accordance with managements general or specific authorizations. **(b)** All transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets. **(c)** Assets are safeguarded from unauthorised access, use or disposition. **(d)** Recorded assets are compared with the existing assets at reasonable intervals, and appropriate action is taken with regard to any differences.
11.	**Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. Analyse and explain by giving examples.**
Ans.	Obtaining an understanding of the entity and its environment, including the entity's internal control, 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 judgement throughout the audit, *for example*, when** **(a)** Assessing risks of material misstatement of the financial statements. **(b)** Determining materiality in accordance with SA 320. **(c)** Considering the appropriateness of the selection and application of accounting policies. **(d)** 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. **(e)** Developing expectations for use when performing analytical procedures. **(f)** Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.
12.	**The Auditor of HK Limited completed the audit of the company in an automated environment. Management of the company requested the auditor to give an idea about any exceptions observed in IT environment that need to be assessed. How the auditor should consider this request and report in light of an audit perspective?**
Ans.	A deficiency in internal control exists if a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or the control is missing. Evaluation and assessment of audit findings and control deficiencies involves applying professional judgement that include considerations for quantitative and qualitative measures. **Fact of the case:** The Auditor of HK Limited completed the audit of the company in an automated environment. Management of the company requested the auditor to give an idea about any exceptions observed in IT environment. The auditor needs to assess each finding or exception to determine the impact on the audit and evaluate if the exception results in a deficiency in internal control. **Conclusions:** Each finding should be looked at individually and in the aggregate by combining with other findings or deficiencies.

13.	**The auditor's determination of materiality is a matter of professional judgement and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, explain the auditor's assumptions about users of financial statements.**
Ans.	The auditor's determination of materiality is a matter of professional judgement 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 the 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 the financial statements are prepared, presented and audited to the levels of materiality; **(c)** Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgement and the consideration of future events; **(d)** Make reasonable economic decisions on the basis of the information in the financial statements.
14.	**You are being appointed as the auditor of Track Ltd. for the first time. You want to determine the materiality level, and for that, you have applied percentage to choose a benchmark as a starting point in determining materiality for the financial statements as a whole. What are the factors that may affect the identification of an appropriate benchmark?**
Ans.	SA 320 "Materiality in Planning and Performing an Audit" prescribes the 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 the materiality of the financial statements as a whole. **Factors that may affect the identification of an appropriate benchmark include the following:** • The elements of the financial statements (*for example*, assets, liabilities, equity, revenue, and 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 bench.
15.	**With respect to audit in an automated environment, explain the following:** **(a) General (IT) Controls** **(b) Material Weakness** **(c) Data Processing**
Ans.	**(a) General (IT) Controls** are a type of internal controls that help in mitigating risks that arise due to use of information technology and information systems in a business. **(b) Material Weakness:** A control deficiency or a combination of deficiencies in internal controls that is important enough to merit the attention of those charged with governance since there is a reasonable possibility that a material misstatement will not be prevented or detected in a timely manner by management. **(c) Data processing** refers to the systematic recording, storage, retrieval, modification and transformation of electronic data using information systems.

16.	**"When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences" Explain.**
Ans.	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 provides an appropriate basisfor reliance on the controls; **(b)** An additional test of controls is necessary; or **(c)** The potential risks of misstatement need to be addressed using substantive procedures.

CHAPTER 4- AUDIT EVIDENCE

SA – 500- AUDIT EVIDENCE

- **MEANING**: Information used by auditor in arriving at the conclusions on which the auditor's opinion is based. **It includes:**
  - **Information contained in the accounting records:** Initial accounting entries & supporting records; Invoices; Contracts; General & subsidiary ledgers, Journal entry & other adjustments to financial statement not reflected in Journal entry; Records such as work sheets & spreadsheets supporting cost allocations, computations, reconciliation.
  - **Other information:** Authenticates accounting records & supports auditor's rationale behind true and fair presentation of financial statements. *Example*: Minutes of meetings; written confirmations from trade receivables & trade payables, manuals containing details of Internal control, etc.

SUFFICIENCY AND APPROPRIATENESS OF AUDIT EVIDENCE:

Sufficiency is the measure of quantity & appropriateness is the measure of quality of audit evidence. The sufficiency and appropriateness of audit evidence are interrelated.

- **Sufficiency is affected by:**
  - Auditor's assessment of the risk of material misstatement (higher assessed risks, more audit evidence); and
  - The quality of such audit evidence (higher quality, less audit evidence).
- **Auditor's judgement as to sufficiency may be affected by the factors such as:**
  - **Materiality:** Less material to user of financial statements Less evidence.
  - More material to user of financial statements = More evidence.
  - **Risk of material misstatement:** Lower risk of material misstatement = Less evidence.
  - Higher risk of material misstatement = More evidence.
  - **Size of a population:** Smaller, more homogeneous population = Less evidence.
  - Larger, more heterogeneous populations = More evidence.
- **Appropriateness of audit evidence:**

  Appropriateness is the measure of the **quality of audit evidence;** that is, **its relevance and its reliability** in providing support for the conclusions on which the auditor's opinion is based.
  - **Relevance** deals with logical connection with, or bearing upon, purpose of the audit procedures and, & assertion under consideration. It may be affected by the direction of testing. A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others.

    Designing Test of controls to obtain relevant audit evidence includes identifying conditions (characteristics/attributes) that indicate performance of a control & deviation which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

    Designing Substantive procedures (Test of details + Substantive analytical procedures) includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.
  - **Reliability:** Evidence is influenced by its source, nature & the circumstances under which it is obtained, including the controls over its preparation & maintenance where relevant. **Generalisations about reliability of various kinds of audit evidence are subject to important exceptions. Some of them are:**
    - **(a)** Reliability increased if obtained from independent source outside entity.
    - **(b)** Reliability of internally generated is increased when the related controls, including those over its preparation & maintenance are effective.
    - **(c)** Audit evidence obtained directly by auditor is more reliable than audit evidence obtained indirectly or by inference.

reliable than evidence obtained orally.

(e) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents.

- **OBTAINING SUFFICIENT APPROPRIATE AUDIT EVIDENCE BY THE AUDITOR-**

Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may also be obtained from previous audits.

As per SA 330, obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level, enable to draw reasonable conclusions. SA 200 - Nature of audit procedures, timeliness of financial reporting, and balance between benefit & cost, are relevant factors in exercising professional judgement regarding whether sufficient appropriate audit evidence has been obtained.

SOURCES OF AUDIT EVIDENCE:

(1) Performing audit procedures to test accounting records.

(2) Performing audit procedures to determine the accounting records are internally consistent & agree to the financial statements.

(3) More assurance is ordinarily obtained from consistent audit evidence obtained from different sources.

(4) Information from sources independent may use as audit evidence include confirmations from third parties, analysts' reports, and comparable data about competitors.

AUDIT PROCEDURES FOR OBTAINING AUDIT EVIDENCE

Audit evidence to draw reasonable conclusions can be obtained by:

(i) Risk assessment procedure.

(ii) Further audit procedure - Test of Control and substantive procedure.

- **AUDIT PROCEDURE TO OBTAIN AUDIT EVIDENCE CAN INCLUDE:**
  - **Inspection:** Examining records or documents, internal or external, in paper form, e- form, or other media.
  - **Observation:** Looking at a process or procedure being performed by others.
  - **External confirmation:** Direct written response to the auditor from a third party in paper form or electronic form.
  - **Re-calculating:** Checking mathematical accuracy of document or records.
  - **Re-performance:** Auditor's independent execution of procedure or control performed by the entity's Internal control.
  - **Analytical procedure:** Study of the relationship between both financial & non-financial data.
  - **Inquiry:** Seeking information of the knowledgeable person, within or outside the entity. Extensively throughout the audit. May be formal written inquiries to informal oral inquiries. Evaluating responses is an integral part of the inquiry process. Responses provide a basis for the auditor to modify or perform additional Audit procedures.

    Inquiry provides important audit evidence & even produce evidence of a misstatement; Inquiry alone ordinarily does not provide sufficient and appropriate audit evidence of the absence of a material misstatement.

- **NATURE & TIMING OF AUDIT PROCEDURES**

Nature & timing of audit procedures to be used may be affected by the fact that some of the accounting data & other information may be available only in e-form or only at certain points or period of time.

Certain e-information may not be retrievable after specified period. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for auditor's review or to perform audit procedures at a time when the information is available.

✍ AUDIT TRAIL

An audit trail is a documented flow of a transaction. It is used to investigate how a source document was translated into an account entry and from there it was inserted into financial statement of an entity. It is used as audit evidence to establish authentication and integrity of a transaction. Purpose is to reduce fraud, material errors and unauthorized use. Helps to enhance internal controls and data security. Also, helps in fixing responsibility, rebuilding events and in thorough analysis of problem areas.

✍ INFORMATION TO BE USED AS AUDIT EVIDENCE

➢ **INFORMATION PREPARED BY EXPERT:**

When information is prepared by expert, nature, timing and extent may be affected by:

- Nature and complexity of matter;
- Risk of material misstatement;
- Availability of alternative sources;
- Expert employed by management or outside party;
- Influence of management;
- Previous experience.

Relying on the work of a Management's Expert: Evaluate Competence, capabilities & objectivity of expert; Obtain understanding expert's work; Evaluate appropriateness of expert's work.

➢ **INFORMATION PRODUCED BY THE ENTITY:** Obtaining audit evidence about accuracy & completeness of information; Evaluating whether the information is sufficiently precise & detailed for the auditor's purposes.

✍ SELECTING ITEMS FOR TESTING TO OBTAIN AUDIT EVIDENCE

The means available to the auditor for selecting items for testing are:

(a) Selecting all items (100% examination);

(b) Selecting specific items (High value items, items over a certain amount, items to obtain information);

(c) Audit sampling.

✍ **INCONSISTENCY IN OR DOUBTS OVER RELIABILITY OF AUDIT EVIDENCE:** If Audit evidence obtained from one source is inconsistent with another or auditor has doubts over the reliability of information, then auditor will determine modifications or additions to audit procedures & effect of the matter.

✍ SA – 610- USING THE WORK OF INTERNAL AUDITOR

➢ **DEFINITION OF INTERNAL AUDIT FUNCTION:** A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

➢ **OBJECTIVES & SCOPE OF INTERNAL AUDIT FUNCTIONS:** It varies & depends on the size & structure of entity & requirements of management & those charged with governance. It includes assurance & consulting activities designed to evaluate & improve effectiveness of entity's governance processes, risk management and Internal control such as:

- **Activities relating to governance:** Assess governance process on ethics & values, performance management & accountability, communicating risk & control information to appropriate areas of the organization & effectiveness of communication among those charged with governance, external & internal auditors and management.
- **Activities relating to risk management:** Assist in identifying & evaluating significant exposures to risk & contributing to improvement of risk management and Internal control. It may perform procedures to assist the entity in the detection of fraud.
- **Activities relating to Internal Control:**
  - **Evaluation of internal control:** Assign specific responsibility for reviewing controls, evaluating & recommending improvements. Provides assurance regarding design, implementation & operating effectiveness of internal control.

- **Examination of financial & operating information:** Assign to review means used to identify, recognize, measure, classify and report financial & operating information, & to make specific inquiry into individual items.
- **Review of operating activities**: Review economy, efficiency & effectiveness of operating activities.
- **Review of compliance with laws & regulations**: Review compliance with laws, regulations & other external requirements & with management policies, directives & other internal requirements.

➢ **WAYS IN WHICH THE EXTERNAL AUDITOR MAY MAKE USE OF THE FUNCTION FOR PURPOSES OF THE AUDIT:**

- To obtain information about risks of material misstatement.
- Use work that has been performed by the internal audit function.
- To perform audit procedures under the direction, supervision and review of the external auditor (Direct assistance).

➢ **SCOPE OF SA 610-**

(a) Using work of Internal auditor to obtain audit evidence and;

(b) for or direct assistance.

➢ **OBJECTIVES OF THE EXTERNAL AUDITOR, WHERE THE ENTITY HAS AN INTERNAL AUDIT FUNCTION**- Determine whether work of internal audit function or direct evidence can be used, and to what extent and whether work is adequate. If using direct assistance to direct, supervise and review work.

➢ **EVALUATING THE INTERNAL AUDIT FUNCTION**

Evaluating the following:

(1) Objectivity of Internal Auditor- Ability to perform task without allowing bias or conflict of interest. Factors affecting external auditor's evaluation:

- Organizational status supports ability of function.
- Those charged with governance oversees employment decision.
- Constraints or restriction on internal auditor.
- Internal auditor is free from conflicting responsibilities.

(2) Competence- Attainment and maintenance of knowledge and skill. Factors affecting external auditor's evaluation:

- Whether internal audit function is adequately and appropriately resourced.
- Established policies for hiring, training internal auditors.
- Whether internal auditor has adequate technical training and proficiency.
- Whether he possesses knowledge relating to entity's financial reporting and Applicable Financial Reporting Framework (AFRF).

(3) Whether the internal audit function applies a **systematic and disciplined approach, including quality control-** External auditor will check whether there is adequate documented procedure covering risk assessment, documentation, reporting, etc.

➢ **DETERMINING THE NATURE AND EXTENT OF WORK OF THE INTERNAL AUDIT FUNCTION THAT CAN BE USED**

- **Examples of work of the internal audit function that can be used by the external auditor-** Testing of the operating effectiveness of controls; Substantive procedures involving limited judgements; Observations of inventory counts.

➢ **CIRCUMSTANCES IN WHICH THE EXTERNAL AUDITOR SHALL PLAN TO USE LESS OF THE WORK OF THE INTERNAL AUDIT-**

- The more judgment is involved in:
  - Planning and performing relevant audit procedures; and
  - Evaluating the audit evidence gathered.
- The higher the assessed risk of material misstatement.
- Lower organizational status and less competence.

- **DISCUSSION AND COORDINATION WITH THE INTERNAL AUDIT FUNCTION-**
  The timing of such work; The nature of the work performed; The extent of audit coverage; Materiality for the financial statements as a whole; Documentation of the work performed; Review and reporting procedures.
- **DETERMINING WHETHER, IN WHICH AREAS, AND TO WHAT EXTENT INTERNAL AUDITORS CAN BE USED TO PROVIDE DIRECT ASSISTANCE**
  The external auditor shall not use an internal auditor to provide direct assistance if there are significant threats to the objectivity of the internal auditor internal auditor lacks competence.

SA 530- AUDIT SAMPLING

- **MEANING:** Application of audit procedures to less than 100% of items within a population of audit relevance.
  OBJECTIVE: To provide a reasonable basis for drawing conclusions about population from which the sample is selected.
- **POPULATION:** Entire set of data from which a sample is selected & about which the auditor wishes to draw conclusions. Population must be complete, reliable and appropriate.
  - **Characteristics of population:** (1) Appropriateness: Appropriate & relevant; (2) Completeness; (3) Reliable: Sufficiently complete & accurate.
- **SAMPLING UNIT:** The individual items that make up the population are known as sampling units.
  - **Sampling process is performed:**
    Test of Control (TOC): Identify deviations from expected internal controls; and
    Test of Details (TOD): Identify misstatements of account balances & class of transactions.
  - **Approaches to sampling-**
    Sampling can be statistical or non-statistical.
    - **Statistical sampling:** Random selection of sample items. Uses scientific method of choosing samples from population. Based on a scientific law, it can be relied upon to greater extent than any arbitrary technique which lacks in basis & acceptability.
      Characteristics of statistical sampling: (1) Random selection; (2) Use probability theory to evaluate sample result; (3) Probability theory includes measurement of sampling risks.
      Advantages of statistical sampling: (1) Sample size do not change with change in population; (2) Sample selection: More objective & defensible; (3) Calculate minimum sample size with specified risk & precision; (4) Provides a means for deriving a "calculated risk" & sampling error; (5) Widely accepted: scientific & not biased.
    - **Non-statistical sampling:** Selected based on personal experience and knowledge. It is criticized on the grounds that it is neither objective nor scientific.

- **SAMPLING *VS.* TRADITIONAL APPROACH-**
  Traditional Approach: This approach to audit is economically wasteful because all the efforts are directed to check all transactions without any exception. It leads to more emphasis on routine checking, which is not necessary in terms of time & cost involved. With shift to formal internal controls, routine errors & frauds have greatly diminished. Internal controls are designed to Prevention, Detection & Correction of frauds & errors. Extensive routine checking as nothing more than a ritual. By routine checking, we traditionally think of the extensive checking & vouching of all entries.
  By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking provided he can put reliance on the internal controls.
  Extent of checking on a sampling plan –
  Factors: (a) Size of the organization; (b) State of internal controls; (c) Adequacy & reliability of books & records; (d) Tolerable error range; and (e) Degree of desired confidence.

➢ **TYPES OF RISK**

- **SAMPLING RISK:** Auditor's conclusion based on a sample may be different from conclusion if entire population were subjected to the same Audit procedures. If acceptable sampling risk is low, larger sample size is needed to keep risk at minimum level. **Two types of errors in it:**
  - Risk of **under reliance on Test of controls** and Risk of incorrect rejection in Substantive Procedures-leads to inefficiency in the conduct of audit.
  - Risk of **over reliance on Test of controls** & Risk of incorrect acceptance in case of substantive procedures - Effects the effectiveness of audit. It leads to erroneous audit opinion.
- **NON-SAMPLING RISK:** Auditor reaches an erroneous conclusion for any reason not related to sampling risk.

➢ **SAMPLING PROCESS:**

I. **Sample design, size and selection of items for testing**

- **Sample design:**

(i) Consider nature of audit evidence sought & possible deviation or misstatement or other characteristics assisting in defining what constitutes a deviation or misstatement & what population to use for sampling.

(ii) While sampling, performs audit procedures to obtain evidence that the population is complete.

(iii) Include a clear understanding of what constitutes a deviation or misstatement while performing audit procedures. Not appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedures.

(iv) 100% examination or use of a large sample size may be appropriate when performing Test of details.

- **Stratification:** Dividing population into discrete sub-population which have similar characteristics. Each sub-population called as "Stratum" & units under those sub-populations arereferred as "Strata". Conclusion drawn from individual units in stratum is extrapolated to stratum & results of each stratum is used to analyses entire population.
- **Value weighted selection:** Sample size, its selection & evaluation will result in a conclusion in monetary amounts.

- **Sample Size** should be sufficient to reduce sampling risk to acceptably low level. Level of sampling risk affects the sample size required. **Lower the risk accepted = Greater the sample size.**

- **Factors influencing sample size for test of control:**
  - **Increase** auditor Risk assessment: **Increase** Test of control sample size
  - **Increase** tolerable rate of deviation: **Decrease** Test of control sample size
  - **Increase** expected rate of deviation: **Increase** Test of control sample size
  - **Higher** level of assurance from samples: **Increase** Test of control sample size
  - **Large** population: **Little effect** sample size
  - **Small** population: Sample **not required.**
- **Factors influencing sample size for test of detail:**
  - **Higher** assessment of risk of material misstatement: **Large** Sample size
  - **Use** of other substantive procedures: **Small** sample size
  - **Higher** level of assurance from samples: **Higher** sample size
  - **Increase** in tolerable misstatement: **Decrease** sample size
  - **Greater** amount of misstatement expected: **Large** sample size
  - **Stratification** of population is appropriate: **Decrease** sample size
  - **Large** population: **Little effect** sample size
  - **Small** population- Sample **not required**
  - **Sample selection methods:**
    - **Random sampling:** Involves use of random number. All items have equal chance of selection.

- **Simple Random Sampling:** Use of random number table either with computer or picking up number in a random way. Good for homogenous population.
- **Stratified Sampling**- Discussed above.
  - **Interval/Systematic sampling:** Number of sampling units in the population is divided by the sample size to give a sampling interval. First item is selected in haphazard way & then item at regular intervals are selected.
  - **Monetary Unit sampling:** Type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.
  - **Haphazard sampling:** No structured approach, does not involve judgement & does not even use the random number tables.
  - **Block sampling:** Involves selection of blocks of contiguous items from within the population. It cannot be used in audit sampling because most populations are structured that items in sequence can be expected to have similar characteristics to each other but different characteristics from items elsewhere in population.

II. Performing audit procedures

- Do Audit procedures on all items selected.
- If Audit procedures not applicable on particular item, sample should be replaced.
- If not able to do Audit procedures on a particular, it will be called deviation for Test of controls & misstatement for Test of details.

III. Nature and cause of deviations and misstatements

- Analyze the deviations & observe any common feature & evaluate their possible effect on the purpose of the Audit procedures & on other areas of the audit.
- Investigate nature & causes of any deviations/misstatements identified & evaluate their possible effect on purpose of Audit procedures & on other areas of the audit.
- Apply judgement & performing additional Audit procedures to obtain sufficient and appropriate audit evidence to ensure that misstatement or deviation does not affect remaining population.

Anomaly: Misstatement/deviation that is not representative of misstatements or deviations in a population.

IV. Projecting misstatements

- To assess quantum of misstatement, but this projection is not sufficient evidence to determine an amount to be recorded.
- Treatment of anomaly- it should be excluded for projection of misstatement.
- For Test of details- projections are done for misstatement whereas for test of controls no projections arerequired since sample deviation rate is population deviation rate.

V. Evaluating results of audit sampling

- Results of sample & deciding use of audit sampling provides a reasonable basis for conclusions about the population or not.
- High rate of deviation/misstatement- **Increase** the assessed risk of material misstatement.
- **Projected and anomalous misstatement > tolerable misstatement:** Sample do not provide reasonable basis.
- Projected and anomalous misstatement is **closer to tolerable misstatement**: There may be asituation that actual misstatement may exceed tolerable misstatement.
- Unacceptable sampling risk: Projected misstatement > auditor expectation while determining sample size.
- **Definitions:**

  Tolerable misstatement: Monetary amount set by auditor in respect of which he seeks to obtain an appropriate level of assurance.
  Tolerable rate of deviation: Rate of deviation from prescribed internal controls procedures set by auditor in respect of which the auditor seeks to obtain an appropriate level of assurance.

SA – 501- SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS

- **OBJECTIVES**: Obtain sufficient appropriate audit evidence regarding: a) Existence and condition of **inventory**; b) Completeness of **litigation and claims**; c) Presentation & disclosure of **segment information** as per applicable Financial Reporting Framework.
- **INVENTORY:** When it is material to financial statement, obtain sufficient appropriate audit evidence regarding the existence & condition of Inventory by:
  - **Attendance at physical inventory counting**: (1) Evaluate management's instructions & procedures for recording & controlling results of entity's physical inventory counting; (2) Observe performance & obtain audit evidence for reliability of management's count procedures; (3) Inspect inventory; (4) Perform test counts.
  - **Perform audit procedures** over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.
- **MATTERS RELEVANT IN PLANNING ATTENDANCE AT PHYSICAL INVENTORY COUNTING:** (1) Nature of inventory; (2) Stages of completion of WIP; (3) Risk of material misstatement related to inventory; (4) Nature of Internal control related to inventory; (5) Whether adequate procedures expected to be established & proper instructions issued; (6) Timing of physical inventory counting (7) Whether entity maintains perpetual inventory system; (8) Locations where inventory is held, including materiality & risk of material misstatement at different locations, in deciding appropriate location; (9) Whether assistance of an auditor's expert is needed.
- **PHYSICAL INVENTORY COUNTING PERFORMED OTHER THAN FINANCIAL STATEMENT DATE:** Perform audit procedures to obtain audit evidence about changes in inventory between count date & financial statements date are properly recorded.
- **UNABLE TO ATTEND PHYSICAL COUNTING DUE TO UNFORESEEN CIRCUMSTANCES:** Perform on an alternative date and perform audit procedures on intervening transactions.
- **PHYSICAL INVENTORY COUNTING IS IMPRACTICABLE:** Perform alternative audit procedures to obtain sufficient appropriate audit evidence for existence & condition of inventory. If not possible, modify the opinion as per SA 705.
  Impracticable due to nature & location of Inventory: Matter of difficulty, time, or cost involved is not a valid basis to omit an audit procedures. Perform alternative audit procedures, like inspection of documentation of subsequent sales or purchased prior to physical counting. If not possible, modify the report.
- **INVENTORY IN CUSTODY & CONTROL OF THIRD PARTY:** Request confirmation from third party as to quantities & condition of inventory held on behalf of the entity. Perform inspection or other audit procedures appropriate in the circumstances.
- **LITIGATION & CLAIM:** Design and perform audit procedures to identify litigation and claims which may give rise to risk of material misstatement, including:
  (1) Inquiry of management & others within entity, including in-house legal counsel;
  (2) Review minutes of meetings of those charged with governance & correspondence between entity & its external legal counsel; and
  (3) Reviewing legal expense accounts.
- **If assessed risk of material misstatement identified or audit procedures indicate material litigation/claim exist, communicate directly to entity's external legal counsel.**
  If management refuses to communicate or external legal counsel refuses to respond & auditor unable to obtain sufficient appropriate audit evidence, modify the opinion.
  Take written representation from management & those charged with governance that all actual or possible litigation & claims are disclosed to auditor and accounted for & disclosed in financial statement.
- **SEGMENT INFORMATION:** Obtain sufficient appropriate audit evidence regarding the presentation & disclosure as per applicable financial reporting framework by understanding method used by management, evaluate such methods & testing the application of such methods. Also, perform analytical procedures or other audit procedures.

- **UNDERSTANDING OF THE METHODS USED BY MANAGEMENT-** (1) Sales, transfers & charges between segments & elimination of intersegment amounts. (2) Comparisons with budgets & other expected results. (3) Allocation of assets & costs among segments. (4) Consistencywith prior periods & adequate disclosures of inconsistencies.

SA – 505 EXTERNAL CONFIRMATION

- **MEANING:** Audit evidence obtained as a direct written response to auditor from a third party (the confirming party), in paper form or e-form or other medium.
- **DEFINITIONS-**
  - **Positive confirmation request**: Confirming party respond directly to auditor indicating whether confirming party agrees/disagrees with the information in the request.
  - **Non-response**: Failure of confirming party to respond or fully respond to a positive confirmation request.
  - **Exception**: Response indicates difference between information requested to be confirmed or contained in entity's records and information provided by the confirming party.
  - **Negative confirmation request:** Confirming party respond directly to auditor only if confirming party disagrees with the information provided in the request. It provides less persuasive audit evidence than positive confirmations.

    Negative confirmation requests **are not used as sole substantive** audit procedures to address an assessed risk of material misstatement at the assertion level **unless** all the following are present:
    - Auditor assessed risk of material misstatement as low & obtained sufficient appropriate audit evidence regarding operating effectiveness of Internal control relevant to the assertion.
    - Population comprises large number of small, homogeneous, account balances, transactions or conditions.
    - A very low exception rate is expected; and
    - Auditor is not aware of circumstances/conditions that would cause recipients of negative confirmation requests to disregard such requests.
- **EXTERNAL CONFIRMATION PROCEDURES:** Maintain control over external confirmation requests, including:
  - **Determining the information to be confirmed/requested:** Generally, Account balance & their elements may also include terms of agreements, contracts or transactions or absence of certain conditions.
  - **Selecting appropriate confirming party:** More relevant & reliable audit evidence if auditor believes confirming party is knowledgeable about information.
  - **Designing confirmation requests – factors:** Identified risk of material misstatement; layout and presentation;Prior experience on audit; Assertions being addressed; Method of communication; Management authorisation/encouragement to the confirming parties; Ability of the intended confirming party to confirm.
  - **Sending requests, including follow-up requests**: Send additional confirmation request within reasonable time if reply not received.
- **MANAGEMENT'S REFUSAL TO SEND CONFIRMATION REQUEST:**
  - Inquire reasons with validity & reasonableness; Evaluate implications on assessed risk of material misstatement including fraud risk & on related nature, timing and extent of other audit procedures; Perform alternative audit procedures.
  - If there is doubt about the reliability, obtain further audit evidence. If response of confirmation request is not reliable, evaluate the implications on the assessed risk of material misstatement including fraud risk & on related nature, timing and extent of other audit procedures.
  - If conclude- Unreasonable refusal or unable to obtain relevant & reliable audit evidence from alternative audit procedures: Communicate those charged with governance & determine implications on auditor's opinion.

- **ALTERNATIVE AUDIT PROCEDURES-**
  - Accounts Receivable- Examine subsequent cash receipt, shipping docs, etc.
  - Accounts Payable- Examine subsequent cash payments, goods received notes, etc.
- **EVALUATING THE EVIDENCE OBTAINED-** Categorize the response as – (a) Agreement with information provided, (b) Deemed unreliable; (c) Non-response; (d) Indicating exception.

SA – 510 OPENING BALANCES- INITIAL AUDIT ENGAGEMENT

- **INITIAL AUDIT ENGAGEMENT IN WHICH EITHER:** (1) financial statements for the prior period were not audited; or 2) financial statements for the prior period were audited by a predecessor auditor.
- **OBJECTIVES OF AUDITOR:**
  Obtain sufficient appropriate audit evidence about whether:
  (1) Opening balances contain misstatements that materially affect the current period's financial statements.
  (2) Appropriate accounting policies reflected in opening balances have been consistently applied in current period's financial statements & any change appropriately disclosed & presented in financial statements as per Financial Reporting Framework.
- **AUDIT PROCEDURES:** Read most recent financial statements & predecessor auditor's report, if any. Obtain sufficient appropriate audit evidence about the opening balances contain misstatements that materially affect current period's financial statements by:
  - Prior period's closing balances have been correctly brought forward & any adjustment disclosed properly in current year's P&L.
  - Opening balances reflect the application of appropriate accounting policies.
  - **Perform:** (1) If prior years financial statements were audited, copies of the audited financial statements (2) Evaluating audit procedures performed in current period provide evidence relevant to opening balances; (3) Specific audit procedures to obtain evidence regarding opening balance.
    If material misstatement obtained in opening balances, perform additional audit procedures. If concluded, misstatement exist in current period's financial statements, communicate to management & those charged with governance.
- **PROCEDURES ADOPTED BY THE AUDITOR TO OBTAIN AUDIT EVIDENCE REGARDING OPENING BALANCES:**
  - The nature, timing and extent to obtain sufficient and appropriate audit evidence about opening balance depends on:
    - Accounting policies followed.
    - Nature of Account balances, classes of transactions and risk of material misstatement.
    - Significance of opening balance.
    - Whether prior period financial statement were audited.
  - **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*- subsequent cash receipts and subsequent cash payments in case of Account receivable and accounts payable.
  - **For non-current assets and liabilities**, such as PPE, we can examine accounting records and invoices. For others, we can take external confirmation.
- **CONSISTENCY OF ACCOUNTING POLICIES:** Obtain sufficient appropriate audit evidence that accounting policies reflected in opening balances have been consistently applied in current period's financial statements & any change appropriately disclosed & presented in financial statements as per Financial Reporting Framework. If not consistent or changes not disclosed, express qualified opinion or adverse opinion.
- **REPORTING IN RELATION TO OPENING BALANCES:**
  Unable to obtain sufficient appropriate audit evidence regarding the opening balances, express qualified opinion or a disclaimer of opinion.

- If concluded, misstatement in opening balance affecting materially current year financial statements & effect not disclosed or accounted for in financial statements, express qualified or adverse opinion.

SA -550- RELATED PARTIES

- **DEFINITION:** A party that is either:
  (a) Related party as defined in the Applicable Financial Reporting Framework; or
  (b) Where Applicable Financial Reporting Framework or does not indicate:
  (i) Having control or significant influence over entity,
  (ii) Entity has control or significant influence over another entity,
  (iii) Common controlling ownership (Fellow subsidiary, same Key management etc.)
- **MEANING OF CONTROL AND SIGNIFICANT INFLUENCE IN REFERENCE TO RELATED PARTY- SAME AS AS-18**
- **NATURE OF RELATED PARTY RELATIONSHIPS AND TRANSACTIONS:** Related Party Transactions in normal course of business: No high risk of material misstatement on financial statement. Due to nature, it may give higher risk of material misstatement.
  Example:
  (1) Extensive & complex range of relationships and structures.
  (2) Information, systems may be ineffective at identifying transactions & opening balances.
  (3) Not be under normal market terms & conditions.
- **UNDERSTANDING THE ENTITY'S RELATED PARTY RELATIONSHIPS & TRANSACTIONS**
  Auditor shall inquire:
  - Identity of related party;
  - Nature of relationship; and
  - Transaction details with related party.
    Auditor shall inquire management and other to obtain understanding of controls, management has established to:
  - Identify and disclose related party relations in accordance with applicable Financial Reporting Framework.
  - Authorize significant transaction with related parties.
  - Authorize significant transaction outside normal course of business.

SA 520- ANALYTICAL PROCEDURES

- **MEANING:** Evaluation of financial information through analysis of both financial and non-financial data. It includes consideration of comparisons of the entity's financial information with: **(1)** Prior period comparable information.
  (2) Anticipated results of entity (Budget).
  (3) Similar industry information.
- **OBJECTIVE:**
  Obtain relevant & reliable audit evidence when using substantive analytical procedures; and design & perform analytical procedures near end of audit that assist in forming an overall conclusion.
- **PURPOSE:** Assess reasonability about account balances using comparison & ratio analysis.
  - **Example of how auditor can independently verify correctness of P & L expense:**
    (1) Abnormal fall in cost of manufacture or administrative cost is suspected, compare entries in outstanding book with previous year. Vouchers for one month immediately before the close of following years to verify none of expense are charged in following year.
    (2) It is possible to independently verify correctness of some of items of expenses included in the P&L. Like cost of imported goods can be verified by duty paid, Quantity of goods can be verified by GST paid on it, Income/expenses having direct relationship with amount of

profits/sales – Commission paid. Such calculation of ratios, trends & comparisons is termed as analytical review.

- **Timing of analytical procedures:** It is done in planning, testing & completion phase. In planning, it assists in understanding client's business & identifying areas of potential risk. Also, helps in determining nature, timing and extent of his other audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions. It is using both financial data and non- financial information.

➢ **FACTORS TO BE CONSIDERED FOR SUBSTANTIVE AUDIT PROCEDURES (SAP):**

- **Availability of data:** Reliable & relevant data facilitate effective analytical procedure.
- **Disaggregation:** Degree of disaggregation in available data can directly affect degree of its usefulness in detecting misstatements.
- **Account type:** Income statement accounts tend to be more predictable because they reflect accumulated transactions over a period, while Balance Sheet accounts represent net effect of transactions at a point in time. Balance Sheet accounts are subject to greater management judgment & less subject to analysis by analysts.
- **Source:** Some classes of transactions tend to be more predictable because they consist of numerous, similar transactions. Transactions recorded by non-routine & estimation-based classes of transactions are subject to management judgment & more difficult to predict.
- **Predictability:** Substantive analytical procedures are more appropriate when account balance or relationships between items of data are predictable that may reasonably be expected to exist & continue.

Inherent risk or "What can go wrong": Inherent risk = higher, design tests of details to address higherinherent risk. If significant risks identified, audit evidence solely from Substantive analytical procedure is unlikely to be sufficient.

➢ **TECHNIQUES AVAILABLE AS SUBSTANTIVE ANALYTICAL PROCEDURES**

- **Trend analysis:** Commonly used technique comparing of current with prior period data or with trend in two or more prior period. Evaluate current balance of account moves in line with trend established, or based on understanding of factors that may cause the account to change.
- **Ratio analysis:** Useful for analyzing asset & liability accounting and revenue & expense accounting It is compared over time or with ratios of separate entities within group, or with the ratios of other companies in the same industry.
- **Reasonableness tests:** It does not rely on events of prior periods, but upon non-financial data. Reviewing relationship of certain account balances to other balances for reasonableness of amounts.
- **Structural modelling:** Constructs statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances.

➢ **ANALYTICAL PROCEDURES USED AS SUBSTANTIVE TESTS:**

(1) Determine suitability based on assertion & risk of material misstatement;
(2) Evaluate reliability of data-based on source, comparability, nature, controls on information.
(3) Develop an expectation-Account compared with actual balance.
(4) Determine acceptable difference- between actual values & expectation.

➢ **SUITABILITY OF PARTICULAR ANALYTICAL PROCEDURES FOR GIVEN ASSERTIONS:** Applicable to large volumes of transactions;

- Based on expectation that relationships among data exist & continue in absence of known conditions to contrary;
- Depend upon the auditor's assessment of how effective it will be in detecting a misstatement that may cause financial statements to be materially misstated;
- Even unsophisticated predictive model can be effective as analytical procedure.

➢ **RELIABILITY OF DATA:** Source, Comparability, Nature & relevance of information available; Controls over preparation of information to ensure its completeness, accuracy and validity.

➢ **MATTERS RELEVANT FOR EVALUATION OF WHETHER EXPECTATION IS SUFFICIENTLY**

PRECISE:
(1) Accuracy with which expected results of substantive analytical procedures can be predicted.
(2) Degree to which information can be disaggregated.
(3) Availability of information, both financial & non-financial.

Amount of difference of recorded amounts from expected values that is acceptable depends upon: (a) Materiality level; (b) Desired level of assurance; & (c) Risk of material misstatement.

- **INVESTIGATE RESULTS OF PROCEDURE:** Inquiring of management & obtaining appropriate audit evidence relevant to management's responses; Performing other audit procedures as necessary.
- If analytical procedure identifies unrecognized misstatement, revise risk of material misstatement & modify further audit procedures accordingly.

Question Solver Points:

1. Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.
2. The quality of audit evidence is affected by the relevance and reliability of the information upon which it is based.
3. The auditor has to obtain sufficient appropriate audit evidence to draw reasonable conclusions on financial statements.
4. Sufficiency is the measure of the quantity of audit evidence. Appropriateness is measure of quality of audit evidence. **(PP Book C/I-Q.2) (PP book SA 500- Q.1)**
5. Audit procedures to obtain audit evidence can include inspection, observation, external confirmation, recalculation, reperformance, analytical procedures and inquiry. **(PP Book Q.11)**
6. Inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls. **(PP Book C/I-Q.42)**
7. 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. **(PP Book C/I-Q.4)**
8. 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.
9. 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. **(PP Book Q.7)**
10. The auditor may rely on the works of experts employed by management, provided he is satisfied that sufficient and appropriate audit evidence is obtained with reasonable assurance to form an opinion on the financial statements.
11. Internal audit function refers to 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.
12. Audit sampling refers to the application of audit procedures to less than 100% of items within a population of audit relevance, such that all sampling units;(*i.e.*, all the items in the population) have an equal chance of selection in accordance with SA 530. 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. **(PP Book SA 530 Q.1)**
13. Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics. **(PP Book C/I-Q.11)**
14. Statistical sampling uses the scientific method of choosing samples from a given population. **(PP Book C/I-Q.15)**

15. The non-statistical sampling is criticized on the grounds that it is neither objective nor scientific. **(PP Book C/I-Q.19)**
16. Stratified sampling is used when the population is diversified, *i.e.*, heterogeneous. **(PP Book C/I-Q.14)**
17. SA 501- "Audit Evidence- Specific Considerations for Selected Items" deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence with respect to certain aspects of inventory, litigation and claims involving the entity and segment information in an audit of financial statements.
18. SA 505 "External Confirmations" deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 500.
19. A positive confirmation request is 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. **(PP Book C/I-Q.6)**
20. As per SA 510, "Initial Audit Engagements – Opening Balances", the auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements. **(PP Book SA 510- Q1)**
21. Standard on Auditing (SA)550 "Related Parties" deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it applies in relation to risks of material misstatement associated with related party relationships and transactions.
22. "Analytical procedures" mean evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. **(PP Book SA 520. Q.4)**
23. SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusions on the financial statements.

PERFECT REVISION QUESTIONS

Q. No.	Questions and Answers
	SA 500 – Audit Evidence
1.	**What is meant by the sufficiency of Audit Evidence? Explain the factors affecting the auditor's judgement as to the sufficiency of audit evidence.**
Ans.	Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality. **Following are the factors affecting the auditor's judgement as to the sufficiency of audit evidence:** **(a) Materiality:** It may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand, if assertions are more material to the users of the financial statements, more evidence would be required. **(b) Risk of material misstatement:** It may be defined as the risk that the financial statements are materially misstated prior to the audit. **This consists of two components described as follows at the assertion level:** (i) **Inherent risk –** The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls. (ii) **Control risk –** The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control. **(c) Size of a population:** It refers to the number of items included in the population. Less evidence would be required in the case of the smaller, more homogeneous population, but on the other hand, in the case of larger, more heterogeneous populations, more evidence would be required.
2.	**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, explain the considerations auditor would consider for the purpose of his audit.**
Ans.	**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)** The nature and complexity of the matter to which the management's expert relates. **(b)** The risks of material misstatement in the matter. **(c)** The availability of alternative sources of audit evidence. **(d)** The nature, scope and objectives of the management's expert's work. **(e)** Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services. **(f)** The extent to which management can exercise control or influence over the work of the management's expert. **(g)** Whether the management's expert is subject to technical performance standards or other professional or industry requirements. **(h)** The nature and extent of any controls within the entity over the management's expert's work. **(i)** The auditor's knowledge and experience of the management's expert's field of expertise. **(j)** The auditor's previous experience of the work of that expert.

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16 of 22

3.		**The objective of auditing is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. This can be obtained by performing which procedures? Name the types of audit procedures the auditor can perform to obtain audit evidence?**
Ans.		**Audit procedures to obtain audit evidence includes:** **(a) 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. **(b) Observation:** Observation consists of looking at a process or procedure being performed by others. Observation provides audit evidence about the performance of a process or procedure but is limited to the point in time at which the observation takes place and by the fact that the act of being observed may affect how the process or procedure is performed. **(c) 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 any other medium. **(d) Recalculation:** Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically. **(e) Re-performance:** Re-performance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control. **(f) Analytical Procedures:** Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. **(g) Inquiry:** Inquiry consists of seeking information from 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.
		SA 501 – Audit Evidence (Specific Consideration for Selected Items)
4.		**ABC Ltd. is engaged in manufacturing different types of yarns. Ongoing through its financial statements for the past years, it is observed that inventory is material to the financial statements. You, as an auditor of the company, wanted to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory as appearing in the financial statements. Discuss how you would proceed as an auditor.**
Ans.		**When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:** **(a)** Attendance at physical inventory counting, unless impracticable, to: (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting; (ii) Observe the performance of management's count procedures; (iii) Inspect the inventory; and (iv) Perform test counts. **(b)** Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.
5.		**Explain clearly the examples of matters relevant in planning attendance at physical inventory counting.**
Ans.		**Matters relevant in planning attendance at physical inventory counting include:** **(a)** Nature of inventory. **(b)** Stages of completion of work in progress. **(c)** The risks of material misstatement related to inventory.

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

SA 505 – External Confirmation

6. **When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including sending the requests, including follow-up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures; the auditor would be required to maintain control over external confirmation requests.**

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

7. **CA Rohit is appointed as an auditor of Grace Ltd., he wants to design a suitable confirmation request letter for a few debtors of Grace Ltd. As a senior auditor of the firm, explain to him with reference to SA 505 "External Confirmation" all the conditions that should be present to use Negative Confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level.**

Ans. Negative confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative information provides less persuasive audit evidence than positive confirmations. **Accordingly, CA Rohit, Auditor of Grace Ltd. shall not use negative confirmation requests as the sole substantive 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.
(d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

SA 510 – Initial Audit Engagement

8. **The newly appointed auditor of BTN Limited wants to obtain "sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements. What audit procedures, should he perform for this purpose?**

Ans.	**Audit procedures regarding Opening Balances:** As per SA 510, "Initial Audit Engagements – Opening Balances", 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.
9.	**Discuss the objective of the auditor with respect to opening balances in conducting an initial audit engagement.**
Ans.	In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether: **(a)** Opening balances contain misstatements that materially affect the current period's financial statements; and **(b)** Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.
	SA 550 – Related Party
10.	**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. Explain with the help of at least *three* examples.**
Ans.	Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. **Example:** **(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.
	SA 530 Audit Sampling
11.	**What is the meaning of Sampling? Also, discuss the methods of Sampling. Explain in the light of SA 530, "Audit Sampling".**
Ans.	***Audit Sampling*** means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection

	in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected. **Methods of selecting samples:** **(a) Random Sampling:** Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve the use of random number tables. A random sampling includes two very popular methods, which are discussed below: • **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. It is considered that random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection. • **Stratified Sampling:** This method involves dividing the whole population to be tested into 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 this stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment. **(b) 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 have determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although, the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by the use of a computerized random number generator or random number tables. **(c) Monetary Unit Sampling:** It is a type of value-weighted selection in which sample size, selection and evaluation result in conclusion in monetary amounts. **(d) Haphazard sampling:** Haphazard selection, in which the auditor selects the sample without following a structured technique. Although, no structured techniqueis used, the auditor would nonetheless avoid any conscious bias or predictability (*for example*, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling. **(e) Block Sampling:** This method involves the selection of blocks 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.
12. **Ans.**	**What are the advantages of Statistical sampling in Auditing?** **Advantages of Statistical sampling in Auditing:** **(a)** The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested. **(b)** The sample selection is more objective and, thereby, more defensible. **(c)** The method provides a means of estimating the minimum sample size associated with a specified risk and precision. **(d)** 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.

	(e) 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. (f) It is a widely accepted way of sampling as it is more scientific, without personal bias, and the result of the sample can be evaluated and projected in a more reliable way.
13. Ans.	**Explain the factors to be considered while determining the extent of checking on a sampling plan.** **The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:** **(a)** Size of the organisation under audit. **(b)** State of the internal control. **(c)** Adequacy and reliability of books and records. **(d)** Tolerable error range. **(e)** Degree of the desired confidence.
14. Ans.	**It is imperative for the auditor to project misstatements for the population while performing audit proceedings through sampling. Comment.** **(a)** 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. **(b)** 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. **(c)** 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.
15. Ans.	**In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that the stratification or value-weighted selection technique is appropriate. Guide the auditor on the use of stratification and value-weighted sampling techniques.** **SA 530 provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.** **(a) Stratification:** Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk. When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of an overstatement. **(b) Value-Weighted Selection:** When performing tests of details, it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, *for example*, the accounts receivable balance, the auditor may then examine the particular items, *for example*, individual balances, that contain those monetary units. One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection and can result in smaller sample sizes. This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

	SA 520 ANALYTICAL PROCEDURES
16.	**While applying the Substantive Analytical Procedures, what techniques can be used by the statutory auditor of a company to obtain sufficient and appropriate audit evidence?**
Ans.	**While applying the Substantive Analytical Procedures, the statutory auditor of a company may use the following techniques to obtain sufficient and appropriate audit evidence:** **(a) 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. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account or based on an understanding of factors that may cause the account to change. **(b) 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. **(c) Reasonableness tests:** Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (*e.g.*, occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In other words, these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts. **(d) 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).
17.	**The statutory auditor of MNO Ltd., CA Kishore, identifies certain inconsistencies while applying analytical procedures to the financial and non-financial data of MNO Ltd. What should CA Kishore do in this case withreference to SA 520, "Analytical Procedures"?**
Ans.	As per SA 520, "Analytical Procedures", if while applying analytical procedures, the statutory auditor identifies fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, **the auditor shall investigate such differences by:** (a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: 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. (b) 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. (c) In the present case, CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non-financial data of MNO Ltd. CA Kishore should inquire the management of MNO Ltd. and obtain sufficient and appropriate audit evidence relevant to management response. Further, CA Kishore should also perform other audit procedures if required in the circumstances of the case to obtain further sufficient and appropriate audit evidence.

18. **What are the factors that determine the extent of reliance that the auditor places on the results of analytical procedures? Explain with reference to SA 520, "Analytical procedures".**

Ans. The reliability of data is influenced by its source and nature and is dependent onthe circumstances under which it is obtained. **The following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:**

(a) Source of information available. *For example*, information may be more reliable when it is obtained from independent sources outside the entity;

(b) Comparability of the information available. *For example*, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

(c) Nature and relevance of the information available. *For example*, whether budgets have been established as results to be expected rather than as goals to be achieved; and

(d) Controls over the preparation of the information that is designed to ensureits completeness, accuracy and validity. *For example*, controls over the preparation, review and maintenance of budgets.

SA 610

19. **Discuss some of circumstances when work of the internal auditor cannot be used by external auditor.**

Ans. **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.

20. **Internal audit not only analyses the effectiveness with which the internal control of a company is operating but also improves the effectiveness of internal control. Elucidate the statement.**

Ans. **Objectives of Internal Audit:**

As per SA-610, "Using the Work of an Internal Auditor", the objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control, such as the following:

(a) **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 organisation and effectiveness of communication among those charged with governance, external and internal auditors and management.

(b) **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 the effectiveness of the financial reporting process). The internal audit function may perform procedures to assist the entity in the detection of fraud.

(c) **Activities relating to internal control:**

(i) Evaluation of internal control.

(ii) Examination of financial and operating information.

(iii) Review of operating activities.

CHAPTER 5-AUDIT OF ITEMS OF FINANCIAL STATEMENTS

INTRODUCTION

- **ASSERTIONS-** It refers to **representations by management, explicit or otherwise, embodied in the Financial Statements,** consider by auditor for different type of misstatements.

- **GENERAL POINTERS VOUCHING & VERIFICATION IN CASE OF BALANCE SHEET ITEMS & INCOME STATEMENT:**
  - Obtain schedule/ list of heads & reconcile it with General Ledger or Financial Statements.
  - Check internal control applicable to ensure that controls are operating effectively & preventing, detecting and correcting errors.
  - Check minutes of meetings of board any other committee etc.
  - Obtain written representation from management to ensure that all details are included, no-omissions are made, information & access has been provided to auditor.
  - Perform Substantive analytical procedure to assess reasonableness of asset or liability. Perform: ratio analysis, trend analysis, reasonable test or can use statistical tools for it.
  - Check that entries are made in proper period, proper account with accurate amount and after proper approval.
  - Do inquiry procedures to understand the process.
  - Inquiry procedures to discuss any material differences identified.
  - Check nature of expense is of revenue nature to record in Profit & Loss capital nature if recorded in Balance sheet.

BALANCE SHEET CAPTIONS:

Head	Descriptions
Share Capital	• Verify period-end share capital balance against previous year's audited financial statements. • Obtain confirmation from Company Secretary if no changes occurred. • Ensure paid-up capital does not exceed Authorized Capital. • Verify relevant resolutions for any fresh issue made. • Check compliance with Companies Act, 2013 and SEBI regulations for fresh issues. **Share Premium:** • Ensure premium received on shares is transferred to Securities Premium Account. • Verify the proper application of premium as per regulations: Bonus issue, Write-off preliminary expense, Discount on issue, Premium on redemption and buy-back. **Shares Issued at a Discount:** • Company cannot issue shares at discount except for sweat equity shares or in pursuance with debt converted in shares. **Sweat Equity Shares:** • Verify issuance compliance with Companies Act, 2013. • Confirm the issuance was authorized by a special resolution. • Check if conditions for issuance have been met; Same class of shares, resolution passed, requirements of SEBI if listed. **Reduction of Capital:** • Confirm proper convening of shareholders' meeting and circulation of proposal. • Verify authorization in Articles of Association for capital reduction.

	• Examine Tribunal's order confirming reduction. • Check Registrar's Certificate. • Vouch accounting entries for capital reduction. • Confirm proper disclosure of asset revaluation. • Verify necessary amendments in Memorandum of Association. **Required Disclosure:** • Share Capital: Details of Authorized, Issued and Subscribed Shares. • A reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period; shares in the company held by each shareholder holding more than 5% shares specifying the number of shares held; • Utilization of Borrowed Funds and Share Premium: Disclosure of fund advancements, loans, investments and guarantees with compliance declarations.
Reserves and Surplus	• Trace opening balance to previous year's statements. • Trace movements to Statement of Profit & Loss. • Verify board resolutions for dividend payments and related taxes. **Presentation & Disclosure:** • Classify Reserves and Surplus into various components. • Disclose balances, changes and transfers for each component.
Borrowings	**Existence:** • Review board minutes for approval of new lending agreements. • Obtain independent balance confirmations for all borrowings. • Verify details of leases and hire purchase creditors against underlying contracts. **Completeness:** • Obtain a schedule of short and long-term borrowings. • Review board minutes for evidence of additional debt. • Ensure timely accounting for all borrowings. **Valuation:** • Agree loan balances to loan agreements. • Recompute interest, discount or premium on redemption. • Verify foreign currency loan restatements. **Presentation & Disclosure:** • Long-Term Borrowings: • Classify into categories such as bonds, term-loans, deferred payment liabilities, etc. • Ensure compliance with loan agreements and loan covenants. • Under Short-Term Borrowing heading: "Current maturities of Long-term borrowings" separately disclosed. • Where the company has not used the borrowings from banks and financial institutions for the specific purpose for which it was taken at the Balance Sheet date, the company shall disclose the details of where they have been used. • **Borrowings from banks/financial institutions** on the basis of security of current assets: quarterly returns or statements of current assets filed. If not, summary of reconciliation and reasons of material discrepancies. • If any **charge** not register with registrar of companies (ROC) within time, details and reasons to be disclosed.

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Trade Receivables	**Existence:** • Verify controls to prevent duplicate invoicing. • Request period-end accounts receivable aging. • Confirm balances with customers directly. **Completeness:** • Perform cut-off tests for sales invoices. • Match invoices to shipping logs for proper timing. **Valuation:** • Review allowance for doubtful accounts. • Analyze aging reports for bad-debt provisions. **Presentation & Disclosure:** • Classify amounts due as secured, unsecured, or doubtful.
Cash and Cash Equivalent	**Existence:** • Perform surprise cash counts. • Obtain bank reconciliation statements for all accounts. • Confirm balances with banks directly. **Presentation & Disclosure:** • Classify cash into balances with banks, cheques on hand, etc.
Inventories	**Existence:** • Participate in physical inventory counts. • Ensure segregation of consigned goods. • Reconcile physical inventory with perpetual records. **Completeness:** • Perform purchase and sales cut-off tests. • Reconcile physical inventory amounts. **Valuation:** • Verify valuation methods (FIFO, Weighted Average). • Assess Net Realizable Value for damaged or obsolete items. **Presentation & Disclosure:** • Classify inventory as raw materials, work-in-progress, finished goods, etc.
Property, Plant and Equipment (PPE):	**Existence:** • Review entity's plan for physical verification of PPE. • Obtain physical verification report and reconcile with fixed asset register. **Completeness:** • Verify movement in PPE schedule. • Check additions meet recognition criteria per accounting standard. • Ensure accurate recording of disposals and gains/losses on disposal. **Valuation:** • Confirm depreciation has been charged on all depreciable assets. • Assess depreciation method for consistency. • Verify impairment assessment compliance per AS 28.
Presentation & Disclosure:	Disclose reconciliation of gross and net carrying amounts of each class of assets at beginning & end of reporting period showing additions, disposals, acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value) & other adjustments & related depreciation & impairment losses/reversals disclosed separately. • **Classify PPE items (land, buildings, etc.).** – Title deeds of immovable property not held in name of the company ○ Relevant line item in the Balance sheet. ○ Description of item of property.

	o Gross Carrying Value. o Title deed held in the name of the company. o Whether title deed holder is a promoter, director or relative ^ of promoter*/director or employee of promoter/director. o Property held since which date. o Reason for not being held in the name of the company.
Intangible Assets	**Existence:** • Verify active use of intangible assets. • Confirm additions and deletions reconcile with ledger. **Completeness:** • Review movement in intangible assets schedule. • Check additions meet recognition criteria per AS 26. **Valuation:** • Confirm amortization on all intangible assets. • Assess amortization method for consistency. • Verify impairment assessment compliance. **Presentation & Disclosure:** • Classify intangible assets (goodwill, software, etc.). • Disclose reconciliation of gross and net carrying amounts.
Trade Payables and Other Current Liabilities:	**Existence:** • Implement controls to prevent duplicate recording. • Perform direct confirmation procedures with suppliers. **Completeness:** • Perform cut-off tests for invoice recording. • Test purchases or expenses against supporting documents. **Valuation:** • Review process for identifying write-back of old liabilities. • Assess reasonableness of statutory dues liabilities.
Loans and Advances and Other Current Assets	**Existence:** • Perform direct confirmation procedures with borrowers. • Verify loan agreements and approvals. **Completeness:** • Compare loan and advance list with ledger balances. • Verify additions meet recognition criteria. **Valuation:** • Review allowance for doubtful accounts. • Assess amortization method for accuracy. **Presentation & Disclosure:** • Classify loans (security deposits, etc.). • Sub-classify loans by security and risk. • **Loans or Advances** in the nature of loans are granted to promoters, directors, Key Managerial Personnels & related parties that are: (1) repayable on demand or (2) without specifying any terms or period of repayment.
Provisions and Contingent Liabilities	**Audit Procedure:** • Compare provisions with ledger balances. • Inspect underlying agreements and workings. • Obtain expert reports for complex provisions. **Presentation & Disclosure:** • Disclose carrying amounts and changes in provisions. • Provide details of unused amounts reversed.

STATEMENT OF PROFIT AND LOSS – CAPTIONS

STATEMENT OF PROFIT AND LOSS – CAPTIONS

Head	Description
Sales Audit	• **Procedure**- Understand sales process controls, test reliability, sample transactions and conduct substantive testing. • **Occurrence:** Verify revenue is not overstated by checking invoice accuracy, prevent duplicates and review sales sequences. Check for fictitious customers. • **Completeness:** Ensure revenue is correctly recorded, perform cut-off tests and verify credit notes issued after year end. Trace from shipping document. • **Measurement:** Accurately measure sales as per Accounting Standards, tracing transactions from inception to completion.
Other Income Audit	• **Procedure:** Verify interest income calculations, confirm dividends received and ensure accurate recording of investment gains/losses. • **Disclosure:** Review undisclosed income disclosed in financial statement, whether they are properly recorded.
Purchases Audit	• **Occurrence:** Review vendor selection, goods receipt procedures and original purchase invoices to prevent under-statement or over-statement. • **Completeness:** Perform cut-off tests, verify treatment of goods-in-transit and obtain management confirmation of all purchases.
Employee Benefits Audit	• **Procedure:** Test controls over employee benefit payment process, check sample transactions and perform substantive analytical procedure. • Obtain a list of all employees and check monthly movement. Check monthly reasonability. Check calculation of PF, ESI and TDS.
Depreciation and Amortization Audit	• Review accounting policies, fixed asset register and verify whether depreciation and amortization charges are valid and adjustments made of residual value. • Assess accuracy of depreciation calculations, ensure proper accounting treatment and verify disclosure requirements.
Other Expenses Audit	• Verify expenditure relevance, authenticity, classification and authorization. • Whether expense belongs to current period, revenue *vs.* capital expenditure and compliance with delegation of authority matrix.

ADDITIONAL DISCLOSURES:

(1) Corporate Social Responsibility (CSR):
- Disclose amount required and spent on CSR activities.
- Explain shortfalls, nature of activities and related party transactions.
- Detail provisions for contractual obligations related to CSR liabilities.

(2) BENAMI PROPERTY:
- Disclose details of proceedings for holding benami property.
- Include property details, beneficiaries and status of proceedings.
- Specify if property is on books and provide explanations for omissions.

(3) RATIOS:
- Disclose key financial ratios like current ratio, debt-equity ratio, etc.
- Explain numerator and denominator components.
- Provide reasons for significant ratio changes (>25%) compared to the previous year.

(4) Crypto Currency or Virtual Currency Details:
- Disclose profit/loss on transactions, currency held and deposits for trading/investing.
- Ensure transparency regarding involvement with crypto or virtual currency.

✍ **COMMON POINTS FOR BALANCE SHEET AND PROFIT AND LOSS:**

➢ **BALANCE SHEET ITEMS PROCEDURES**

- Assertions for Balance Sheet – **Existence, completeness, cut off, valuations, rights and obligations and presentation and disclosure.**
- **Existence:** Assets, liabilities and equity balances exist as at period end.
  - **In tangible asset, cash, inventory, ROU:** Observe & attend physical verification.
  - **In case of intangible asset, debtor, security deposit, loans, bill receivable, ROU, borrowing, creditor:** Check agreement i.e., inspection of documents, records, agreements, trust deed, charges.
  - **In Borrowings, Trade payables/receivables, Bank, Loan & advances:** Perform External confirmation procedure.
  - **In Trade payable/receivable:** Check ageing report.
- **Completeness & cut-off:** All assets, liabilities and equity balances that were supposed to be recorded have been recognized in financial statement & all assets and liabilities are reported in appropriate period.
  - Check that all transactions related to asset or liability have been properly recorded and no transaction is omitted or extra done, check arithmetical accuracy.
  - Check cut-off procedures to ensure that the transactions at year end or beginning of next year are recorded in correct period.
  - Check on sample or test basis few transactions at the end of the year or beginning of next year with their invoices, supporting documents, agreements, delivery items.
- **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 over-statement or under-statement.
  - **In case of current investment:** Check market value to ensure that investment is valued at cost or market value, *whichever is lower*.
  - **In case of long-term investment:** Check market value to ensure that investment provision for diminution is properly made.
  - **In Inventory:** Cost or Net Realisable Value (NRV) *whichever is lower*.
  - **In case of PPE, Intangible Asset:** Measure at cost.
  - **In case of all Balance Sheet items:** Correct valuation as per respective AS/IND-AS.
  - **In case of foreign currency item:** Check that foreign currency items are properly converted or restated at year end using year end rates.
  - **In case of marketable securities like share, debenture, bond:** Refer valuation report.
- **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.
  - Inspect the title deed or document of title or invoices or agreement or share certificate.
  - Do external confirmation procedures.
- **Presentation & Disclosure:** Whether particular items in the financial statements are properly classified, described and disclosed. Refer Schedule III and AS.

➢ **INCOME STATEMENT ITEMS PROCEDURES**

- Various types of assertions for statement of Profit & Loss- **measurement, completeness, occurrence, cut offs, presentation and disclosure.**
- **Occurrence:** Transactions recognized in the financial statements have occurred and relate to the entity.
  - Check transactions with their respective invoices, agreements, purchase or sales order to ensure that the transactions have actually occurred during the year.
  - Check bank statement to check the receipt or payment to ensure that the same relates to current year.
  - **Revenue:** Recorded twice, Fictitious customer or sales, Substantial uncertainty on collection.

- **Purchase:** Check quantity inspection, Goods Received Note (GRN) prepared & signed, Invoice approved.

- **Completeness & Cut-off:** All transactions that were supposed to be recorded have been recognized in the financial statements. Transactions have not been omitted. Whether all income and expenses are reported in the correct accounting period.
  - Check that all transactions have been properly recorded & no transaction is omitted or extra done.
  - Check cut-off procedures to ensure that the transactions at year end or beginning of next year are recorded in correct period.
  - Check on sample/test basis few transactions at the end of the year or beginning of next year with their invoices, supporting documents, agreements, delivery items, etc.
  - **Revenue:** Check Quantity, GST returns, Credit notes.
  - **Employee benefit Expense:** All personnel have been fully accounted for.
- **Measurement:** Transactions have been recorded accurately at their appropriate amounts in financial statements.
  - Check on sample basis or test check basis that the expense or income is properly measured and accounted in the books of the accounts.
  - Ensure that the invoices amount reconciled with amount recorded in the books of accounts.
  - Auditor will also check internal controls like approvals.
  - **Other Income:** FD interest calculation, Bank confirmation, 26 AS.
  - **Depreciation** ensures it is computed on proper rates for proper period as per Companies Act. Recompute the depreciation.
  - **Interest** ensures it is computed on the rates as per loan agreement and computed for proper period. Recompute the interest.
  - **Provision for tax:** Check taxation provisions are properly applied and followed. Recompute the taxation amount as per Income Tax Act.
  - Check rates and prices for sales, dividend, commission income, etc.
- **Presentation & disclosure:** Transactions have been classified and presented fairly in the Financial Statement. Refer Schedule III and AS.

Question Solver Points:

1. Assertion refers to the 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.
2. Assertions pertaining to Balance sheet captions comprise of existence, completeness, cut-off, rights and obligations, valuation and presentation and disclosure.
3. Assertions pertaining to Income statement captions comprise of occurrence, completeness, cut-off, measurement and presentation and disclosure.
4. Requirements of Schedule III of Companies Act, 2013 have to be kept in mind while verifying assertions in case of a company.
5. "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. **(PP book-C/I-Q.3)**
6. Capital reserve means that the part of profits reserved by the company for a particular purpose. Reserve capital means that the part of the authorized capital that has not yet been called up by the company. **(PP book-C/I-Q.14)**
7. Employee benefits expenses, commonly called payroll expenses, represent the aggregate sum an entity pays to its employees for their labour/efforts, as well as associated expenses such as perquisites/benefits, post-employment benefits. **(PP book-C/I-Q.1)**
8. Dividends are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established. **(PP book-C/I-Q.2)**
9. Dividends are recommended by the Board and declared by the Shareholders. **(PP book-C/I-Q.12)**

10. Revenue reserves represent profits that are available for distribution to shareholders and

10. Revenue reserves represent profits that are available for distribution to shareholders and capital reserves are not available for distribution. **(PP book-C/I-Q.4)**
11. The securities premium account may be applied by the company towards bonus issue, writing of preliminary expense, buy back or discount/issue of shares. **(PP book-C/I-Q.7)**
12. Depreciation is charged when the asset is ready for use **(PP book-C/I-Q.9)**
13. An increase in Authorised capital requires alteration of capital clause of memorandum of Association. **(PP book-C/I-Q.10)**
14. While auditing trade receivable balance, direct confirmations as per SA 505 is considered to be the most important audit activity. **(PP book-C/I-Q.13)**
15. Negative assertions encountered in the financial statements 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. **(PP book-C/I-Q.21)**

PERFECT REVISION QUESTIONS

Q. No.	Questions and Answers
1.	**How would you vouch or verify the following:** **(a) Advertisement Expenses** **(b) Sale of Scrap**
Ans.	**(a) Advertisement expenses:** **(i)** Verify the bills/invoices from the advertising agency to ensure that rates charged for different types of advertisement are as per the contract. **(ii)** See that the advertisement relates to the client's business. **(iii)** Inspect the receipt issued by the agency. **(iv)** Ascertain the nature of expenditure, revenue or capital expenditure, and see that it has been recorded properly. **(v)** Ascertain the period for which payment is made and see that prepaid amount, *if any*, is carried to the balance sheet. **(vi)** See that all outstanding advertisement bills have been provided for. **(b) Sale of scrap:** **(i)** Review the internal control as regards generation, storage and disposal of scrap. **(ii)** Check whether the organization is maintaining a reasonable record for the generation of scrap. **(iii)** Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of the earlier year. **(iv)** Check the rates at which scrap has been sold and compare the rate with the previous year. **(v)** Vouch sales, with invoices raised, the advertisement for tender, rate contract with scrap dealers. **(vi)** Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap. **(vii)** Make an overall assessment of the value of realization from scrap as to its reasonableness.
2.	**How will you vouch or verify the following?** **(a) Trademarks and copyrights** **(b) Investments income in the case of charitable institutions** **(c) Contingent liabilities** **(d) Leasehold rights**
Ans.	**(a) Trademarks and copyrights:** **(i)** Obtain a schedule of Trade Marks and Copyrights duly signed by the responsible officer and scrutinize the same and confirm that all of them are shown in the Balance Sheet. **(ii)** Examine the written agreement in case of assignment of Copyrights and Assignment Deed in case of transfer of Trade Marks. Also, ensure that trademarks and copyrights have been duly registered. **(iii)** Verify the existence of Copyright by reference to the contract between the author and the entity and note down the terms of payment of royalty. **(iv)** See that the value has been determined properly and the costs incurred for the purpose of obtaining the trademarks and copyrights have been capitalized. **(v)** Ascertain that the legal life of the Trademarks and copyrights has not expired. **(vi)** Ensure that the amount paid for both the intangible assets is properly amortized having regard to appropriate legal and commercial considerations, as per the principles enunciated under AS-26 on Intangible Assets. **(b) Investments income in the case of charitable institutions:** **(i)** Vouching for the amounts received with the dividend and interest counterfoils.

	(ii) Checking the calculations of interest received on securities bearing fixed rates of

	(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 dividends received with the schedule of investments making special inquiries into any investments held for which no dividend has been received. **(c) Contingent liabilities:** **(i)** Inspect the minute books of the company to ascertain all contingent liabilities known to the company. **(ii)** Examine the contracts entered into by the company and the likelihood of contingent liabilities emanating therefrom. **(iii)** Scrutinize the lawyer's bills to track unreported contingent liabilities. **(iv)** Examine bank letters in respect of bills discounted and not matured. **(v)** Examine bank letters to ascertain guarantees on behalf of other companies or individuals. **(vi)** Discuss with various functional officers of the company about the possibility of contingent liability existing in their respective fields. **(vii)** Obtain a certificate from the management that all known contingent liabilities have been included in the accounts and have been properly disclosed. **(viii)** Ensure that proper disclosure has been made as per Schedule III of the Companies Act, 2013 and AS-29, "Provisions, Contingent Liabilities and Contingent Assets". **(d) Leasehold rights:** **(i)** Inspect the lease or assignment thereof to ascertain the amount of premium, if any, for securing the lease, and its terms and conditions and that the lease has been duly registered. **(ii)** Ascertain that all conditions, the failure to comply with which might result in the forfeiture or cancellation of the lease. **(iii)** Examine the counterpart of the tenants' agreement if part of the leasehold property has been sublet. **(iv)** Make certain that due provisions for any claim that might arise under the dilapidation clause on the expiry of the lease have been made, and if no such provision has been made, draw the client's attention to the matter. **(v)** Ensure that the outlay as well as any legal expenses incurred to acquire the leases, which are shown as an asset in the Balance Sheet, is being written off at the rate which could completely wipe off the asset over the unexpired term of the lease.
3.	**Auditor A of ABC & Co., a firm of auditors, is conducting the audit of XYZ Ltd. and, while performing testing of additions, wanted to verify that all PPE (Property, Plant and Equipment) purchase invoices are in the name of the entity he is auditing. For all additions to land, building in particular, the auditor desires to have concrete evidence about ownership. The auditor is worried about whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements. Advise the auditor.**
Ans.	**(i)** 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. **(ii)** For all additions to land, building in particular, the auditor should obtain copies of the conveyance deed/sale deed to establish whether the entity is mentioned to be the legal and valid owner.

	(iii) The auditor should insist and verify the original title deeds for all immovable properties held as at the balance sheet date. **(iv)** In case the entity has given such immovable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of the immovable property as security. **(v)** In addition, the auditor should also verify the register of charges available with the entity to assess that any charge has been created against the PPE.
4.	**Explain how you will verify the items given while conducting an audit of an entity?** **(a) Recovery of bad debts written off** **(b) Receipt of insurance claims**
Ans.	**(a) Recovery of bad debts written off:** **(i)** Ascertain the total amount lying as bad debts and verify the relevant correspondence with the trade receivables whose accounts were written off as bad debts. **(ii)** Ensure that all recoveries of bad debts have been properly recorded in the books of accounts. **(iii)** Examine notification from the Court or from the bankruptcy trustee. Letters from collecting agencies or from account receivables should also be seen. **(iv)** Check the Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly. **(v)** Verify the acknowledgement receipts issued to account receivables or trustees. **(vi)** Review the internal control system regarding writing off and recovery of bad debts. **(b) Receipt of insurance claims:** **(i)** The auditor should examine a copy of the insurance claim lodged with the insurance company correspondence with the insurance company and with the insurance agent should also be seen. Counterfoils of the receipts issued to the insurance company should also be seen. **(ii)** The auditor should also determine the adjustment of the amount received in excess or short of the value of the actual loss as per the insurance policy. **(iii)** A copy of the certificate or report containing full particulars of the amount of loss should also be verified. **(iv)** The accounting treatment of the amount received should be seen particularly to ensure that the revenue is credited with the appropriate amount and that in respect of the claim against the asset, the Statement of Profit & Loss is debited with the shortfall of the claim admitted against the book value if the claim was lodged in the previous year, but no entries were passed, entries in the Statement of Profit & Loss should be appropriately described.
5.	**How will you vouch and/or verify the following:** **(a) Goods sent out on Sale or Return Basis.** **(b) Borrowing from Banks.**
Ans.	**(a) Goods sent out on Sale or Return Basis:** **(i)** Check whether a separate memorandum record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold, and the sales account is credited. **(ii)** Verify that price of such goods is unloaded from the sales account and the trade receivables record. Check the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.

	(iii) Ensure that the goods in respect of which the period of approval has expired at the end of the year have either been received back, or customers' accounts have been debited. (iv) Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the end of the year lying with the party, has been included in the closing inventory. **(b) Borrowing from Banks:** Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows: (i) Reconcile the balances in the overdrafts or loan accounts with that shown in the passbook and confirm the last-mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year. (ii) Obtain independent balance confirmation from the bank showing balances, particulars of securities deposited with the bank as security for the loans or of the charge created on an asset and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges. (iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank. (iv) Confirm, in the case of a company, that the restraint contained **in Section 180** of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened. (v) Ascertain the purpose for which the loan has been raised and the manner in which it has been utilized, and that this has not prejudicially affected the entity.
6. **Ans.**	**How will you vouch and/or verify payment of taxes?** **Vouching of payment of taxes:** (a) Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the receipted challan. (b) Payments or advance payments of income tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid. (c) The interest allowed on advance payments of income tax should be included as income and penal interest charged for non-payment should be debited to the interest account. (d) Now a days, electronic payment of taxes is also in trend. Electronic payment of taxes means payment of taxes by way of an internet banking facility or credit or debit cards. (e) The entity can make electronic payment of taxes also from the account of any other person. However, the challan for making such payment must clearly indicate the Permanent Account Number (PAN) of the assessee on whose behalf the payment is made. This should be checked by the auditor. (f) It is not necessary for the entity to make payment of taxes from his own account in an authorized bank. While vouching for such e-payment, the auditor should cross verify the payments of taxes through the receipted challan along with PAN No. /TAN No. etc.
7. **Ans.**	**How will you vouch or verify the following:** **(a) Goods sent on consignment** **(b) Foreign travel expenses** **(c) Receipt of capital subsidy** **(d) Provision for income tax** **(a) Goods Sent on Consignment:** (i) Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods in hand. (ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any

consignment inventory was in the hands of the consignee at the beginning of the consignment inventory was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.

(iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of the agreement between the consignor and the consignee to check the commission and other expenses debited to the Consignment Account and credited to the Consignee's Account. The accounts sales also must be correspondingly checked.

(iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost *plus* proportionate non-recurring expenses, *e.g.*, freight, dock dues, customs due, etc., unless the value is lower. In case the net realisable value is lower, the inventory in the hand of the consignee should be valued at net realisable value. Also, see that the allowance has been made for damaged and obsolete goods in making the valuation.

(v) See that goods in hand with the consignee have been shown separately under the head inventories.

(b) Foreign travel expenses:

(i) Examine Travelling Allowance bills submitted by the employees stating the details of the tour, details of expenses, etc.

(ii) Verify that the tour programme was properly authorised by the competent authority.

(iii) Check the Travelling Allowance bills along with accompanying supporting documents such as air tickets, travel agent bills and hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.

(iv) See that the tour report accompanies the Travelling Allowance bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour, as shown by the tour report, confirms the authorization for the tour.

(v) Check Reserve Bank of India's permission, *if necessary*, for withdrawing the foreign exchange. For a company, the amount of foreign exchange spent is to be disclosed separately in the accounts as per the requirement of Schedule III to the Companies Act, 2013 and Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates".

(c) Receipt of Capital Subsidy:

(i) Check the application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.

(ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.

(iii) Ensure that the conditions to be fulfilled and other terms, especially whether the same is for a specific asset or is for setting up a factory at a specific location.

(iv) Check relevant entries for receipt of subsidy.

(v) Check compliance with requirements of AS 12 on "Accounting for Government Grants," *i.e.*, whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

(d) Provision for income tax:

(i) Obtain the computation of income and income tax prepared by the entity and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.

(ii) Review adjustments, expenses, disallowed special rebates, etc., with particular reference to the last available completed assessment.

(iii) Examine relevant records and documents pertaining to advance tax, self-assessment tax and other demands.

(iv) Compute tax payable as per the latest applicable rates in the Finance Act.

(v) Ensure that overall provisions on the date of the Balance Sheet are adequate having regard to current year provision, advance tax paid, assessment orders, etc.

(vi) Ensure that the requirements of AS 22 on Accounting for Taxes on Income have been appropriately followed for the period under audit.

8. How would you vouch or verify the Work in progress?

Ans. Work in progress:

(a) Ascertain how the various stages of production or value additions are measured, and in case estimates are made, understand the basis for such estimates.

(b) 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 or information maintained by the entity.

(c) Ensure that material costs exclude any abnormal wastage factors.

9. How is "Cash and Cash Equivalents" disclosed in the financial statements as required under Schedule III (Part I) to the Companies Act, 2013?

Ans. The following disclosures, as required under Schedule III (Part 1) of the Companies Act, 2013, shall be made in the financial statements:

Cash and Cash Equivalents:

(a) Cash and cash equivalents shall be classified as:

(i) Balances with banks;

(ii) Cheques, drafts on hand;

(iii) Cash on hand;

(iv) Others (specify nature);

(b) Earmarked balances with banks (*for example*, for unpaid dividends) shall be separately stated.

(c) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(d) Repatriation restrictions, *if any*, in respect of cash and bank balances shall be separately stated.

(e) Bank deposits with more than 12 months maturity shall be disclosed separately.

10. APQ Ltd. deals in real estate and classifies all of its land holdings under current assets as inventory. The same is, therefore, values at cost or market value, whichever is lower. How would you verify profit or loss arising on the sale of plots of land by such a dealer?

Ans. Verification of Profit or Loss arising on the sale of plots by real estate dealer:

(a) Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realized for it.

(b) This basis of the distribution of the common charges between different plots of land developed during the period and the basis for the allocation of the cost of individual properties comprised of a particular piece of land should be scrutinized.

(c) If land price lists are available, these should be compared with actual selling prices obtained. And, it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.

(d) Where the part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.

(e) The prices obtained for various plots of land sold should be checked with the plan map of the entire tract, and any discrepancy or unreasonable price variations should be enquired into. The sale price of different plots of land should be verified in reference to certified copies of sale deeds executed.

(f) Out of the sale proceeds, the provision should be made for the expenditure incurred on the improvement of the land, which so far has been accounted for.

11. List out the steps to be taken by the auditor while vouching or verifying the 'Refund

11.	**List out the steps to be taken by the auditor while vouching or verifying the 'Refund of General Insurance Premium'.**
Ans.	**The auditor shall take the following steps while vouching or verifying the Refund of General Insurance Premium:** **(a)** Ascertain the reasons for the refund of the insurance premium. **(b)** Examine the insurance policy or cover note to find out the amount of the premium. **(c)** Verify the advice of refund received from the insurance company. When the refund is admitted, the insurance company sends the advice. This will be evidence as a covering letter to the cheque for the refund. Sometimes, a cheque is issued after a receipt is sent in advance to the insurance company. **(d)** Scrutinize the correspondence between the insurance company and the client. **(e)** Check entries in a bank book or the bank statement, *if necessary*, the counterfoil of the pay-in-slips can also be verified.
12.	**Explain with examples the audit procedure to establish the existence of intangible fixed assets at the period-end.**
Ans.	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. ***For example***: For verifying the existence of software, the auditor should verify whether such software is in active use by the entity, and for the purpose, the auditor should verify the sale of related services or goods during the period under audit, in which such software has been used. ***For example***: For verifying the existence of design or drawings, the auditor should verify the production data to establish if such products for which the design or drawings were purchased are being produced and sold by the entity. In case any intangible asset is not in active use, deletion should have been recorded in the books of account post approvals by the entity's management and amortization charge should have ceased beyond the date of deletion.
13.	**Explain the disclosure requirements of Schedule III in respect of Trade Receivables.**
Ans.	**(a)** The aggregate amount of Trade Receivables outstanding for a period exceeding 6 months from the date they are due for the payment should be separately stated. **(b)** Trade receivables shall be sub-classified as: **(i)** Secured, considered good; **(ii)** Unsecured, considered good; **(iii)** Doubtful. **(c)** Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately. **(d)** Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.
14.	**ABC Ltd. has issued shares for cash at a premium of ₹450, *i.e.*, an amount in excess of the nominal value of the shares, which is ₹10 for cash. Section 52 of the Companies Act, 2013 provides that a company shall transfer the amount received by it as securities premium to a Securities Premium Account. Advise the means by which the amount in the account can be applied.**
Ans.	In case a company has issued shares at a premium, that is, an 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. As per the section, where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium

received on those shares shall be transferred to a "Securities Premium Account" and the

	received on those shares shall be transferred to a "Securities Premium Account" and the provisions of this Act relating to the reduction of the share capital of a company shall apply as if the Securities Premium Account were the paid-up share capital of the company. **Application of securities premium account:** The Securities Premium Account may be applied by the Company: **(a)** towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares; **(b)** in writing off the preliminary expenses of the company; **(c)** in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; **(d)** in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or **(e)** for the purchase of its own shares or other securities under **Section 68.** The auditor needs to verify whether the premium received on shares, *if any*, has been transferred to a "Securities Premium Account" and whether the application of any amount out of the said "Securities Premium Account" is only for the purposes mentioned above.
15. **Ans.**	**Write the audit Procedure for verification of the existence of Trade Receivables.** **For Verification of Existence of Trade Receivables, the auditor should check the following:** **(a)** Check whether there are controls in place to ensure that invoices cannot be recorded more than once and receivable balances are automatically recorded in the general ledger from the original invoice. Ask for a period-end accounts receivable ageing report and trace the balance as per the report to the general ledger. **(b)** Check whether realization is recorded invoice-wise or not. If not, check that money received from debtors is adjusted chronologically invoice-wise and on a FIFO basis, *i.e.*, the previous bill is adjusted first. **(c)** If any large balance is due for a long time, the auditor should ask for reasons and justification for the same. **(d)** A list of trade receivables selected for confirmation should be given to the entity for preparing request letters for confirmation, which should be properly addressed. **(e)** The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. It should be ensured that confirmations, as well as any undelivered letters, are returned to the auditor and not to the client. **(f)** Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. **(g)** Where no reply is received, the auditor should perform alternate procedures regarding the balances. **(h)** Agreeing on the balance to cash received subsequently. **(i)** Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred. (examination in-depth for those balances) **(j)** 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 was reasonable and at arm's length. **(k)** Check that receivables other than sales or services are not included in the list. **(l)** Review a trend line of sales and accounts receivable, or a comparison of the two over time, to check if there are any unusual trends, *i.e.*, perform Analytical procedures. Make inquiries about reasons for changes in trends with the management and document the same in audit work papers.

16. **While conducting an audit of Air Space Ltd., the auditor observes that it has issued shares at a discount to its creditors when its debt is converted into shares in pursuance of a debt restructuring scheme in accordance with any guidelines specified by the Reserve Bank of India. Discuss explaining clearly the provisions relating to a discount on the issue of shares and its verification by the auditor.**

Ans. **As per Section 53 of the Companies Act, 2013:**

(a) A company shall not issue shares at a discount except as provided in **Section 54**.

(b) Any share issued by a company at a discount shall be void.

(c) However, 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 RBI Act, 1934 or the Banking (Regulations) Act, 1949.

(d) Where any company fails to comply with the provisions of **Section 53**, such company and every officer who is in default shall be liable to:

- **(i)** a penalty that may extend to an amount equal to the amount raised through the issue of shares at a discount or ₹5 Lakhs, *whichever is less*, and
- **(ii)** the company shall also be liable to refund all monies received with interest at the rate of 12% p.a. from the date of issue of such shares to the person to whom such shares have been issued.

The auditor needs to check:

(a) 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 the issue of share capital and the issue price.

(b) Further, the auditor should also verify that in case a 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.

(c) In the given case of Air Space Ltd, it is clear that it can issue shares to its creditors when its debt is converted into shares in accordance with the approved restructuring scheme.

17. **CA Q, the auditor of XYZ Ltd. while conducting audit observes that the company has made various provisions in the books of account. What are the audit procedures that CA Q will follow to verify the existence, completeness, and valuation of the provisions made?**

Ans.

Assertion	Audit Procedure
Existence	• Inspect underlying agreements like agreement with customers to assess warranty commitments, any legal & other claims on entity.
Completeness	• Obtain list of all provisions & compare them with balances in ledger. • Obtain Written representation from management that it has made all provisions which were required to be made as per recognized accounting principles.
Valuation	• Obtain underlying working & basis for each of provisions made & verify whether same is complete & accurate • Wherever required, obtain expert's report, calculation & underlying working for provision amount. Request for assessment made by legal expert in relation to likelihood of liability devolving on entity *i.e.*, whether probable or possible or remote as defined above. Verify underlying assumptions used by expert with data shared by management.

18. **While verifying the legal and professional expenses of the client company, what**

18.	**While verifying the legal and professional expenses of the client company, what audit procedures should the auditor perform?**
Ans.	**While verifying the legal and professional expenses of the client company, the auditor should perform the following audit procedures:** **(a)** Obtain a month-wise and consultant-wise summary. **(b)** In case of monthly retainership agreements, verify whether the expenditure for all 12 months has been recorded correctly. **(c)** 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 or highlighted to the auditor for his specific consideration.

CHAPTER 6- AUDIT DOCUMENTATION

SA 230-AUDIT DOCUMENTATION

- **DEFINITION:** Record of audit procedures performed; relevant audit evidence obtained & conclusions reached.
- **OBJECTIVES OF AUDITOR:**
  Objectives of 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.
- **NATURE OF AUDIT DOCUMENTATION:**
  (a) Evidence of auditor's basis for concluding the audit.
  (b) Evidence that audit was planned and performed as per SAs.

- **PURPOSE:**
  (1) Assist team to plan & perform audit.
  (2) Assist team in direction, supervision and review.
  (3) Team accountable for its work.
  (4) Record significant matters for future audit.
  (5) Conduct of quality control reviews & inspections.
  (6) Conduct of external inspections.

- **FORM, CONTENT AND EXTENT OF AUDIT DOCUMENTATION:**
  - **AUDIT DOCUMENTATION SHOULD BE SUFFICIENT TO UNDERSTAND:**
    (a) Nature, extent and timing of audit procedures performed.
    (b) Results of audit procedures performed & evidence obtained.
    (c) Significant matters arising & their conclusions.
    (d) Significant professional judgements made for reaching conclusions.

  - **DOCUMENTING THE NATURE, EXTENT AND TIMING OF AUDIT PROCEDURES PERFORMED:**
    (a) Characteristics of specific matters tested.
    (b) Who performed work & date of completion.
    (c) Who reviewed work & date of review.

  - Document significant matters discussed with management & those charged with governance & others.
  - Documenting inconsistency addressed between information & conclusion of significant matter.

- **FACTORS AFFECTING FORM, CONTENT AND EXTENT:**
  (1) Size & complexity of entity.
  (2) Nature of audit procedures to be performed.
  (3) Identified risk of material misstatement.
  (4) Significance of audit evidence obtained.
  (5) Nature & extent of exceptions identified.
  (6) Audit methodology & tools used.
  (7) Document conclusion or basis for conclusion.

- **EXAMPLES OF AUDIT DOCUMENTATION: IT INCLUDES:**
  Audit programmes, analyses, issues memoranda, summaries of significant matters, letters of confirmation & representation, checklists, correspondence (including e-mail) concerning significant matters.

➢ **AUDIT FILE:**
One or more folders or other storage media (physical or e-form), containing the records that comprise the Audit Documentation for a specific engagement.

➢ **ASSEMBLY OF FINAL AUDIT FILE:**
SQC-1 requires firm policy & procedure for timely assembly of audit files. Assemble of all audit file is within 60 days after the auditor's report date. Assembly after the date of audit report is an administrative process & does not involve new audit procedures or conclusions. Changes can be made if administrative in nature such as discarding old documents, signing off on checklist, sorting, collating or documenting evidence already collected before the date of audit report.

- Auditor shall not delete/discard Audit Documentation till end of its retention period *i.e.*, Firm to establish policies & procedure to retain Audit Documentation for 7 years from auditor's report date (as per SQC-1).

➢ **DOCUMENTATION OF SIGNIFICANT MATTERS & RELATED SIGNIFICANT PROFESSIONAL JUDGEMENTS:**

- Form, Contents and Extent of Audit Documentation depend upon professional judgement exercised. Documentation serves to explain the auditor's conclusions & reinforce quality of judgments. When reviewing matters of continuing significance, these matters are of particular interest to those responsible for reviewing Audit Documentation.
- **EXAMPLES OF SIGNIFICANT MATTERS ARE THOSE MATTERS THAT GIVE RISE TO SIGNIFICANT RISKS:**
  (1) Results of audit procedures indicating that financial statements could be materially misstated or need to revise auditor's previous assessment of the risk of material misstatement & the auditor's responses to those risks.
  (2) Circumstances causing auditor significant difficulty in applying necessary audit procedures.
  (3) Findings that could result in a modification to the audit opinion or inclusion of an emphasis of matter Para.

- **EXAMPLES OF MATTERS WHERE DOCUMENTATION OF PROFESSIONAL JUDGEMENT IS NECESSARY:**
  - Nature, timing and extent of Audit Procedures.
  - Sufficiency and appropriateness of Audit Evidence.
  - Forming of conclusions and opinion.
  - Determining materiality levels.

➢ **COMPLETION OF MEMORANDUM OR AUDIT DOCUMENTATION SUMMARY:**
It prepares & retains as part of the Audit Documentation summary that describes: -
- Significant matters identified &
- How they were addressed.

Such summary facilitates:

➢ Effective & efficient review and inspection of the Audit Documentation of large and complex audits.
➢ Assist auditor's consideration of significant matters.
➢ Whether there is any individual relevant SA objective that the auditor cannot achieve that prevent the auditor from achieving the overall objectives of the auditor.

➢ **OWNERSHIP OF AUDIT DOCUMENTATION:**
Property of auditor as per SQC -1. At his discretion he may provide extract or portion from Audit Documentation to client.

Question Solver Points:

1. Audit Documentation is the record of audit procedures performed; relevant audit evidence obtained & conclusions the auditor reached.
2. The objective of Auditor is to prepare documentation that provides a sufficient and appropriate record of the basis for the auditor's report; and evidence that the audit was planned & performed in accordance with SAs and applicable legal and regulatory requirements.
3. The auditor will prepare audit documentation on a timely basis which will enhance quality of the audit and facilitates the effective review.
4. The auditor shall prepare audit documentation on a timely basis. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. 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. **(PP Book-C/I-Q.5)**
5. 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.
6. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. **(PP Book Q.2)**
7. 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 which is 7 years as per SQC 1. **(PP Book Q2)**
8. Audit Documentation is the property of the auditor. **(PP Book C/I- Q.2)**

PERFECT REVISION QUESTIONS

Q. No.	Questions and Answers
1.	**A new team member of GSR & Co., the auditors of Esteem Limited, was of the view that Audit Documentation would not serve any purpose at any stage of the audit. Explain.**
Ans.	**Purposes of Audit documentation are:** **(a)** Assisting the engagement team to plan and perform the audit. **(b)** Assisting members of the engagement team to direct and supervise the audit work and to discharge their review responsibilities. **(c)** Enabling the engagement team to be accountable for its work. **(d)** Retaining a record of matters of continuing significance to future audits. **(e)** Enabling the conduct of quality control reviews and inspections in accordance with SQC 1. **(f)** Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements. **Facts of the case:** A new team member of GSR & Co., the auditors of Esteem Limited, was of the view that Audit Documentation would not serve any purpose at any stage of the audit. **Conclusion:** From the above points, it can be concluded that Audit Documentation serves a number of purposes and hence it would be incorrect to say audit documentation would not serve any purpose at any stage of the audit.
2.	**SQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files. Explain.**
Ans.	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. **(a)** SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services" requires firms to establish policies and procedures for the timely completion of the assembly of audit files. **(b)** An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. **(c)** 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. **(d)** 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. **(e)** SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report or, if later, the date of the group auditor's report.

3.	**The form, contents and extent of audit documents depend on certain factors. Explain.**
Ans.	**The form, contents and extent of audit documents depend on certain factors such as:** **(i)** The size and complexity of the entity. **(ii)** The nature of the audit procedures to be performed. **(iii)** The identified risks of material misstatement. **(iv)** The significance of the audit evidence obtained. **(v)** The nature and extent of exceptions identified. **(vi)** 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. **(vii)** The audit methodology and tools used.
4.	**Judging the significance of a matter requires an objective analysis of the facts and circumstances. Documentation of the professional judgements made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgement. Explain with the help of examples.**
Ans.	Judging the significance of a matter requires an objective analysis of the facts and circumstances. **Matters that give rise to significant risks:** **(1)** 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. **(2) Circumstances** that cause the auditor to significant difficulty in applying necessary audit procedures. **(3)** Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter Paragraph in the auditor's report. **An important factor** in determining the form, contents and extent of audit documentation of significant matters is the extent of professional judgement exercised in performing the work and evaluating the results. **Documentation of the professional judgement made for significant judgement serves the following:** **(a)** 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. **(b)** The basis for the auditor's conclusion on the reasonableness of areas of subjective judgements. *For example*, the reasonableness of significant accounting estimates. **(c)** 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.
5.	**"Audit documentation summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits". Explain.**
Ans.	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: **(a)** The significant matters identified during the audit, and **(b)** 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 the auditor's consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant. To SAs objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

CHAPTER 7-COMPLETION AND REVIEW

SA 560

SUBSEQUENT EVENTS

- **Meaning:** Events occurring between financial statements date & audit report date, and facts that become known to the auditor after the audit report date.
  Financial statements may be affected by certain events that occur after financial statement date. Many financial reporting frameworks refer to ordinarily identify two types of events:
  (1) Existed at financial statement date; and
  (2) Arose after financial statement date.

- **Objectives:**
  - Obtain sufficient appropriate audit evidence about subsequent events that require adjustment or disclosure in financial statements.
  - Respond appropriately to facts that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.
- **Audit procedures regarding events occurring between the financial statements date & Audit Report date:**
  (1) Auditor shall perform Audit procedure designed to obtain sufficient appropriate audit evidence that all events that require adjustments/disclosure in financial statement.
  (2) Do not perform audit procedures on matters to which previously applied audit procedures with satisfactory conclusions.
  (3) Consider auditor's risk assessment including: Obtaining understanding of management's identification process of subsequent events; Inquire management's & those charged with governance;
  (4) Reading latest minutes of the meetings; and Reading entity's latest subsequent interim financial statements, *if any*.
- Request management & those charged with governance to provide written representation: All subsequent events are adjusted or disclosed as per applicable financial reporting framework.

Subsequently Discovered Fact

- **Before the financial statements are issued**
  - Discuss matter with management and those charged with governance.
  - Determine if financial statements need amendments.
  - Inquire how management will amend financial statements.
    - If management agrees to amend the financial statements.
      - Extend Audit procedures to the date of new audit report and issue a new audit report.
      - Dual date the report
        Amend the auditor's report to include an additional date in which auditor's responsibility is restricted to those amendments only.
        Include a statement in the Emphasis of matter/Other matter paragraph that states that auditor's procedures are restricted to those subsequent events only.
    - If management does not agree to amend the financial statements.
      - If auditor has not provided audit report to the management, auditor can modify the opinion as per SA 705.
      - If auditor has already provided the report to the management, notify management and those charged with governance not to issue the financial statements. If they issue despite communication, auditor may take legal actions.
- **After the financial statements are issued**
  - Same procedure as before. However, in addition to extending audit procedure of amending the report, auditor will also review the steps taken by management to inform those people who are already in possession of the previously issue financial statement.

SA- 570 GOING CONCERN

- **SA 570- GOING CONCERN APPLIES ONLY IF-**

Situation	Action
Going concern assumption is not appropriate.	Company will have to prepare financial statements on liquidated basis.
Going concern assumption is appropriate, but material uncertainty exists.	Material uncertainty is required to be disclosed properly in financial statements.

- **GOING CONCERN BASIS OF ACCOUNTING:** Financial statements are prepared on assumption that the entity is a going concern & will continue its operations for the foreseeable future. General purpose financial statements are prepared using going concern assumption, unless management either: intend to liquidate/cease operations or has no realistic alternative but to do so. Assets & liabilities are recorded on the basis that the entity will be able to realize its assets & discharge its liabilities in the normal course of business.
- **RESPONSIBILITY FOR ASSESSMENT OF THE ENTITY'S ABILITY TO CONTINUE AS A GOING CONCERN**
  Management assesses entity's ability to continue as going concern which involves making a judgement. Relevant factors are:
  - Degree of uncertainty increases as event goes farther in future.
  - Size and complexity of entity and degree to which it is affected by future events.
- **OBJECTIVES OF THE AUDITOR:**
  (1) Obtain sufficient appropriate audit evidence regarding & conclude on, appropriateness of management's use of going concern basis of accounting in preparation of the financial statement; (2) Conclude, based on evidence obtained,whether material uncertainty exists that may cast significant doubt on the entity's ability to continue as going concern; and
  (3) Report in accordance with this SA.
- **RESPONSIBILITIES OF AUDITOR:**
  Same as objectives of the auditor.
  However, as per SA 200 Inherent limitations, auditor's ability to detect material misstatement are greater for future events.
  Auditor cannot predict such future events or conditions. Absence of any reference of material uncertainty in report cannot be viewed as a guarantee as to entity's ability to continue as a going concern.
- **Risk assessment procedures and Related Activities:** Consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. Determine whether management has already performed a preliminary assessment to continue as a going concern.
  - If assessment has been performed, discuss the assessment with management & determine whether management has identified events or conditions that, may cast significant doubt on entity's ability to continue as going concern and, if so, management plans to address them; or
  - If assessment yet to be performed, discuss with management basis for intended use of going concern basis ofaccounting & inquire of management whether events or conditions exist that may cast significant doubt on the entity's ability to continue as going concern.
  - Auditor to remain alert throughout audit for audit evidence of such events or conditions.
  - Revise auditor's risk assessment procedure & modify the further audit procedures accordingly when additional audit evidence is obtained during the audit that affects the auditor's assessment of risk.

- **EVENTS OR CONDITIONS THAT CASTING SIGNIFICANT DOUBT ON ENTITY TO CONTINUE AS A GOING CONCERN:**
  - **Financial:** Net liability position; Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; Withdrawal of financial support by creditors; Negative operating cash flows; Adverse key financial ratios.
  - **Operating:** Management intentions to liquidate/cease operations; Loss of key management; Loss of a major market, key customers, license, or principal suppliers; Labour difficulties; Shortages of important supplies; Emergence of successful competitor.
  - **Others:** Pending legal proceedings against the entity may result in claims that entity is unlikely to be able to satisfy; changes in law or regulation adversely affect entity; non-compliance with capital or other statutory; uninsured or underinsured catastrophes.

- **Additional Audit Procedures When Events or Conditions Are Identified:** (1) Requesting management to make assessment to continue as going concern; (2) Evaluating management plans for future actions; (3) Where the entity has prepared a cash flow forecast, evaluating reliability of data generated & adequate support for assumptions; (4) Considering any additional facts or information. (5) Requesting written representations from management regarding their future action plans & its feasibility.
- **Examples of audit procedures explained above :** Analyzing & discussing cash flow, profit and other relevant forecasts; Analyzing & discussing the entity's latest interim financial statements; Reading terms of debentures & loan agreements; Reading minutes of shareholders, Those charged with governance and relevant committees meetings; Inquire entity's legal counsel regarding existence of litigation & claims and their outcome; Evaluating the entity's plans to deal with unfilled customer orders; Confirming existence, terms & adequacy of borrowing facilities; Obtaining & reviewing reports of regulatoryactions; Determining adequacy of support for disposals of assets.
- **Adequacy of disclosures when events or conditions have been identified and material uncertainty exists:**
  Determine whether financial statements adequately disclose events and conditions and management's plan to deal with those events and disclose in audit report that material uncertainty exists and entity may be unable to realize its assets and discharge liabilities.
- **Adequacy of disclosure when events or conditions have been identified and material uncertainty exists:**
  If events or conditions are identified, evaluate whether adequate disclosure about events or conditions have been given as per Applicable Financial Reporting Framework.
- **Implications for the Auditor's Report**

Implication for auditor's report

- Use of going concern is appropriate but material uncertainty exists.
  - Adequate disclosure about material uncertainty is not made in Financial statements. → Qualified or adverse opinion.
  - Use of Adequate disclosure about material uncertainty is made in Financial statements. → Unmodified opinion with separate section in report with the heading 'Material uncertainty relating to going concern'.
- Use of going concern is not appropriate.
  - Adequate disclosure about material uncertainty is not made in Financial statements. → Unmodified opinion with separate section in report about going concern.
  - Use of Adequate disclosure about material uncertainty is made in Financial statements. → Adverse opinion
- Management unwilling to make or extend its assessment. → Qualified or adverse opinion as auditor would not be able to obtain sufficient appropriate audit evidence regarding use of going concern.

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5 of 15

SA 450 EVALUATION OF MISTATEMENT IDENTIFIED DURING AUDIT

SA 450 deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, *if any*, on the financial statements.

- **OBJECTIVES OF AUDITOR IN ACCORDANCE WITH SA 450:**
  Evaluate:
  (a) The effect of identified misstatements on the audit; and
  (b) The effect of uncorrected misstatements, *if any*, on the financial statements.

- **CONSIDERATION OF IDENTIFIED MISSTATEMENTS AS THE AUDIT PROGRESSES**
  The auditor shall determine whether the overall audit strategy and audit plan needs to be revised if:
  - The nature of identified misstatements and the circumstances of their occurrence indicate that other material misstatements may exist.
  - The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320.

- **COMMUNICATION AND CORRECTION OF MISSTATEMENTS**
  Auditor shall communicate on a timely basis all misstatements to management.
  If management refuses to correct some or all of the misstatements communicated by the auditor, auditor shall obtain an understanding of management's reasons to be considered while evaluating whether the financial statements as a whole are free from material misstatement.

- **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 and the circumstances; 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.

- **COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE**
  The auditor shall communicate with those charged with governance regarding uncorrected misstatements and the effect.

- **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.

SA 580-WRITTEN REPRESENTATION

- **MEANING:** Confirm certain matters or to support other audit evidence. Written representation in this context do not include financial statements, the assertions therein, or supporting books and records.
- **WRITTEN REPRESENTATION AS AUDIT EVIDENCE:** Like responses to inquiries, written representation are audit evidence. Requested from those responsible for preparation & presentation of financial statements. It does not provide sufficient appropriate audit evidence on their own. Written representation does not affect the nature or extent of other audit evidence.
- **OBJECTIVES OF AUDITOR:**
  (1) To obtain written representation: Management has fulfilled responsibility for preparation of financial statements & information provided to auditor.

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(2) **To support other evidence** relevant to financial statements or specific assertions.
(3) **To respond appropriately** to written representation provided by management or if management does not provide written representation requested by auditor.

➢ **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.

➢ **WRITTEN REPRESENTATIONS ABOUT MANAGEMENT'S RESPONSIBILITIES**
Involves confirmation of fulfilment of Management's responsibilities in following areas:

- **Preparation of the Financial Statements**
  Request management to provide a written representations that they have fulfilled their 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. *For example*, an actuary, staff engineer, Internal Counsel.

- **Information provided and completeness of transactions**
  The auditor shall request management to provide a Written Representations that:
  - It has provided the auditor with all relevant information & access agreed as per terms of the engagement; and
  - All transactions have been recorded & are reflected in the financial statements.

➢ **WHY WRITTEN REPRESENTATIONS ABOUT MANAGEMENT RESPONSIBILITIES ARE NECESSARY?**
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.
Thus, Written Representations draws on the agreed acknowledgement & understanding of management. Also, auditor may ask management to reconfirm its acknowledgement & understanding of those responsibilities in written representation. **Particularly appropriate when:**

- Those who signed terms no longer have the relevant responsibilities;
- Terms of the audit engagement were prepared in a previous year;
- Indication that management misunderstands those responsibilities; or
- Changes in circumstances make it appropriate to do so.

➢ **OTHER WRITTEN REPRESENTATIONS:** If it is necessary to obtain one or more written representation to support other audit evidence relevant to financial statements or specific assertions, request such other written representation.

➢ **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 judgement or intent.

➢ **DATE & PERIOD(s) COVERED BY WRITTEN REPRESENTATION:** Near as practicable to but not after, audit report date. Only concerned with events occurring up to the date of the auditor's report.
➢ **FORM OF WRITTEN REPRESENTATION:** Representation letter addressed to auditor. If law or regulation requires management to make written public statements about its responsibilities, such matters need not to be covered in representation letter.

- **DOUBT ON RELIABILITY OF WRITTEN REPRESENTATION:** If concern about competence, integrity, ethical values or diligence of management determine effect on reliability of representations. If written representation are inconsistent with other audit evidence, perform audit procedures to resolve matter. If remain unresolved, reconsider assessment of competence, integrity, ethical values or diligence of management. If written representation not reliable, determine possible effect on the opinion.
- **REQUESTED WRITTEN REPRESENTATION NOT PROVIDED:**
  (1) Discuss matter with management.
  (2) Re-evaluate integrity of management & evaluate effect on the reliability of representations.
  (3) Take appropriate actions, including determining the possible effect on the opinion.
  If Management does not provide Written Representation about fulfilment of its responsibility with respect to, preparation of financial statement, information provided or completeness of transaction or if written representation for above matters is not reliable, **then auditor will give disclaimer of opinion.**

SA 260- COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

- **SIGNIFICANCE OF COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE**
  An effective two-way communication assist:
  - **The auditor and those charged with governance in understanding matters related to the audit.**
  - The auditor in obtaining information relevant to the audit.
  - Those charged with governance in fulfilling their responsibility to oversee the financial reporting process.
- **WHO ARE "THOSE CHARGED WITH GOVERNANCE"?**
  The person or organization 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.
- **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.
- **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 and an overview of the planned scope and timing of the audit;
  (b) To obtain information relevant to the audit;
  (c) To provide those charged with governance with timely observations; and
  (d) To promote effective two-way communication.
- **MATTERS TO BE COMMUNICATED BY AUDITOR**
  Following matters are required to be communicated by auditor with those charged with governance:
  (a) The auditor's responsibilities in relation to the financial statements audit:
  - The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and
  - 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.
  (c) Significant findings from the audit.
  The auditor shall communicate with those charged with governance:

- The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statements disclosures;
- Significant difficulties encountered during the audit;
- Significant matters arising during the audit discussed with management;
- Written representations the auditor is requesting;
- Circumstances that affect the form and content of the auditor's report.

➢ **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 statement that the engagement team and firm have complied with relevant ethical requirements regarding independence.
- All relationships and other matters that may reasonably be thought to bear on independence.

➢ **THE COMMUNICATION PROCESS:**

- Communicate form, timing and general content.
- Need not include all matters.
- Only significant matters that arose during audit.

➢ **ADEQUANCY OF THE COMMUNICATION PROCESS**

Evaluate if two-way communication is adequate or not and take appropriate action.

➢ **DOCUMENTATION**

If communicated orally, document what matters are communicated, when and to whom. If in writing, include a copy as part of documentation.

SA 265

COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL WITH THOSE CHARGED WITH GOVERNANCE

➢ **SCOPE OF SA 265- COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT**

SA 265 deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements.

➢ **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.

➢ **Meaning of "Deficiency in internal control" and "significant deficiency in internal control"**

(a) Deficiency in internal control – This exists when:

(i) A control is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or

(ii) A control, necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

(b) Significant deficiency in internal control:

A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency

- Likelihood of the deficiencies leading to material misstatements.

- Susceptibility to loss or fraud.
- Subjectivity and complexity of determining estimated amounts.
- Financial statements amounts exposed to the deficiencies.
- The importance of the controls to the financial reporting process (monitoring controls, controls over prevention of fraud, controls over selection of accounting policies, controls over significant transaction with related parties etc.).
- 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

- Evidence of ineffective aspects of the control environment, such as:
  - Indications that significant transactions in which management is financially interested.
  - Identification of management fraud.
  - Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
- Absence of a risk assessment procedure within the entity.
- Evidence of an ineffective risk assessment procedure.
- Evidence of an ineffective response to identified significant risks.
- Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.

➢ **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:

In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance.

Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties.

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 andmanagement 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;

(iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit.

Question Solver Points:

1. 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. **(PP Book SA 560 Q.1)**
2. Such events may be those that provide evidence of conditions that existed at the date of the financial statements and those that provide evidence of conditions that arose after the date of the financial statements.
3. 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.

4. Auditor has to conclude whether material uncertainty exists about entity's ability to continue as going concern. **(PP Book SA 570- Q.1)**
5. It is the management's responsibility to assess the entity's ability to continue as a going concern. Management's assessment of the entity's ability to continue as a going concern involves making a judgment.
6. SA 450- Evaluation of misstatements identified during the audit deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, *if any*, on the financial statements.
7. 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.
8. SA 580 Written Representations deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance.
9. 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.
10. 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. **(PP Book SA 580- Q.5)**
11. SA 260- Communication with those charged with Governance deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.
12. SA 265 Communicating Deficiencies in Internal Control to those charged with governance and Management deals with the auditor's responsibility to communicate appropriately to those charged with governance and management, deficiencies in internal control that the auditor has identified in an audit of financial statements.
13. Deficiency in Internal control exists when a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis or a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.
14. Significant deficiency in internal control is 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.
15. Communicating significant deficiencies in internal control in writing to those charged with governance reflects the importance of these matters and assists those charged with governance in fulfilling their oversight responsibilities.

PERFECT REVISION QUESTIONS

Q. No.	Questions and Answers
1.	**SA 560, "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Explain those events and also define subsequent events.**
Ans.	**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. SA 560, "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. **Such financial reporting frameworks ordinarily identify two types of events:** **(a)** Those that provide evidence of conditions that existed at the date of the financial statements; and **(b)** Those that provide evidence of conditions that arose after the date of the financial statements. SA 700 explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware, and that occurred up to that date.
2.	**The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. Explain.**
Ans.	**(i)** The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. **(ii)** The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. **(iii)** The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. **The auditor shall take into account the auditor's risk assessment which shall include the following:** • Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified. • Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements. • Reading minutes, *if any*, of the meetings, of the entity's owners, management and those charged with governance that has 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. • Reading the entity's latest subsequent interim financial statements, *if any*.

3.	**On the basis of which assumption, the financial statements of a company are prepared? Also, describe the objectives of the auditor regarding going concern.**
Ans.	Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. **Objectives of the auditor regarding going concern:** **(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.
4.	**M/s ANS & Associates has been appointed as the statutory auditors of MNO Ltd. The company has been suffering losses due to the emergence of a highly successful competitor, thereby leading to negative net worth. Also, the sales head, key management personnel of the company left the company due to health issues. When CA Amar, the engagement partner, discussed the scenario with the management of the company, he did not get any satisfactory reply from the management. What is the responsibility of M/s ANS & Associates with regard to SA 570?**
Ans.	As per SA 570, one of the objectives of the auditor regarding going concern is to obtain sufficient and appropriate audit evidence regarding the same and to conclude on the appropriateness of the management's use of the going concern basis of accounting in the preparation of the financial statements. Further, it also contains the list of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern which are: **(a)** Financial indicator: Negative net worth. **(b)** Operating indicator: Loss of key management and emergence of a highly successful competitor. **Facts of the case:** M/s ANS & Associates has been appointed as the statutory auditors of MNO Ltd. The company has been suffering losses due to the emergence of a highly successful competitor, thereby leading to negative net worth. Also, the sales head, key management personnel of the company left the company due to health issues. When CA Amar, the engagement partner, discussed the scenario with the management of the company, he did not get any satisfactory reply from the management. **Conclusion:** **(a)** From the above facts, it appears that MNO Ltd. is not going concern. **(b)** If the management of MNO Ltd. has used the going concern basis of accounting, the auditor should first ask the management to adjust the financial statements. **(c)** If the management of MNO Ltd. does not agree with the same, CA Amar shall consider the impact on his audit report.
5.	**Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Explain stating objectives of the auditor regarding written representation.**

Ans.	**Audit evidence** is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are requested from those responsible for the preparation and presentation of the financial statements. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. **The objectives of the auditor regarding the written representation are:** **(1) To obtain written representations from management.** Also, that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor. **(2) To support other audit evidence** relevant to the financial statements or specific assertions in the financial statements by means of written representations. **(3)** To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.
6. **Ans.**	**"Although written representations provide necessary audit evidence yet they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal". Discuss.** Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Written representations are requested from those responsible for the preparation and presentation of the financial statements. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities or about specific assertions.
7. **Ans.**	**List out some matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a "significant deficiency".** **Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency:** **(1)** The likelihood of the deficiencies leading to material misstatements in the financial statements in the future. **(2)** The susceptibility to loss or fraud of the related asset or liability. **(3)** The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates. **(4)** The financial statement amounts exposed to the deficiencies. **(5)** The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies. **(6) The importance of the controls to the financial reporting process, *for example*:** **(a)** General monitoring controls (such as oversight of management). **(b)** Controls over the prevention and detection of fraud. **(c)** Controls over the selection and application of significant accounting policies. **(d)** Controls over significant transactions with related parties. **(e)** Controls over significant transactions outside the entity's normal course of business.

	(f) Controls over the period-end financial reporting process (such as controls over non-recurring journal entries). (7) The cause and frequency of the exceptions detected as a result of the deficiencies in the controls. (8) The interaction of the deficiency with other deficiencies in internal control.
8.	**CA PK Jacob is conducting audit of a company for year 2021-22. The company is engaged in export of ethnic rugs to buyers in Europe. The audit is nearing completion in month of July 2022. However, it becomes known to the auditor that one of overcomes has made a legal claim against the company on 1st June 2022 for injury caused to a customer of one European buyer due to sub-standard dyes used in rugs of one lot of order shipped in August, 2021. The management of company has decided to agree to an out of court settlement of ₹5 crore to protect its reputation. The financial statements of the company are silent on this issue.** **Discuss, how, CA PK Jacob should proceed to deal with above issue.**
Ans.	In the given case, the auditor has come to know of legal claim against the company before issue of audit report. It has also come to his knowledge that management of company has agreed to an out of court settlement of ₹5 crore. It is an example of subsequent event between the date of the financial statements and the date of the auditor's report. It provides evidence of conditions that existed at the date of the financial statements and requires adjustment in financial statements. He should ask company management to make necessary adjustments to the financial statements. If adjustment is not made by management, he should consider impact on auditor's report.
9.	**During course of audit of a company, CA. Varun Aggarwal notices that company is facing significant skilled labour shortages resulting in hampering of operations of company. The company's manufacturing is dependent upon skilled labour coming from villages in certain districts of Eastern UP. However, due to job opportunities available near villages now, many are not interested in going out from their native villages.** **Such a situation has led to company not being able to keep its commitments, losing out on orders and fall in its revenues. Fixed costs of the company remain at a high level. As a result, company is facing a liquidity crunch and is not able to pay its creditors on time. The bankers of company are also not willing to help the company to tide over liquidity crisis. The auditor is having doubts over going concern status of the company.** **How should management of the company try to address auditor's concerns? What audit procedures may be performed by auditor in such a situation?**
Ans.	Significant shortage of skilled labour, inability to pay creditors on time and overall liquidity crisis faced by the company are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. In such a situation, management should try to address auditor's concerns by preparing its future plan of action including preparation of cash flow forecast showing inflow and outflow of cash. Such a cash flow forecast should address auditor's concerns regarding liquidity crisis being faced by the company. The auditor should perform audit procedures to evaluate the reliability of the underlying data to prepare the forecast and determining whether there is adequate support for the assumptions underlying the forecast. The auditor should also consider whether any additional facts or information have become available since the date on which management made its assessment.

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15 of 15

10.	**You are nearing completion of audit of a company. On going through your working papers, it is noticed that finished goods inventory was overvalued by ₹2 crore. It has also been noticed that freight of ₹10 lakhs paid on import of machinery was charged to Statement of Profit and Loss.** **Discuss, how you should proceed and communicate in above situation before singing audit report.**
Ans.	The instances highlighted in above situation are examples of misstatements identified during the audit. Over valuation of inventory of finished goods by ₹2 crore and wrongly charging freight of ₹10 lakhs paid on machinery to Statement of Profit and Loss instead of Capitalizing are examples of misstatements. The auditor should communicate above identified misstatements to those charged with governance and request for correction of these misstatements. In case, these are not corrected, understand the reasons for not making the corrections and reassess materiality. It should also be considered whether uncorrected statements are material individually or in aggregate. Effect of uncorrected misstatements on the opinion in auditor's report should be communicated to those charged with governance.

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CHAPTER 8-AUDIT REPORT

SA-700-FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS

Deals with the auditor's responsibility to form an opinion on the financial statement & also deals with the form & content of the auditor's report issued as a result of an audit of financial statements.

- **OBJECTIVES:** To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained and to express clearly through written report.
- **TO FORM OPINION- AUDITOR TO OBTAIN REASONABLE ASSURANCE:** To form an opinion on whether financial statement are prepared in accordance with applicable financial reporting framework - Auditor has to obtain reasonable assurance about whether financial statement as a whole is free from material misstatement, whether due to fraud or error.
  That conclusion shall take into account:
  - Whether sufficient appropriate audit evidence has been obtained;
  - Whether uncorrected misstatements are material, individually or aggregate;
  - The evaluations.

- **QUALITATIVE ASPECTS OF ENTITY'S ACCOUNTING PRACTICES:** Management makes number of judgements in amount & disclosure. SA 260 contains qualitative aspects of accounting practices. Auditor may become aware of possible bias in management's judgements.
  Lack of neutrality together with uncorrected misstatements causes financial statement to be materially misstated. Indicators of a lack of neutrality:
  - Selective correction of misstatements brought to management's attention during audit.
  - Possible management bias in the making of accounting estimates.

- **SPECIFIC EVALUATIONS BY AUDITOR:** (1) Financial statements disclose significant accounting policies selected & applied; (2) Accounting policies selected are consistent with financial reporting framework & are appropriate; (3) Accounting estimates by management are reasonable (4) Information presented in financial statement is relevant, reliable, comparable & understandable; (5) Financial statements provide adequate disclosures to understand effect of material transactions & events; (6) Terminology used in the financial statement is appropriate.

- **DEFINITIONS**
  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 that management may be required to give disclosure beyond what is required to achieve fair presentation;
  (ii) Acknowledges that management might depart from requirements under 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.
- **FORM OF OPINION**
  - **Unmodified Opinion**: Concludes that Financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.
  - **Modified Opinion:** Concludes that, based on evidences obtained, the financial statements as a whole are notfree from material misstatement; or unable to obtain SAAE to conclude that financial statements as a whole are free from material misstatement.

ELEMENTS OF AUDIT REPORT

- **TITLE:** Independent Auditor Report.
- **ADDRESSEE:** To shareholder or those chaged with governance.
- **AUDITOR'S OPINION:** (1) Identify entity whose Financial statements have been audited; (2) State that Financial statement have been audited; (3) Identify title of each statement comprising Financial statements (4) Refer to the notes, including summary of significant accounting policies; and (5) Specify the date of, or period covered by, each financial statement comprising the Financial statements.
- **BASIS FOR OPINION:** (1) States that audit was conducted in accordance with SA; (2) Refers to section of report that describes the auditor's responsibilities under SAs; (3) Includes a statement that auditor is independent of entity in accordance with relevant ethical requirements relating to audit & has fulfilled auditor's other ethical responsibilities in accordance with these requirements; (4) States whether auditor believes that he has obtained sufficient appropriate audit evidence to provide a basis for the auditor's opinion.
- **GOING CONCERN:** As given in SA 570.
- **KEY AUDIT MATTERS:** For Listed entities, the auditor shall communicate Key Audit matters in accordance with SA 701.
- **RESPONSIBILITIES FOR THE FINANCIAL STATEMENT:** This section shall describe management's responsibility for:
  - **Preparing the Financial statements** in accordance with financial reporting framework & for such Internal Control as management determines is necessary to enable preparation of Financial statements that are free from material misstatement, whether due to fraud or error; and
  - **Assessing entity's ability to continue as Going Concern** & whether use of Going Concern basis of accounting is appropriate & disclosed matters relating to Going Concern. Explanation of management's responsibility for this assessment shall include a description of when the use of Going Concern basis of accounting is appropriate.

    SA 200 explains the premise, relating to:
  - Responsibilities of management & those charged with the governance.
  - Management & those charged with the governance accept responsibility for preparation of the financial statement. Management also accepts responsibility for such Internal Control to enable the preparation of financial statement that are free from material misstatement, whether due to fraud or error.
  - Description of management's responsibilities in auditor's report helps to explain to users the premise on which an audit is conducted.
  - This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process such as those charged with the governance.

- **AUDITOR'S RESPONSIBILITIES FOR THE AUDIT OF FINANCIAL STATEMENT:**
  (I)

Auditor's Responsibility Section to State

- Objective of the auditor
- That reasonable level of assurance is high level of assurance and not guarantee.
- That misstatements can arise from fraud and error.

(II)

Auditor's Responsibility Section to Further

- State that auditor exercises professional judgement and maintains professional skepticism.
- Describe an audit by stating that auditor's responsibilities are:
  - To identify and assess the risks of material misstatement.
  - To obtain an understanding of the internal control system.
  - To evaluate the appropriateness of accounting policies.
  - To conclude the appropriateness of management's use of going concern.
  - To evaluate the overall presentation, structure and content of financial statements.
- Describe auditor's responsibility in group audit.

(III) The Auditor's Responsibilities for the Audit of the financial statements Section of the Auditor's Report also shall:

(a) State that auditor communicates with those changed with governance, planned scope and timing of audit and significant audit findings including deficiencies in internal control.

(b) For audit of listed entities, auditor provides to those charged with governance a statement that auditor has complied with ethical requirements regarding independence.

(c) For audit of listed entities for which Key audit matter is communicated, the auditor determines those matters that are most significant in audit.

- **LOCATION OF THE DESCRIPTION OF THE AUDITOR'S RESPONSIBILITIES**
  - within body,
  - within appendix to audit report,
  - reference to location of a website of an appropriate authority.
- **OTHER REPORTING RESPONSIBILITIES**- Report on other legal and regulatory requirements.
- **SIGNATURE OF THE AUDITOR**: Signed by Engagement partner with Membership Number or Firm's Registration No.
- **PLACE OF SIGNATURE:** The place where the audit report is signed.
- **DATE OF AUDITOR'S REPORT**: Report should be dated no earlier than the date when sufficient appropriate audit evidence obtained.

Unique Document Identification Number – UDIN: CA having full-time COP to mention UDIN on financial documents or certificates attested by them. Curb malpractices by third person misrepresenting themselves as CA Members misleading Authorities & Stakeholders.

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.

SA – 705- MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

It deals with auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion.

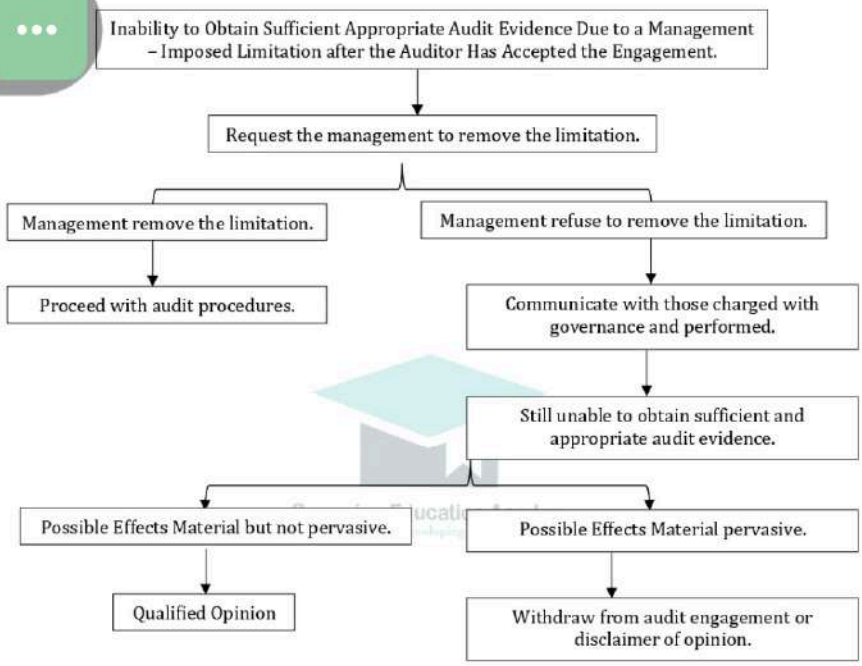
- **CIRCUMSTANCES OF MODIFICATION:**
  - (1) Conclude that, based on evidences obtained, the financial statement as a whole are not free from material misstatement; or
  - (2) Unable to obtain sufficient appropriate audit evidence to conclude that financial statement as a whole are free from material misstatement.
- Objective of the auditor is **to express clearly an appropriately modified opinion.**
- **TYPES OF MODIFIED OPINION:**
  - **(a) Qualified Opinion:** (1) Obtained sufficient appropriate audit evidence, concludes that misstatements and material, but not pervasive or (2) Unable to obtain sufficient appropriate audit evidence and material but not pervasive.
  - **(b) Adverse Opinion:** Obtained sufficient appropriate audit evidence, concludes that misstatements and both material and pervasive.
  - **(c) Disclaimer of Opinion:** Unable to obtain sufficient appropriate audit evidence and could be material & pervasive. Only in extremely rare circumstances, auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of 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 statement.
- **PERVASIVE EFFECTS:** In auditor's judgement: (1) Are not confined to specific elements, accounts or items of the Financial statement; (2) If so confined, represent or could represent a substantial proportion of the Financial statements; or (3) In relation to disclosures, are fundamental to users' understanding of the Financial statements.
- **WHICH TYPE OF OPINION IS APPROPRIATE?**

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 misstated.	Qualified opinion	Disclaimer of opinion

- **FORM & CONTENT OF AUDITOR'S REPORT WHEN THE OPINION IS MODIFIED:** When audit opinion is modified, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section. **Additional/modification in Opinion Para as below:**
  - **(i) Qualified Opinion**: Except for the effects of the matter(s) described in the Basis for Qualified Opinion section.
  - **(ii) Adverse Opinion:** Because of the significance of the matter(s) described in the Basis for Adverse Opinion section.
  - **(iii) Disclaimer of Opinion**: The auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements.
- **BASIS FOR OPINION:** Amend the heading "Basis for Opinion" to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and within this section, include a description of the matter giving rise to the modification.
- **Description of Auditor's Responsibilities for Audit of the Financial Statements When the Auditor Disclaims an Opinion on the Financial statements:** (1) Statement that the auditor's responsibility is to conduct an audit of the entity's Financial statements in accordance with SAs & to

issue an auditor's report; (2) Statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on Financial statements; and (3) Statement about auditor independence & other ethical responsibilities required by SA 700.

➢ **Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management-Imposed Limitation after the Auditor Has Accepted the Engagement**



✍ **SA 706- EMPHASIS OF MATTER PARAGRAPHS (EOM) & OTHER MATTER PARAGRAPHS (OMP) IN THE INDEPENDENT AUDITOR'S REPORT**

➢ **EMPHASIS OF MATTER PARAGRAPH:** Matter appropriately presented or disclosed in Financial statements that, in auditor's judgement, is of such importance that it is fundamental to users' understanding of Financial statements.

➢ **OTHER MATTER PARAGRAPH:** Matter other than those presented or disclosed in Financial statements that, in auditor's judgement, is relevant to users' understanding of audit, the auditor's responsibilities or auditor's report.

➢ **EMPHASIS OF MATTER/OTHER MATTER PARAGRAPH IN AUDITOR'S REPORT:**
- **Emphasis of matter shall be included**: The auditor would not be required to modify the opinion as result of matter & the matter has not been determined to be a Key audit matter.
- **Other matter paragraph shall be included**: Not prohibited by law or regulation & matter has not been determined to be a Key audit matter.

- **SEPARATE SECTION FOR EMPHASIS OF MATTER & OTHER MATTER PARAGRAPH:** Include Paragraph within a separate section with heading "Emphasis of matter" or "Other Matter".
  For Emphasis of matter, give a clear reference to the matter being emphasized & to where relevant disclosures can be found; Indicate Auditor's opinion is not modified in respect of the matter emphasized.
- **EMPHASIS OF MATTER IS NOT SUBSTITUTE:**
  (1) modified opinion;
  (2) Disclosures in Financial statements as per financial reporting framework;
  (3) Reporting as per SA 570 on material uncertainty exists.
- **EXAMPLE:**
  - **Emphasis of matter**- Future outcome of exceptional litigation; Significant subsequent event; Early application of a new AS & its effect; Major catastrophe.
  - **Other matter paragraph**- Audit of Subsidiaries by component auditor.
- **PLACEMENT:**
  Emphasis of matter- immediately following Basis of Opinion. When Key audit matter is presented: either directly before or after the Key audit matter section.
  Other matter paragraph- after the Opinion paragraph & any Emphasis of matter paragraph.
- **COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE**- auditor shall communicate with those charged with governance if he expects to include emphasis of matter/other matter paragraph

SA – 701- COMMUNICATING KEY AUDIT MATTERS (KAM) IN THE INDEPENDENT AUDITOR'S REPORT

- **MEANING**: Matters that, in auditor's professional judgement were of most significance in the audit of financial statements of the current period. Key audit matter are selected from matters communicated with those charged with governance.
- **PURPOSE OF COMMUNICATING KEY AUDIT MATTERS** - Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding matters which were most significant in audit.
- **DETERMINE KEY AUDIT MATTER:** Communicate matters with those charged with governance, that require significant auditor attention. Auditor shall take into: (1) Areas of higher assessed risk of material mis-statement/significant risks. (2) Significant Management judgement, including accounting estimates having high uncertainty. (3) Effect on audit of significant events or transactions.
- **COMMUNICATING KEY AUDIT MATTER:** Each Key audit matter, using an appropriate sub-heading, in audit report under the heading "Key Audit Matters". **States that:** (a) Key audit matter are those matters that, in auditor's professional judgement, were of most significance & these matters were addressed in context of the audit and (b) auditor does not provide a separate opinion on these matters
- **COMMUNICATING KEY AUDIT MATTER– NOT A SUBSTITUTE FOR DISCLOSURE IN THE FINANCIAL STATEMENTS ETC.**
  (a) Not a substitute for disclosures in the Financial statements that the applicable financial reporting framework requires;
  (b) Not a substitute for the auditor expressing a modified opinion as per SA 705;
  (c) Not a substitute for reporting as per SA 570 when a material uncertainty exists;
  (d) Not a substitute for a separate opinion on individual matters.

SA – 710- COMPARATIVE INFORMATION—CORRESPONDING FIGURES & COMPARATIVE FINANCIAL STATEMENTS

- **COMPARATIVE INFORMATION:** Amounts & disclosures included in the Financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.
- **NATURE OF COMPARATIVE INFORMATION:** Depends on requirements of financial reporting framework. There are two different broad approaches:
  (1) For **corresponding figures**, opinion on the Financial statements refers to the current period only;
  (2) For **comparative** Financial statement, opinion refers to each period for which Financial statements are presented.
- Approach to be adopted is often may be specified by law/regulation or terms of engagement.
- **OBJECTIVES:** (a) To obtain sufficient appropriate audit evidence whether comparative information has been presented in accordance with requirements of applicable financial reporting framework, (b) To report in accordance with reporting responsibilities.
- **AUDIT PROCEDURE REGARDING COMPARATIVE INFORMATION:**
  (1) Determine whether Financial statements include comparative information required by a further audit procedures. Evaluate whether: Comparative information agrees with amounts & other disclosures in prior period. Accounting policies in comparative information are consistent; if change in accounting policy, changes properly accounted & disclosed.
  (2) If possibility of Material misstatement in comparative information, perform additional procedure.
  (3) Request Written representations for all periods. Obtain specific written representation regarding any prior period item that is separately disclosed in current year's Profit and Loss.
- **CORRESPONDING FIGURES:** Where amounts & other disclosures for prior period are included as an integral part of current period Financial statements & are intended to be read only in relation to the amounts & other disclosures relating to current period ("current period figures").
  - **When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances:**
    (a) If prior period report, included a qualified opinion, a disclaimer of opinion, or an adverse opinion: If matter is still unresolved, modify the opinion. In the Basis for Modification para: Refer to both period figures in description of matter giving rise to the modification; or explain that opinion has been modified because of effects or possible effects of unresolved matter on the comparability.
    (b) If auditor obtains audit evidence that a material misstatement exists in the prior period financial statements: If unmodified opinion was given previously and misstatement dealt with applicable financial reporting framework is not corrected - Qualified/adverse opinion in Current period.
    (c) Prior Period Financial Statements Not Audited: State in Other matter paragraph. It does not relieve auditor to obtain sufficient appropriate audit evidence that opening balances do not contain material misstatement affecting current period financial statement.
- **COMPARATIVE FINANCIAL STATEMENTS:**
  - **Meaning**: Where amounts & other disclosures for prior period are included for comparison with financial statements of current period but, if audited, are referred to in auditor 's opinion.
  - Auditor's opinion shall refer to each period for which financial statements are presented.
  - If opinion on prior period differs from opinion the auditor previously expressed, disclose reason for the different opinion in another matter paragraph.
  - If prior period audit is done by predecessor auditor & auditor concludes material misstatement exist affecting prior period financial statements on which predecessor auditor had previously reported without modification, Comminate to management & those charged with governance & request that predecessor auditor be informed.
  - If prior period financial statements amended predecessor auditor agrees to issue a new auditor's report, Report only on current period. If prior period financial statements not audited, state in other matter paragraph that Comparable Financial statements are unaudited. It does not relieve

auditor to obtain sufficient appropriate audit evidence that opening balances do not contain material misstatement affecting current period financial statement.

Prior Period Financial Statements Audited by a Predecessor Auditor (common for corresponding figure or comparative information)
Auditor to state in other matter paragraph:
(a) That Financial statement of prior period was audited by predecessor auditor,
(b) Type of opinion expressed; if modified- specify reason,
(c) Date of report

AUDIT OF BRANCH OFFICE ACCOUNTS

- **ACCOUNTS OF BRANCH OFFICE AUDITED BY** – Statutory Auditor or another eligible person qualified to be company's auditor. For foreign branch, person qualified to audit companies as per their laws.
- **DUTIES AND RIGHTS OF BRANCH AUDITOR** – Same as that of Company Auditor.
- **REPORT OF BRANCH AUDITOR** – Sent to Company Auditor.
- The main auditor **has to consider the report of the branch auditor** and has a right to seek clarification and to visit the branch. The branch auditor **shall send his report to the main auditor** of the company.
SA 600, "Using the Work of another Auditor specified that 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. Inform other auditor of matters requiring special consideration.
(b) Advise the other auditor of the significant accounting, auditing and reporting requirements.

SA 299- JOINT AUDIT

- **MEANING**: Audit of financial statements of an entity by two or more auditors.
- **ADVANTAGES:**

Sharing of expertise.	Displacement of the auditor of the company taken over in a take-over often obviated.
Advantage of mutual consultation.	In case of MNCs – Work can be spread using the expertise of the local firms.
Lower workload.	Lower staff development costs.
Better quality of performance.	Lower costs to carry out the work.
Improved service to the client.	A sense of healthy competition towards a better performance.

- **DISADVANTAGES:**

Fees sharing.	Problems of coordination.
Psychological problems between firms of different standing associated in the joint audit.	Areas of work of common concern being neglected.
Superiority complexes of some auditors.	Uncertainty about the liability for the work done.

- **RESPONSIBILITIES (Joint & Several responsibilities of Joint Auditors):**

The audit work (Not divided among the joint auditors) – Carried out by all joint auditors.	Examining that the financial statements of the entity comply with the requirements of the relevant statutes.
Decisions under audit planning in respect of common audit areas – Took by all the joint auditors.	Presentation and disclosure of the financial statements as per applicable financial reporting framework.

Matters 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.	Audit report complies with the requirements of the relevant statutes and applicable SAs and other relevant pronouncements.

➢ **PLANNING:**

- Before the commencement of the audit – Joint auditors to discuss & develop a Joint Audit Plan.
- Engagement partner and Other Key Members of the Engagement Team will also be involved in the audit planning.
- Joint auditors will establish of an overall audit strategy and also set the scope, timing and direction of the audit and also guides the development of the audit plan.
- **For developing the joint audit plan, the joint auditors should:**
  - identify the division of audit areas and common audit areas;
  - ascertain the reporting objectives of the engagement;
  - consider and communicate among all joint auditors the significant factors;
  - directing the engagement team's efforts;
  - consider the results of preliminary engagement activities.
  - ascertain the nature, timing and extent of resources to accomplish the engagement.
- Consider and assess the risks of material misstatement and communicate to other joint auditors.
- Joint auditors to discuss and document the nature, timing, and extent of the audit procedures for common and specific allotted areas of audit. Work allocation document to be signed by all the joint auditors and Communicated to those charged with governance.
- Joint auditors to obtain a Common Engagement Letter and Common Management Representation Letter.

  Coordination among joint auditors: When a joint auditor comes across matters which are relevant to the areas of other joint auditors should communicate to all other joint auditors in writing.

➢ **AUDIT CONCLUSION AND REPORTING:**

- Joint auditors to issue a common audit report.
- In case of any disagreement among joint auditors, then they shall express an opinion in a separate audit report.

➢ **REVIEW OF WORK BY ANOTHER JOINT AUDITOR:** There is no need to review the work of another joint auditor as it is assumed that the other Auditor has done the work as per the applicable SA. Communication with those charged with governance: When joint auditors expect to modify the opinion in the audit report or include EOM (Emphasis of Matter) OR OM (Other Matters) paragraph, then they should communicate to those charged with governance.

REPORTING REQUIREMENTS UNDER THE COMPANIES ACT, 2013

➢ **SECTION 143 (1): AUDITOR WILL INQUIRE IN THESE MATTERS**

- Loans and advances made by the company on the basis of securities have been properly secured.
- Transactions represented by book entries are prejudicial to the interests of the company.
- A company (not an Investment/Banking company) sold its shares/debentures/othersecurities at a price less than the purchase price.
- Loans and advances made by the company shown as deposits.
- Personal expenses charged to the Revenue Account.
- Position of cash received against the allotment of shares.

➢ **SECTION 143 (2): DUTIES OF REPORTING**

- Duty to report to the members of the company on the accounts to be laid at the general meeting.
- While making the report – Auditor to consider the provisions of the Act and Accounting standard and SA.

- **SECTION 143 (3): MATTERS TO BE REPORTED IN AUDIT REPORT**
  - Obtained all the necessary information & explanations to the best of his knowledge.
  - Books of accounts and Returns of the Branches not visited by the auditor – Properly kept by the company.
  - Report on accounts of any branch office audited by a person other than the company's auditor has been sent to him.
  - Company's Balance Sheet and P&L A/c corresponding with the books of accounts and returns.
  - Financial Statements comply with AS.
  - Observations/Comments of the auditors on financial transactions/matters having any adverse effects on the company.
  - State the reasons for qualifications in Qualified Report or negative report.
  - Any director disqualified under **Section 164**.
  - Reporting on Internal Financial Controls (IFC) of the company. Reporting on IFC is applicable to all companies except the following:
    - OPC
    - Small Companies
    - Private companies (Turnover of *less than* ₹50 crores (as per latest audited Financial statement) and Aggregate borrowings from banks/FIs/body corporates of *less than* ₹25 crores at any point in time during the financial year).
- **Rule 11 of Companies Audit and Auditors Rules (CAAR) 2014 (Report in audit report if not reported by company in its Financial statements):**
  - Disclosed the impact of pending litigations on its financial position.
  - Made provision (required by any law/AS) for foreseeable material losses.
  - Any delay in transferring amounts to the Investor's Education and Protection Fund.
  - The company has lent money/received money for investment in a third party (Ultimate Beneficiary).
  - Any material misstatement in the financial statements.
  - Dividend declared/paid during the year by the company.
  - Used accounting software which has audit trail feature.

REPORTING UNDER COMPANIES AUDITOR'S REPORT ORDER, 2020 [CARO, 2020]

- **FOLLOWING COMPANIES EXEMPTED FROM REPORTING UNDER CARO 2020:**
  - Banking company;
  - Insurance company;
  - Section 8 Company;
  - An OPC and a small company;
  - **A private limited company which complying with all the following conditions:**
    - Not a subsidiary or a holding company of any public company.
    - Paid-up share capital and Reserves & Surplus is *less than or equal to* **₹1 crore** as on the Balance Sheet date.
    - Total borrowings from any bank or financial institutions is *less than or equal to* **₹1 crore** at any point of time during the previous financial year.
    - Total revenue is *less than or equal to* **₹10 crores** during the previous financial year.

MATTERS TO BE INCLUDED IN AUDITOR'S REPORT (PARA 3):

- **CLAUSE 1 – PPE:**
  - Proper records – PPE & Intangible assets (Quantity & Location for PPE)
  - Physically verified and Material Discrepancies – notices and accounted.
  - Title deeds of immovable properties (except lease) in the name of company.

- Revaluation and Disclose Change if *greater than are equal to* **10%.**
- Benami property proceedings – initiated or pending.

➢ **CLAUSE 2 – INVENTORY:**
- Physical verification is reasonable.
- Discrepancies *greater than equal to* 10% - how dealt in books.
- If Working capital limits of greater than ₹5 crores- Quarterly returns are as per books or not.

➢ **CLAUSE 3 – L/A/G/I (LOAN/ADVANCE/GUARANTEE/INVESTMENT) TO ANY ENTITY:**
- Aggregate amount and Balance Outstanding (not for company that has the business of giving loans).
- Terms and conditions are not prejudicial.
- Repayment schedule is fixed or not Outstanding Repayment regular.
- Overdue (OD) amount + Steps for OD >90 days.
- Any settlement of old loans (Extend/Renew/Settlement by a fresh loan).
- For Repayable on demand or without specified terms – Aggregate amount + % to total loans and Loans to promoter or related party.

➢ **CLAUSE 4 – LOANS & INVESTMENTS** – Compliance of Section 185 & 186.

➢ **CLAUSE 5 – DEPOSITS OR DEEMED DEPOSITS:**
- Compliance of Section 73 to 76 (If not, disclose nature of the contravention).
- Any order passed by the National Company Law Tribunal/Company Law Board/Reserve Bank of India/Court.

➢ **CLAUSE 6 – COST RECORDS:** Check applicability. If yes, whether maintained or not.

➢ **CLAUSE 7 – STATUTORY DUES:**
- Whether company is regular in payments of Undisputed Statutory Dues.
- Amount of Outstanding Undisputed Statutory Dues [For more than 6 months].
- For Disputed statutory dues – Amount involved and Forum.

➢ **CLAUSE 8 – INCOME NOT DISCLOSED IN BOOKS BUT DISCLOSED FOR INCOME TAX ACT:**
- Transactions not recorded in books of accounts but disclosed or surrendered to IT Department.
- Previously unrecorded income recorded properly.

➢ **CLAUSE 9 – DEFAULTS & NON-COMPLIANCES WITH RESPECT TO TERM LOANS:**
- Defaults in Principal or Interest (Yes – Period + Amount + Lender-wise details).
- Declared willful defaulter.
- Loans raised diverted to new purposes.
- STF used for LTP (STF- Short term funds; LTP- long term purposes).
- Funds for Group Cos. - S/A/JV (Transaction + Amount) (Subsidiary/ Associate/ Joint Venture)
- Details of Secured loans and default in its repayment.

➢ **CLAUSE 10 – SECURITIES:**
- IPO/FPO used for original purpose. (Initial/ Further Public Offer)
- PA/PP – Section 42 & 62 complied (If not, details + amount involved). (PA- Preferential allotment/ PP- Private Placement)

➢ **CLAUSE 11 – FRAUDS:**
- Noticed or Reported (Nature + Amount).
- Any report filed with CG in Form ADT-4.
- Whistle blower complaints details.

➢ **CLAUSE 12 – NIDHI COMPANY:**
- Net Owned Funds Deposits = 1:20, this ratio is compiled or not.
- 10% unencumbered term deposits maintained.

- Defaults in repayment or interest.

➢ **CLAUSE 13 – RELATED PARTY TRANSACTIONS:**
- Compliance of Section 177 & 188.
- Disclosures in Financial Statement.

➢ **CLAUSE 14 – INTERNAL AUDIT:**
- IA is commensurate with the size and nature of business.
- Reports considered by the statutory auditor.

➢ **CLAUSE 15- NON-CASH TRANSACTIONS:** Compliance of Section 192.

➢ **CLAUSE 16 – NBFC, HFC & CIC (Non-Banking Finance Company/ Housing FinanceCompany/ Core Investment Company):**
- Applicability {If yes, check COR (certificate of registration)}.
- Check COR for NBFC or HFC activities.
- Company is CIC or not (If yes, fulfillment of criteria of CIC).
- No. of CICs in group.

➢ **CLAUSE 17 – CASH LOSSES:** Incurred in previous or current financial year. (If yes, state the amount).

➢ **CLAUSE 18 – RESIGNATION BY STATUTORY AUDITORS:** Details of resignation and I/O/C (issues, objection and conflicts) raised by outgoing auditors.

➢ **CLAUSE 19 – GOING CONCERN ANALYSIS:**
- On basis of ratios/Ageing/Payments/Other information /Knowledge of BOD & Management Plans – check No material uncertainty exists and company capable of meeting liabilities at Balance Sheet date.

➢ **CLAUSE 20- CSR:**
- Unspent amount {related to OGP (ongoing project)} – transferred to Unspent CSR A/c.
- Unspent amount (related to other than OGP) – transferred to any Schedule VII Fund.

➢ **CLAUSE 21- QUALIFICATIONS OR ADVERSE REMARKS:**
- Remarks for Group Company - S/A/JV – Para no. and Details.

➢ **REASONS TO BE STATED FOR UNFAVOURABLE/QUALIFIED ANSWERS (Para 4):**
- Give basis for unfavourable or qualified answers.
- Give reasons for not expressing opinions. (Such reasons to be given on point-by-point basis)

Question Solver Points:

1. The objectives of the auditor as per SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements" are to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and to express clearly that opinion through a written report.
2. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. **(PP book- C/I- Q.13)**
3. 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. **(PP book- C/I- Q.1)**
4. The auditor shall modify the opinion in the auditor's report when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement. **(PP book- C/I- Q.3)**

5. There are three types of modified opinions, namely:

Qualified opinion- Material misstatement or scope limitation but not pervasive.

Adverse opinion- Material misstatement and pervasive. **(PP book- C/I- Q.4)**

Disclaimer of opinion- Scope limitation and pervasive.

6. 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. **(PP book- C/I- Q.6)**
7. As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the objective of the auditor is to draw users' attention by way of clear additional communication in the auditor's report, to a matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it isfundamental to users' understanding of the financial statements (Emphasis of matter paragraph) ; or as appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report (other matter paragraph).
8. As per SA 701, "Communicating Key Audit Matters in The Independent Auditor's Report", the objectives of the auditor are to determine key audit matters and having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.
9. Communicating key audit matters in the auditor's report is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make or that are otherwise necessary to achieve fair presentation. **(PP book- C/I- Q.5)**
10. As per SA 710, there are two different broad approaches to the auditor's reporting responsibilities in respect of comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.
11. As per SA 600, when the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit.
12. The main auditor has to consider the report of the branch auditor and has a right to seek clarification and to visit the branch but cannot ask for a copy of working papers and therefore, the branch auditor is under no compulsion to give photocopies of his working papers to the company auditor. **(PP book- C/I- Q.19)**
13. SA 299 "Joint Audit of Financial Statements" deals with the professional responsibilities which the auditors undertake in accepting appointments as joint auditors.
14. All the joint auditors are jointly and severally responsible for the audit work, which is not divided among the joint auditors and is carried out by all joint auditors. **(PP book- C/I- Q.17)**

PERFECT REVISION QUESTIONS

Q. No.	Questions and Answers
1.	**Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report?**
Ans.	**The emphasis of Matter paragraph:** A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements. **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.
2.	**The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Explain stating the advantages of the joint audit.**
Ans.	The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing the total work. **The advantages of a joint audit are:** **(a)** Sharing of expertise. **(b)** Advantages of mutual consultation. **(c)** Lower workload. **(d)** Better quality of performance. **(e)** Improved service to the client. **(f)** Displacement of the auditor of the company taken over in a takeover is often obviated. **(g)** 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. **(h)** Lower staff development costs. **(i)** Lower costs to carry out the work. **(j)** A sense of healthy competition towards a better performance.
3.	**Discuss the following:** **In Joint Audit, "Each Joint Auditor is responsible only for the work allocated to him".**
Ans.	As per SA 299, "Joint Audit of Financial Statements", 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:** **(a)** the audit work, which is not divided among the joint auditors and is carried out by all joint auditors; **(b)** decisions took by all the joint auditors under audit planning in respect of common audit areas; **(c)** 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;

	(d) examining that the financial statements of the entity comply with the requirements of the relevant statutes; **(e)** presentation and disclosure of the financial statements as required by the applicable financial reporting framework; ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.
4.	**"An auditor is required to make specific evaluations while forming an opinion in an audit report." State those evaluations.**
Ans.	**Specific Evaluations by the auditor: In particular, the auditor shall evaluate whether:** **(a)** The financial statements adequately disclose the significant accounting policies selected and applied; **(b)** The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate; **(c)** The accounting estimates made by management are reasonable; **(d)** The information presented in the financial statements is relevant, reliable, comparable and understandable; **(e)** The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and **(f)** The terminology used in the financial statements, including the title of each financial statement, is appropriate.
5.	**Delightful Ltd. is a company engaged in the production of smiley balls. During the FY 2020-21, the company transferred its accounts to a computerized system (SAP) from the manual system of accounts. Since the employees of the company were not well versed with the SAP system, there were many errors in the accounting during the transition period. As such, the statutory auditors of the company were not able to extract correct data and reports from the system. Such data were not available manually also. Further, the employees and the management of the company were not supportive in providing the requisite information to the audit team. The auditor believes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive.** **Explain the kind of audit report that the statutory auditor of the company shall issue in this case.**
Ans.	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. **Facts of the case:** The statutory auditors of Delightful Ltd. were not able to extract correct data and reports from the system. Such data were not available manually also. Further, the employees and the management of the company were not supportive in providing the requisite information to the audit team. Thus, the auditor does not have information to verify the financial statements. The auditor believes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive. **Conclusion:** In the present case, the statutory auditors of Delightful Ltd. shall give a disclaimer of opinion.

6.	**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. Apart from the above, explain the other relevant points to be included in the opinion section.**
Ans.	The first section of the auditor's report shall include the auditor's opinion and shall have the heading "Opinion." The Opinion section of the auditor's report shall also: **(a)** Identify the entity whose financial statements have been audited; **(b)** State that the financial statements have been audited; **(c)** Identify the title of each statement comprising the financial statements; **(d)** Refer to the notes, including the summary of significant accounting policies; and **(e)** Specify the date of, or the period covered by, each financial statement comprising the financial statements.
7.	**As an auditor of a listed company, what are the matters that the auditor should keep in mind while determining "Key Audit Matters."**
Ans.	As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. **In making this determination, the auditor shall take into account the following:** **(a)** Areas of higher assessed risk of material misstatement or significant risks identified in accordance with SA 315. **(b)** Significant auditor 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.
8.	**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 identify the division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard.**
Ans.	**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 the division of audit areas and common audit areas; **(b)** Ascertain the reporting objectives of the engagement; **(c)** Consider and communicate among all joint auditors the factors that are significant **(d)** In directing the engagement team's efforts; **(e)** Consider the results of preliminary engagement activities or similar engagements performed earlier. **(f)** Ascertain the nature, timing and extent of resources necessary to accomplish the engagement.
9.	**ABC Ltd. is a company incorporated in India. It has branches within and outside India. Who can be appointed as an auditor of these branches within and outside India? Also, to whom branch auditor is required to report?**
Ans.	**(a)** As per the provisions of the Companies Act, 2013, 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. **(b)** If 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. **(c)** 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. **(d)** Also, 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.
10.	**The auditor's report shall include a section directly following the Opinion section, with the heading "Basis for Opinion". Explain what is included in this "Basis for Opinion" section.**
Ans.	The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion" that: **(a)** States that the audit was conducted in accordance with Standards on Auditing; **(b)** Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs; **(c)** Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. **(d)** States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.
11.	**The auditor's report shall include a section with the heading "Responsibilities of Management for the Financial Statements." SA 200 explains the premise relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Explain.**
Ans.	**Responsibilities for the Financial Statements:** The auditor's report shall include a section with the heading "Responsibilities of Management for the Financial Statements." SA 200 explains the premise relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements. Management also accepts responsibility for such internal control as it determines necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted. **This section of the auditor's report shall describe management's responsibility for:** **(a)** Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; [because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud]. **(b)** Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.
12.	**Explain the reporting requirements the auditor should ensure under CARO 2020 related to Property, Plant and Equipment.**

Ans. As per Paragraph 3 of Companie (Auditor's Report) Order, 2020, an auditor shall report the following in his audit report in respect of PPE and intangible assets:

(a) Proper records of PPE (includes quantitative details and situation of assets) and intangible assets are maintained.

(b) PPE are physically verified by the management at regular intervals and whether any material discrepancies are being noticed.

(c) Title deeds of all immovable properties are disclosed in the financial statements and held in the name of the company except leases. (If the immovable properties are not in the name of the company, give details)

(d) Whether the Revaluation of PPE and intangible assets is done or not. (If yes, whether it is on the basis of the valuation by a Registered Valuer along with any amount of change)

- Amount of change = If ≥10% (aggregate of the net carrying value of each class of PPE or intangible assets), then specify such change.

(e) Any proceedings that are initiated or pending for holding any *Benami* property under the Benami Transactions (Prohibition) Act, 1988. (If yes, whether proper disclosure of its details in Financial statements is made or not)

13. Which class of companies are specifically exempt from the applicability of CARO, 2020?

Ans. Companies (Auditor's Report) Order, 2020 [CARO, 2020] shall not be applicable to the following companies:

(a) A banking company defined in Banking Regulations Act, 1949.

(b) An insurance company defined under Insurance Act, 1938.

(c) A Section 8 Company as per the Companies Act, 2013.

(d) An OPC and a small company.

(e) **A private limited company as per the following conditions:**

(i) Not a subsidiary or a holding company of any public company.

(ii) Have Paid-up Share Capital and Reserves & Surplus of not more than ₹1 crore as on the Balance Sheet date.

(iii) Total borrowings from any bank or financial institution of not more than ₹1 crore.

(iv) Have a total revenue as per the Schedule III of the Companies Act, 2013 of not more than ₹10 crores.

14. Communicating Key Audit Matter is not a substitute for disclosure in the Financial Statements rather, communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Analyse.

Ans. 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.

15. When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures. Discuss the exceptions of the above statement when the prior period financial statements are audited.

Ans. When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances:

(a) 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, and 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:**

(i) 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

(ii) 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.

(b) 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.

(c) Prior Period Financial Statements Not Audited: If the prior period financial statements were not audited, the auditor should state in the 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.

16. **CA Guru is in the process of preparing the final audit report of JPA Private Limited and would like to disclaim his opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence. How shall CA Guru amend the description of the auditor's responsibilities as required by SA 700 (Revised)?**

Ans. Since the auditor, CA Guru, disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence of JPA Pvt. Ltd., **the auditor (CA Guru) 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 the 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.

(c) The statement about auditor independence and other ethical responsibilities that are required by SA 700 (Revised).

17. **"The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework." Explain.**

Ans. 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.

18.	**The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally. Explain.**
Ans.	**(a)** The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users. **(b)** SA 700 promotes consistency in the auditor's report but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions. **(c)** Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global market place by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. **(d)** It also helps to promote the user's understanding and to identify unusual circumstances when they occur.
19.	**The auditor has to make inquires on certain matters under Section 143 of the Companies Act, 2013. Discuss these matters.**
Ans.	As per Section 143 of the Companies Act, 2013, the auditor has to make inquires on the following matters: **(a)** Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members; **(b)** Whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company; **(c)** Where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company; **(d)** Whether loans and advances made by the company have been shown as deposits; **(e)** Whether personal expenses have been charged to Revenue Account; **(f)** Where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.
20.	**State the matters to be included in the auditor's report as per CARO, 2020 regarding:** **(a) Private Placement of Preferential Issues.** **(b) The utilisation of IPO and further public offer.**
Ans.	**(a) Private Placement of Preferential Issues:** Whether the company has made any preferential allotment or private placement of shares or convertible debentures during the year. **(i)** If such allotment or placements have been made, 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. **(ii)** If the funds are not utilized for the purpose for which such funds were raised, then the details in respect of the amount involved and nature of non-compliance shall be reported. **(b) The utilisation of IPO and further public offer:** Whether the money raised by way of an 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 shall be reported.

21.	**Discuss the reporting requirements as per CARO, 2020, regarding:** **(a) disputed and undisputed statutory dues and** **(b) internal audit system of the company.**
Ans.	Matters to be included as per CARO, 2020: **(a) Undisputed and Disputed Statutory dues** Clause (vii) **(1)** 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; **(2)** 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). **(b) Internal Audit System** Clause (xiv) **(1)** whether the company has an internal audit system commensurate with the size and nature of its business; **(2)** whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor.

CHAPTER 9 SPECIAL FEATURES OF AUDIT OF DIFFERENT TYPES OF ENTITIES

GOVERNMENT AUDIT

BACKGROUND

- **As per ARTICLE 266**, Consolidated Fund of India consists of all revenue received from direct & indirect taxes, all loans taken by the government of India & all amount of repayment of loans received by the government of India.
- **Public accounts committee:** Scrutinized expenditure of government entities.
- **Government audit objectives:**
  (1) Accounting for Public Funds;
  (2) Appraisal of Government policies;
  (3) Base for Corrective actions by highlighting the lapses.
- **Auditor for government Audit:** Comptroller and Auditor General through agency of Indian Audit and Accounts Department.

LEGAL FRAMEWORK AND COMPTROLLER & AUDITOR GENERAL

- Appointed by President of India.
- Removal only if two-third majority of both houses of parliament in case of incapacity or proven misbehaviour.
- Holds office for 6 years or 65 years of age *whichever is earlier.*

DUTIES OF COMPTROLLER AND AUDITOR GENERAL:

- Compile & submit Accounts of Union & States.
- Audit & report on all expenditures from Consolidated Fund of India & of each State & of each Union Territory having a Legislative Assembly.
- Audit & report all transactions of Union & of the States relating to Contingency Funds & Public Accounts.
- Audit & report on all trading, manufacturing, P&L Accounts, Balance Sheet & other Subsidiary Accounts.
- Audit all receipts & expenditures of substantially financed body or authority & to report on the receipts & expenditures audited by him.
- Scrutinize procedures of sanctioning grants or loans given & shall have right of access, after giving reasonable previous notice, to books & accounts of that authority or body.
- Audit & report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

POWERS OF COMPTROLLER AND AUDITOR GENERAL:

(1) Inspect any office of accounts under control of Union or State Government including office responsible.
(2) Accounts, books, papers & other documents which deal with/relevant to transactions under audit.
(3) Put such questions or make such observations as he may consider necessary to person in charge.
(4) Dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks.

EXPENDITURE AUDIT:

- **AUDIT AGAINST RULE & ORDERS:** Expenditure incurred conforms to relevant provisions of the statutory enactment & accordance with Financial Rules & Regulations framed by competent authority.
  Rules and order may fall under the following category:
  – Power to incur and sanction expenditure from Consolidated fund of India.
  – Rules and orders dealing with the mode of presentation of claims against government, withdrawing money from the Consolidated Fund.

- Rules and orders regulating the conditions of service, pay and allowances and pensions of government servants.

Function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

- They are not inconsistent with any provisions of the Constitution.
- They are consistent with the essential requirements of audit and accounts.
- Not in conflict with rules of higher authority.
- The issuing authority possesses the necessary rule-making power.

- **AUDIT OF SANCTIONS:** Either special or general, accorded by competent authority authorizing the expenditures.
- **AUDIT AGAINST PROVISION OF FUNDS:** Provision of funds out of which expenditure can be incurred & same has been authorized by competent authority.
- **PROPRIETY AUDIT:** Expenditure is incurred with due regard to broad & general principles of financial propriety. 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.

  Standards of financial propriety:
  - Expenditure should not be *prima facie* more than the occasion demands.
  - No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
  - Public money should not be utilised for the benefit of a particular person or section of the community unless amount is insignificant or enforced in court or as per recognized policy.
- **PERFORMANCE AUDIT:** Various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them.

  Its scope includes:
  - **Efficiency audit:** Whether schemes or projects are executed & their operations conducted economically.
  - **Economy audit:** Whether government have acquired financial, human & physical resources in an economical manner.
  - **Effectiveness audit:** Performance of programmes, schemes, projects with reference to overall targeted objectives as well as efficiency.
  - **Efficiency cum-performance audit:** Objective examination of financial and operational performance of an organisations programme.

➢ **AUDIT OF RECEIPTS**- Not as widespread as expenditure audit but gaining importance in some countries.

- **Audit Objectives**- Verify correct assessment, realization and crediting of government revenues by designated authorities.
- **Regulations and Procedures** - Assess adequacy of regulations and procedures for effective checks on assessment, collection and case allocation. Confirm implementation of these regulations and procedures.
- **Fraud Detection and Investigation**- Ensure adequate checks for prompt detection and investigation of irregularities, double refunds, fraudulent vouchers, or revenue loss.
- **Review of Systems and Procedures**- Examine internal procedures to secure correct accounting of demands, collection, refunds and pursuit of dues up to final settlement. Suggest improvements in systems and procedures.
- **Principle of Audit of Receipts**- Emphasizes the importance of a general overview, with individual cases scrutinized in test checks. Review judicial decisions to assess the effectiveness of assessment procedures.

- **Extent and Quantum of Audit -** Determined by the Comptroller and Auditor General (C & AG). Structured based on test checks, random sampling, and in-depth studies according to transaction nature and departmental activities.

➢ **AUDIT OF STORES AND INVENTORIES:**

Audit of stores and inventories, as a part of expenditure audit under C & AG's responsibilities, involves ensuring adherence to regulations governing various aspects of stores management. The audit aims to identify and report deficiencies in store quantities and control systems. It verifies sanctioned purchases for compliance with rules, emphasizing economical decisions. The audit also checks the reasonableness of prices, ensuring alignment with supply contracts and addresses issues related to quality and quantity certification. Accuracy of receipts, issues and inventory balances is scrutinized, with a focus on compliance with specified consumption norms. Periodic verifications are conducted to identify excess or idle inventory. The audit ensures proper valuation of inventories to align value accounts with physical accounts, addressing any profit or loss adjustments due to revaluation, inventory taking or other causes.

➢ **AUDIT OF COMMERCIAL ACCOUNTS**

Public enterprises are required to maintain commercial accounts and are generally classified under three categories— Departmental enterprise, statutory bodies and government companies. 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 statute 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 and test audit of the accounts.
  - **Supplementary audit: C & AG shall within 60 days from the date of receipt of the audit report have a right to conduct supplementary audit.** It requires information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, & in such form, as C & AG may direct. Any comments given by C & AG upon, or supplement to, audit report shall be sent by company to every person entitled to copies of audited financial statements.
  - **TEST AUDIT:** Any company covered under sub-section (5) or sub-section (7) of section 139, by anorder, cause test audit to be conducted of the accounts of such company and provisions of section 19A of C & AG (Duties, Powers and Conditions of Service) Act, 1971.

✍ **AUDIT OF LOCAL BODIES**

- Covers five distinct types of urban local authorities—the municipal corporations, the municipal councils, the notified area committees, the town area committees, and the cantonment committees.
- Property taxes & octroi—major sources of revenue.
- Functions include regulatory, maintenance and development activities.
- Major expenditure in public health, public safety, education, public works and general administration expenses.
- Revenue grants are of three categories—**General purpose grants, Specific purpose grants and Statutory and compensatory grants.**

➢ **FINANCIAL ADMINISTRATION**

- **Budgetary Procedure:** This is done to get two benefits—financial accountability and control of expenditure. The main objective is to ensure that funds are raised and money are spent by the executive departments in accordance with the rules and regulations and within the limits of sanction and authorization by the legislature.
- **Expenditure Control:** 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. The system of external audit by state government as the only instrument of controlling municipal expenditure.

- **Accounting System:** Municipal accounting and budget format have been criticized as neither simple nor comprehensible.

➢ **OBJECTIVES OF AUDIT OF LOCAL BODIES**

- Reporting on the fairness of the content and presentation of financial statements;
- Reporting upon the strengths and weaknesses of systems of financial control;
- Reporting on the adherence to legal and/or administrative requirements;
- Reporting upon whether value is being fully received on money spent; and
- Detection and prevention of error, fraud and misuse of resources.

➢ **AUDIT PROGRAMME:**

(1) Appointment: Local Fund Audit Wing of State Government or Own auditor.
(2) Auditor's Concerns: Fairness of Financial Statement; Strengths & weaknesses internal control; adherence to legal requirement; Value received for money spent.
(3) Expenditure incurred with rules & regulations;
(4) All sanctions authorised;
(5) Provision of funds & expense;
(6) Check performance of programme & projects.

GENERAL POINTER IN AUDIT OF ANY TYPE OF ENTITY

- Review & understand MOA, AOA, Rules & regulation, trust Deed, Charter document of entity.
- Review & evaluate internal control system effectiveness.
- Review minutes of meeting of board, Managing Committee or Governing Body.
- Check the requirement of applicable Act or regulating body.
- Obtain written representation from the management wherever necessary.
- Check the existence, valuation & ownership of Investment, Fixed assets, Inventory.
- Verify schedule/ list of head & reconcile it with General Ledger or Financial Statements.
- Ensure no expenditure of revenue nature has been capitalized.

AUDIT OF NON-GOVERNEMENT ORGANIZATION

➢ **SOURCES AND APPLICATION OF FUNDS**

(a) Organisations raise funds from members, donors or contributors apart from receiving donation of time, energy & skills for achieving their social objectives like imparting education, providing medical facilities, economic assistance to poor, managing disasters and emergent situations.
(b) Major source of revenue includes grants & donations, fund raising programmes, membership fees, subscriptions of magazine or circulars, interest & dividend etc. Donations & grants received in the nature of **promoter's contribution** are in nature of **capital receipts** & shown as liabilities in Balance Sheet Contribution made towards capital or corpus of an NGO is known as **corpus contribution.**

➢ **PROVISIONS RELATING TO AUDIT**

While planning audit, auditor may concentrate on knowledge of NGO's work, mission, vision, organizational structure, relevant statutes, project and program guidelines, examination of minutes of meetings, setting up of materiality levels and involvement of expert.

Audit Programme:

(a) Corpus fund should be vouched with special reference to the letters from the donor(s).
(b) Check requirements of donor's institutions, board resolution of NGO, rules & regulations of the schemes of ear-marked funds.
(c) Verify agreement with donor or contributor(s) supporting particular programme to ascertain conditions with respect to undertaking the programme or project & if programmes or projects involving contracts, ensure that income tax is deducted, deposited & returns filed and verify the terms of contract.

(d) Verify that provident fund, life insurance premium, employees state insurance & their administrative charges are deducted, contributed & deposited within prescribed time.
(e) Verify agreements with donors & grants letters to ensure that funds received have been accounted for.
(f) Verify inventory in hand and obtain certificate from the management for the quantities and valuation.

AUDIT OF SOLE TRADER

Auditor is appointed by sole proprietor himself and determines the scope and conditions under which audit will be conducted. Advisable to obtain a written engagement letter to avoid any confusion.

AUDIT OF PARTNERSHIP FIRM

- **Advantages:**
  (1) Helps in resolving Dispute;
  (2) Settling accounts at time of Dissolution;
  (3) Reliable for bank advancing loan or prospective purchasers;
  (4) Helpful in negotiations to admit a person as partner;
  (5) Effective safeguard against any undue advantage by any partner.
- **Matter considered in audit:**
  (1) Nature & Scope in appointment letter;
  (2) Study Partnership Documents;
  (3) Verifying business engaged as per objects of Partnership;
  (4) Examine reasonability of Books of Account;
  (5) Verify interest of no partner has suffered prejudicially by activities of firm;
  (6) Provision for tax made before profit distribution;
  (7) Profit/ Loss shared as per their agreed profit-sharing ratio.
- **Audit of LLP:** Govern by Limited Liability Partnership Act 2008.
- **All LLP's except small LLP are required to get their accounts audited.** Small LLP- turnover of < ₹40 lakhs and contribution < ₹25 lakhs.
- **Advantages:** Detection of errors; Settlement of disputes; Increases reliability for banks and others, Better compliance and management and reconstitution.
- **Returns:** To be maintained and filed by an LLP.
  - Every LLP required to file annual return in Form 11 with ROC within *60 days* of closer offinancial year.
  - Every LLP is required to submit Statement of Accounts & Solvency in Form 8 which shall be filed within a period of *30 days* from end of 6 months of financial year.
- **Appointment of auditor-** Appointed by designated partner any time before end of first financial year and at least *30 days* prior to end of subsequent financial years.
- **Auditor's duty regarding audit of LLP**
  (1) Engagement Letter
  (2) Minutes book
  (3) LLP Agreement- Nature of business, amount of capital, interest on capital and drawings, rights and duties etc.
  (4) Reporting whether records are correct and reliable and all information received.

AUDIT OF CHARITABLE ORGANIZATION

(a) Study constitution of Charitable Organization.
(b) Examining system of internal check with regards to amounts collected.
(c) Subscriptions and Donations: Changes made to annual fees or other fees.
(d) Whether official receipt are issued: Confirm control over unused receipt book and obtain all receipt book.

(e) **Legacies** – Verifying the amounts received by reference to correspondence.
(f) Investments Income Vouching the amounts received with the **dividend** and **interest** counter foils and checking the **calculations** of interest received.
(g) Vouching the Income-tax refund with the correspondence with the Income- tax Department;
(h) Vouching payment of grants, also verifying that the grants have been paid only for a charitable purpose.

AUDIT OF EDUCATIONAL INSTITUTE

(a) Vouch fees from students, Cash Book; admission fees; any government or local authority grant; donations; establishment expenditure, etc.
(b) Ensure that any free studentship & concessions, fines for late payment & absence, any increase in salary have been done under proper authority.
(c) Confirm that **hostel dues** were recovered before student's accounts were closed & their deposits of caution money refunded.
(d) Verify Specific Purpose donations were utilised for that purpose only.
(e) Confirm that **caution money** & other deposits paid by students on admission, shown asliability in Balance Sheet not transferred to revenue, unless they are not refundable.
(f) Verify **Investments** representing **endowment funds for prizes** are kept separate & anyincome in excess of prizes has been accumulated & invested along with corpus.
(g) Confirm that **refund of taxes** deducted from income from investment has been claimed &recovered since institutions are generally exempted from income-tax.
(h) Verify annual statements of account & separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel & Provident Fund of staff.

AUDIT OF HOSPITAL

(a) Vouch register of Patients, Cash collections as entered in Cash Book.
(b) Ensure that legacies & donations received for specific purpose have been applied in the manner agreed upon.
(c) Verify that grants received from Government or local authority has been duly accounted for refund in respect of taxes deducted at source has been claimed.
(d) Compare Actual *vs.* Budget Income & Expenditure & ascertain reason for significant deviation.
(e) Check that Depreciation has been written off against all the assets at the appropriate rates.
(f) Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction.
(g) Obtain inventories, especially of stocks and stores as at the end of the year.
(h) Trace all collections of subscription and donations from the Cash Book to the respective Registers.

AUDIT OF CLUB

(a) Vouch the receipt on account of **entrance fees and subscriptions** with members' applications, counter foils issued to them.
(b) Ensure that arears of subscription of present year have been correctly brought forward and necessary steps have been taken to recover member's dues in arears.
- 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.
- Vouch **purchase** of sports items, furniture, crockery, etc. and trace their entries into the respective inventory registers.
- Check the **inventory** of furniture, sports material and other assets physically.
- Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members.
- Vouch purchases of food stuffs, 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.

AUDIT OF CINEMA

(a) Verify the **internal control mechanism**—entrance should be on the basis of ticket only, separate tickets for advance booking, tickets are serially numbered and bound into books etc.
(b) Verify statement of ticket sold prepared with the Cash Collected.
(c) Ensure record of any free passes is maintained & are issued under proper authority.
(d) Reconcile statement of tickets sold with cash collected, amount of entertainment tax collected with total no. of tickets sold and verify the same with monthly returns.
(e) Verify charges collected for advertisement slides & shorts by reference to Register of Slides & Shorts Exhibited kept at cinema with agreements entered into with advertisers in this regard.
(f) Vouch payments on account of film hire with bills of **distributors** and agreements with them.
(g) Examine unadjusted balance out of **advance paid to the distributors** against film hire contracts.
(h) Arrangement for collection of the share in restaurant income should be enquired into — either a fixed sum or a fixed percentage of the taking may be receivable annually.

AUDIT OF HIRE PURCHASE AND LEASING COMPANIES

➢ **Audit of Hire purchase:**
- Hire purchase agreement is in writing.
- Agreement specifies hire purchase price, cash price, number and amount of instalments and goods taken on hire.
- Instalment payments are received regularly.

➢ **Audit of Leasing company**
- Examine object clause to check whether company can undertake financing activities.
- Examine controls about checking credit-worthiness of lessee.
- Examine lease agreement and check description of lessor and lessee, amount of lease, whether equipment will be returned to lessor on completion of lease.
- Ensure invoice is retained.
- See that copies of insurance policy is retained.

AUDIT OF HOTELS

(a) Internal Controls: To overcome problem of pilferage in any hotel, obtain regular trading accounts prepared for period under review, examine them & obtain explanations for any apparent deviations.
(b) Room Sales & Hall Bookings: Verify charged rates used on the guests' bills & standard room rate & any difference should be investigated.
(c) Inventories: The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. Areas where large quantities of inventory are held should be kept locked.
(d) Casual Labour: Verify records maintained for Casual Labour as Hotel Trade operates on a very large extent on this.
(e) Travel Agents & Shops- Obtain ledger through travel agents and check with bills issued to them. Commission paid should be matched with agreement.

AUDIT OF CO-OPERATIVE SOCIETY

➢ **GOVERN BY CO-OPERATIVE SOCIETIES ACT, 1912**
Audit as per section 17 of the co-operative societies act, 1912
- **Qualification of auditors:** CA, persons holding a government diploma in co-operative accounts, auditor in the co-operative department of a government.
- **Appointment of the Auditor:** Appointed by the Registrar of Co-operative Societies.

- **Books, Accounts and other records of Co-operative Societies:** Cash book, Sales and purchase book, assets and liability records and other registers as per nature of business.
- **Restriction on shareholding:** No member of society other than a registered society can hold such portion of share capital as would exceed a maximum of 20% of total number of shares or of value of shareholding to ₹1,000/.
- **Restrictions on loans:** Registered society shall not make loan to any person other than a member.
- **Restrictions on borrowings:** Registered society shall accept loans & deposits from person not a member subject to restrictions & limits of the bye-laws of the society.
- **Investment of funds**- Society can invest in central or state or other co-operative banks or shares, securities of other co-operative societies.
- **Appropriation of profits**- 25% profits transferred to Reserve fund.
- **Contributions to Charitable Purposes:** Amount not exceeding 10% of the net profits remaining after the compulsory transfer to the Reserve Fund.
- **Investment of Reserve Fund outside the business or utilisation as working capital.**
- **Contribution to Education Fund**- Contribute annually towards the Education Fund of the State Federal Society. Charge on profit and not an appropriation.

➢ **SPECIAL FEATURES OF CO-OPERATIVE AUDIT**

- **Examination of overdue debts**- Overdue debts for a period from 6 months to 5 years and more than 5 years will have to be classified and shall have to be reported by an auditor.
- **Overdue Interest** - Overdue interest should be excluded from interest outstanding and accrued due while calculating profit.
- **Certification of Bad Debts**- As per Maharashtra State Act, bad debts can be written off only when they are certified as bad by the auditor.
- **Valuation of Assets and Liabilities**- The auditor will have to ascertain existence, ownership and valuation of assets. Fixed assets should be valued at cost *less* adequate provision for depreciation.
- **Adherence to Co-operative Principles**- 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.
- **Observations of the Provisions of the Act and Rules**- Required to point out the infringement with the provisions of Co-operative Societies Act and Rules and bye-laws.
- **Verification of Members' Register and examination of their pass books**- Examination of entries in members pass books regarding the loan given and its repayments and confirmation of loan balances in person.
- **Special report to the Registrar- If auditor finds serious irregularities in working of the society, he has to report to registrar.**
  Examples of such cases:
  - Personal profiteering by members of managing committee;
  - Detection of fraud relating to expenses & purchases;
  - Specific examples of mis-management;
  - In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management.

➢ **AUDIT, INQUIRY AND INSPECTION OF MULTI-STATE CO-OPERATIVE SOCIETIES**

Multi-State Co-operative Societies (MSCS) Act, 2002 applies to co-operative societies whose objects are not confined to one State.

- Every Multi state co-operative society shall keep **books:**
  (1) sum of money received and expended;
  (2) sale & purchase of goods;
  (3) assets & liabilities;
  (4) If engaged in production, processing & manufacturing, particulars relating to utilization of materials or labour or other items.

➢ **Audit of Multi-State Co-operative Society**

- **Qualification of auditors**- Must be a Chartered Accountant.
  Not eligible for auditor: Body corporate; Officer or Member of Multi state co-operative society; Person who is member or officer or employee of Multi state co-operative society; Person indebted or given guarantee or security on behalf of third person for amount **exceeding ₹1000**.
- **Appointment of Auditors**- First auditor appointed by board within one month and subsequent auditors appointed by members by society in AGM.
- **Power and duties of Auditors**- Same powers as auditor. Make inquiries about matters which are same as matters in 143(1).
- **Content of Auditor's Report-** Auditor shall make a report to the members on the accounts examined by him and whether Balance Sheet give a true and fair view of the state of affairs and profit or loss. Also report whether he has obtained all necessary information and explanations and proper books of accounts are maintained and report from branch offices received.
- **Power of Central Government to direct special audit in certain cases – Central Government to direct special audit if:**
  (1) Affairs not managed in accordance with prudent commercial practices;
  (2) Managed that it will cause serious injury to interests of trade industry or business;
  (3) Financial position is such as to endanger its solvency.
  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.

- **Inquiry and inspection by central registrar under section 78 and 79**
  - **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.
  - **How:** Hold inquiry or inspect the constitutions, working and financial condition of society.
  - **Opportunity of Being Heard:** Before holding such inquiry or inspection fifteen days' notice must be given to the society.
  - **Powers given:**
    - Free access to the books, accounts, documents, securities, cash and other properties.
    - Require the officers of the society to call a general meeting of the society by giving notice of not less than seven days.
    - Summon any person who is reasonably believed by him to have any knowledge of the affairs of the Multi-State co-operative society.
  - **Follow-up:** The central registrar shall within 3 months, communicate inquiry And inspection report to society and other interested persons.

✍ **AUDIT OF TRUSTS & SOCIETIES**

➢ **TRUSTS-**

The auditor has to ascertain: -

- Whether accounts are maintained regularly;
- Whether receipts and disbursements are properly and correctly shown in the accounts;
- Whether all books, deeds, accounts, vouchers or other documents or records required by the auditor were produced before him;
- The amounts of outstanding for more than one year and the amounts written off;
- All cases of irregular, illegal or improper expenditure, or failure or omission to recover monies;
- Whether the maximum and minimum number of the trustees is maintained;
- Whether the meeting are held regularly as provided in such instrument;
- Whether the minute books of the proceedings of the meeting is maintained.

➢ **SOCIETIES**

- The auditor's considerations:
- 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.
- Object of society needs to be ascertained from its memorandum of association or bye laws. Its activities may include charitable, social, cultural or educational activities.
- Ascertain whether society has obtained registration under Foreign Contribution (Regulation) Act, 2010.
- Also registered under Income Tax Act.
- Evaluate appropriateness of accounting policies.
- Ascertain all cases of irregular, illegal or improper expenditure or failure or omission to recover monies.

Question Solver Points:

1. The main objective of government audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration.
2. Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanor to its logical end. **(PP Book- Q.14)**
3. 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. **(PP Book C/I-Q.1)**
4. In India, the function of Government Audit is discharged by the independent statutory authority of the Comptroller and Auditor General through the agency of the Indian Audit and Accounts Department.
5. 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.
6. The audit of government expenditure is one of the major components of a government audit. The basic standards set for audit of expenditure are to ensure that there are provision funds authorized by competent authority fixing the limits within which expenditure can be incurred. **(PP Book Q-1)**
7. Besides conducting audit of receipts and expenditures of government, the Comptroller and Auditor General of India has power for appointment of auditors of government companies. He has the power to conduct supplementary audits of such government companies.
8. Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations, and orders shall be. **(PP Book Q.5)**
9. According to 'Propriety Audit', the auditors try to bring out cases of improper, avoidable or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. **(PP Book C/I-Q.2)**
10. 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. **(PP Book C/I-Q.3)**
11. The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. **(PP Book C/I-Q.4)**
12. NGOs may be defined as non-profit making organizations which raise funds from members, donors or contributors apart from receiving donations of time, energy and skills for achieving their social objectives. **(PP Book C/I-Q.5)**
13. NGOs registered under the Companies Act, 2013 must maintain their books of account under the accrual basis as required by the provisions of **section 128** of the said Act. **(PP Book C/I-Q.15)**

14. Rule 24 of LLP Rules 2009 provides that any LLP, whose turnover does not exceed, in any financial year, ₹40 lakhs, or whose contribution does not exceed ₹25 lakhs, is not required to get its accounts audited. **(PP Book C/I-Q.6)**
15. Every LLP is required to submit a Statement of Account and Solvency in Form 8, which shall be filed within a period of 30 days from the end of six months of the financial year to which the Statement of Account and Solvency relates. **(PP Book C/I-Q.12)**
16. In the case of Co-operative societies, contribution to Education fund is a charge on profits and not an appropriation. **(PP Book C/I-Q.22)**
17. The first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration of such society. **(PP Book C/I-Q.17)**
18. No inspection under **Section 79** of Multi-State Co-operative Societies Act, 2002 shall be made unless a notice has been given to the multi-state co-operative society. **(PP Book- Q.16)**

PERFECT REVISION QUESTIONS

Q. No.	Questions and Answers
1.	**The audit of government expenditure is one of the major components of a government audit. The basic standards set for audit of expenditure are to ensure that there are provision funds authorized by competent authority fixing the limits within which expenditure can be incurred. Explain those standards.**
Ans.	The audit of government expenditure is one of the major components of a government audit. The basic standards set for audit of expenditure are to ensure that there are provision funds authorized by competent authority fixing the limits within which expenditure can be incurred. **These standards are:** **(a) Audit against Rules & Orders:** The expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called the audit against 'rules and orders'. **(b) Audit of Sanctions:** There is a sanction, either special or general, accorded by a competent authority authorising the expenditure. Such an audit is called the audit of sanctions. **(c) Audit against the provision of Funds:** There is a provision of funds out of which expenditure can be incurred and the same has been authorised by a competent authority. Such an audit is called an audit against the provision of funds. **(d) Propriety Audit:** The expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called a propriety audit. **(e) Performance Audit:** The various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Such an audit is termed the performance audit.
2.	**Explain in detail the duties of the Comptroller and Auditor General of India.**
Ans.	**The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C & AG:** **(a) Compile and submit accounts of Union and States:** The C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. **(b) General Provisions Relating to Audit:** It shall be the duty of the C & AG: **(i)** to audit and report on all expenditures from the Consolidated Fund of India and of each State and of each Union Territory that has a Legislative Assembly and to ascertain whether the monies 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; **(ii)** to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts; **(iii)** to audit and report on all Trading, Manufacturing, Profit and Loss Accounts and Balance Sheets and Other Subsidiary Accounts kept in any department of the Union or of a State. **(c) Audit of Receipts and Expenditure:** Where any body or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor-General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and

expenditures of that body or authority and to report on the receipts and expenditures audited by him.

(d) **Audit of Grants or Loans:** Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a Foreign State or International Organisation, the Comptroller and Auditor General shall scrutinize the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.

(e) **Audit of Receipts of Union or States:** It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.

(f) **Audit of Accounts of Stores and Inventory:** The Comptroller and Auditor General shall have the 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.

(g) **Audit of Government Companies and Corporations**: The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The Comptroller and Auditor General of India shall appoint the auditor under **section 139 (5) & (7)** (*i.e.*, appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor General of India which, among other things, include the directions, *if any*, issued by the Comptroller and Auditor-General of India, the action that is taken thereon and its impact on the accounts and financial statements of the company.

3. **State the important objectives of the local body's audit.**

Ans. **The important objectives of the local body's 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 the value is being fully received on money spent; and

(e) Detection and prevention of error, fraud and misuse of resources.

4. **Discuss the power of CAG in the Government audit.**

Ans. **The C & AG Act gives the following powers to the C&AG in connection with the performance of his duties:**

(a) To inspect any office of accounts under the control of the Union or a State Government, including office responsible for the creation of the initial or subsidiary accounts.

(b) To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit be sent to specified places.

(c) To put such questions or make such observations as he may consider necessary to the person in charge of the office and to call for such information as he may require for the preparation of any account or report which is his duty to prepare.

(d) In carrying out the audit, the C & AG has the power to dispense with any part of the detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transactions as he may determine.

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14 of 22

5. Ans.	**Explain the different types of revenue grants which local bodies may receive.** 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 are tied to the provision of certain services or the 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 the state government from local government.
6. Ans.	**Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. Explain.** **(a)** Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. **(b)** The main objective of the audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration. In India, the function of Government Audit is discharged by the independent statutory authority of the Comptroller and Auditor General through the agency of the Indian Audit and Accounts Department. The audit is a necessary function to ensure accountability of the executive to Parliament and within the executives of the spending agencies to the sanctioning or controlling authorities. **(c)** The purpose or objectives of the audit need to be tested at the touch stone of public accountability. The Comptroller and Auditor General (C & AG), in the discharge of his functions, watch that the various authorities act in regard to financial matters in accordance with the Constitution and the laws made by Parliament and conform to the rules or orders made thereunder.
7. Ans.	**Write *a* short note on 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. A transaction may satisfy all the requirements of regularity audit in so far as the various formalities regarding rules and regulations are concerned but may still be highly wasteful. Audit against propriety **seeks to ensure that expenditure conforms to following principles:** **(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 money 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 money should not be utilized 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 travel allowances, granted to meet the expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

Save and Continue →

8.	**Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations, and orders shall be. Analyze and explain.**
Ans.	Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority. Audit of expenditure against regularity is of a quasi-judicial type of work performed by the audit authorities. It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out an 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 there under; **(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 the competent authority, the issuing authority possesses the necessary rule-making power.
9.	**Central Government holds 55% of the paid-up share Capital in Kisan Credit Co-operative Society, which is incurring huge losses. Advise when the Central Government can direct Special Audit under Section 77 of the Multi-State Co-operative Society Act.**
Ans.	Central Government shall order for special audit only if that Government or the State Government either by itself or both hold 51% or more of the paid-up share capital in such Multi-State cooperative society. 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 cooperative society are not being managed in accordance with self-help and mutual deed and cooperative principles or prudent commercial practices or with sound business principles; or **(b)** that any Multi-State cooperative 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 Cooperative society is such as to endanger its solvency. **Facts of the case:** Central Government holds 55% of the paid-up Share Capital in Kisan Credit Co-operative Society, which is incurring huge losses. **Conclusion:** In the present case, since Central Government is holding 55% shares and the financial position of the Kisan Credit cooperative society is in danger, the Central Government can direct for special audit.
10.	**An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance**

of the collected amount to different NGOs. Mention *six* points each, peculiar to the situation, which you would like to incorporate in your audit programme for audit of said receipts and remittances of donations.

Ans. **Receipts of donations:**

(a) Internal Control System: Existence of internal control system, particularly with reference to the division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of the money.

(b) Custody of Receipt Books: Existence of system regarding the issue of receipt books, whether unused receipt books are returned, and the same are verified physically including checking of a number of receipt books and sequence of numbering therein.

(c) Receipt of Cheques: Receipt Book should have a carbon copy for duplicate receipts and be signed by a responsible official. All details relating to the date of the cheque, bank's name, date, amount, etc., should be clearly stated.

(d) Bank Reconciliation: Reconciliation of Bank Statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.

(e) Cash Receipts: Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking the entity to post thank you letters mentioning the amount, date and receipt number.

(f) Foreign Contributions: Foreign contributions, *if any*, to receive special attention to compliance with applicable laws and regulations.

Remittances of donations to different NGOs:

(a) Mode of Sending Remittance: All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to the recipient.

(b) Confirming Receipt of Remittance: All remittances are supported by receipts and acknowledgements.

(c) Identity: Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.

(d) Direct Confirmation Procedure: Send confirmation letters to entities to whom donations have been paid.

(e) Donation Utilisation: Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.

(f) System of NGOs' Selection: System for selecting NGOs to whom donations have been sent.

11. **CA is appointed as the auditor of a charitable institution. Discuss the audit procedure undertaken by him while auditing the Subscriptions and Donations received by the charitable institution.**

Ans. **Subscriptions and Donations:**

Ascertaining, *if any*, the changes made in the amount of annual or life membership subscription during the year.

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 especially 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 money received from box collections, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued; paying special attention to

	the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and (f) Verifying the total subscriptions and donations received with any figures published in reports, etc., issued by the charity.
12. Ans.	**Write *a* short note on the following:** **Restriction on the shareholding in a co-operative society.** (a) 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 20% of the total number of shares or of the value of shareholding to ₹1,000. (b) The auditor of a co-operative society will be concerned with this provision so as to watch any breach relating to the 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.
13. Ans.	**No inspection under Section 79 of Multi-State Co-operative Societies Act, 2002 shall be made unless a notice has been given to the multi-state co-operative society. Explain stating clearly when and how such inspection can be made. Also, state the powers available with the Central Registrar in this regard along with provisions relating to communication of the inspection report under the said section.** **Inspection of Multi-State Co-operative societies under Section 79:** (a) **When:** The Central Registrar may, on a request from (i) federal co-operative to which a Multi-State Co-operative society is affiliated or a creditor; or (ii) not less than one-third of the members of the board; or (iii) not less than one-fifth of the total number of members of a Multi-State Co-operative society. (b) **How:** By general or special order in writing on this behalf, inspect or direct any person authorized by him by order in writing on this behalf to make an inspection into the constitution, working and financial condition of a Multi-State co-operative society. (c) **The opportunity of being heard:** No inspection shall be made unless a notice of not less than fifteen days has been given to the multi-state co-operative society. (d) **Powers available:** The Central Registrar or the person authorized by him shall have the following powers: (i) He shall at all times have access to all books, accounts, papers, vouchers, securities, stock and other property of that society and may, in the event of serious irregularities discovered during inspection, take them into custody and shall have the power to verify the cash balance of the society and subject to the general or special order of the central registrar to call a meeting of the society where such general meeting is, in his opinion necessary. (ii) Every officer or member of a Multi-State Co-operative society shall furnish such information with regard to the working of the society as the central registrar or the person making such inspection may require. (e) **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.	**State the points which you will consider in the audit of a Club.**
Ans.	**(a) Entrance Fee:** Vouch the receipt on account of entrance fees with members' applications and counter foils issued to them, in reference to minutes of the Managing Committee. **(b) Member Subscriptions:** Vouch members' subscriptions with: **(i)** the counterfoils of receipt issued to them; **(ii)** trace receipts for a selected period to the Register of Members; **(iii)** also, reconcile the amount of total subscriptions due with the amount collected and that outstanding. **(c) Subscription Arrears/in Advance** Ensure that: **(i)** arrears of subscriptions for the previous year have been correctly brought over; **(ii)** arrears for the year under audit and subscriptions received in advance have been correctly adjusted; **(iii)** subscriptions received in advance should have been properly accounted for. **(d) Arithmetical Accuracy:** Check totals of various columns of the Register of members and tally them across. **(e) Register of Members:** See the Register of Members to ascertain: **(i)** the member's dues which are in arrear; and **(ii)** enquire whether necessary steps have been taken for their recovery; **(iii)** the amount considered irrecoverable should be mentioned in the Audit Report. **(f) 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. **(g) Purchases:** Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective inventory registers. **(h) 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 the year should be verified physically and its valuation checked. **(i) 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. **(j) 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. **(k) Management Powers:** Examine the financial powers of the secretary and, if these have been exceeded, report specific case for confirmation by the Managing Committee.
15.	**What are the points which you will consider in the audit of accounts of Partnership?**
Ans.	**(a) 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, especially the limitation, if any, under which the auditor shall have to function. **(b) Partnership Documents:** Studying the minute book, if any, maintained to record the policy decision taken by partners, especially 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. **(c) 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.

(d) **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.

(e) **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.

(f) **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.

(g) **Division of Profits**: Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

16. **The general transactions of a hospital include patient treatment, collection of receipts, donations, capital expenditures. You are required to mention special points of consideration while auditing such transactions of a hospital.**

Ans. **Special points of consideration while certain auditing transactions of a hospital are stated below:**

(a) **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.

(b) **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.

(c) **Legacies and Donations**: Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(d) **Reconciliation of Subscriptions**: Trace all collections of subscriptions 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 is still outstanding).

(e) **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.

17. **What are the special steps involved in conducting the audit of an Educational Institution?**

Ans. (1) **General**:

(a) 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.

(b) 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, especially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

(2) **Fee from students**:

(a) 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.

(b) 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.

	(c) 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. **(d)** 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. **(e)** 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. **(f)** Confirm that fines for late payment or absence, etc., have been either collected or remitted under proper authority. **(g)** Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded. **(3) Expenditures:** **(a)** Verify that the Provident Fund money of the staff has been invested in appropriate securities. **(b)** 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. **(c)** Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book. **(d)** Vouch, in the usual manner, all establishment expenses and enquire into any unduly heavy expenditure under any head. If there was an 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. **(e)** See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.
18. **Ans.**	**As an auditor, what points will you consider while auditing the books of Cinema?** **(1) Verify the internal control mechanism:** **(i)** that entrance to the cinema-hall during the show is only through printed tickets; **(ii)** that they are serially numbered and bound into books; **(iii)** that the number of tickets issued for each show and class is different though the numbers of the same class for the show on the same day, each week, run serially; **(iv)** that for advance booking a separate series of tickets is issued; and **(v)** that the inventory of tickets is kept in the custody of a responsible official. **(2)** Confirm that at the end of the show, a statement of tickets sold is prepared and cash collected is agreed with it. **(3)** Verify that a record is kept of the 'free passes' and that these are issued under proper authority. **(4)** Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class and vouch and verify the entertainment tax returns filed each month. **(5)** Vouch the entries in the Cash Book in respect of cash collected on the sale of tickets for different shows on a reference to Daily Statements which have been testing checked as afore mentioned with a 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 inquired 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 the sale of various items of food stuffs, purchase of foodstuffs, cold drinks, etc., as in the case of the club.
19. Ans.	**As an auditor, what would be your areas of consideration while auditing the element of Room Sales during the audit of a 5-Star Hotel?** (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 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 that 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) Ensure compliance with the provisions of FEMA and RBI if receipts are in foreign currency. Ensure application of proper Conversion rate. (f) Special emphasis is to be laid on receipts through Credit Cards. (g) The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts.
20. Ans.	**Pilfering is one of the greatest problems in any hotel, and the importance of internal control cannot be undermined. Explain.** Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. It is the responsibility of management to introduce controls which will minimise the leakage as far as possible. Evidence of their success is provided by the preparation of regular, perhaps weekly, trading accounts for each sales point and detailed scrutiny of the resulting profit percentages, with any deviation from the anticipated form being investigated. **Audit procedure:** (a) The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations. (b) The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic records. This would enable the auditor to ensure that controls regarding the revenue cycle are in order.

	(c) The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities. If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor. As a result of the transient nature of many of his clients' records, the auditor must rely to a very large extent on the gross margin shown by the accounts. As a result, the scope of his audit tests will necessarily be increased, and, in the event of a material margin discrepancy being unexplained, he will have to consider qualifying his audit report.

CHAPTER 10- AUDIT OF BANKS

TYPES OF BANKS

(1) Commercial Banks	(4) Regional Rural Banks
(2) Co-operative Banks	(5) Payment Banks
(3) Development Banks (more commonly known as 'Term-Lending Institutions')	(6) Small Finance Banks

RESERVE BANK OF INDIA (RBI)

OBJECTIVE OF RBI:
Regulating functioning of Banking Industry of India.

RBI RESPONSIBILITIES:
- Development & supervision of constituents of Indian Financial System;
- Determining monetary & credit policies;
- Regulating activities of commercial & other banks.

RBI FUNCTIONS:
Issuance of currency; Regulation of currency issue; Banker to Central & State governments; Banker to all banks; No commencement business of banking or open new branches without obtaining license from RBI; RBI also has power to inspect any bank.

REGULATORY FRAMEWORK:
Reserve Bank of India Act, 1934; Payment & Settlement Systems Act, 2007; Banking Regulation Act, 1949; State Bank of India Act, 1955; Companies Act, 2013; State Bank of India (Subsidiary Banks) Act, 1959; Prevention of Money Laundering Act, 2002; Regional Rural Banks Act, 1976; Information Technology Act, 2000; Credit Information Companies' Regulation Act, 2005; Banking Companies Act, 1980; Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

TYPES OF BANK AUDIT REPORT- BY SCAs (STATUTORY CENTRAL AUDITORS):
- Report on adequacy and operating effectiveness of Internal control over financial reporting.
- Long Form Audit Report (LFAR).
- Report on compliance with SLR requirements.
- Report on treasury operations of the bank (instructions issued by the RBI).
- Report on the income recognition and asset classification (guidelines issued by the RBI).
- Report on serious irregularity (if any).
- Report on compliance of recommendations of the Ghosh Committee & Jilani Committee.
- Report on adverse credit-deposit ratio in the rural areas.

BANK AUDIT APPROACH:

(1) Drawing an audit plan based on nature and level of operation, nature of adverse features, audit risk etc.

(2) Control Environment at Bank:
Bank should have appropriate controls to mitigate its risks, including effective segregation of duties, accurate measurement and reporting of positions, verification and approval of transactions. **Common questions to understand Internal controls are- Who, What, When, Where, Why, How.**

(3) Engagement team discussion:

(3) **Engagement team discussion:**

Engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements.

Matters to be discussed with Engagement team: Errors likely to be occurred; Errors identified in previous years; Methods which may perpetrate fraud; Audit responses to engagement risks, pervasive risks & specific risks; Maintain professional skepticism throughout audit engagement; Need to alert to information that indicates the occurrence of any material misstatement.

Advantages of discussion: Specific emphasis to susceptibility of financial statements; proper delegation of work to Engagement Team; involve specialists to address fraud.

INCOME RECOGNITION POLICY:

- Income form Non-Performing Assets (NPA)- Cash Basis
- Income form Others- Accrual Basis

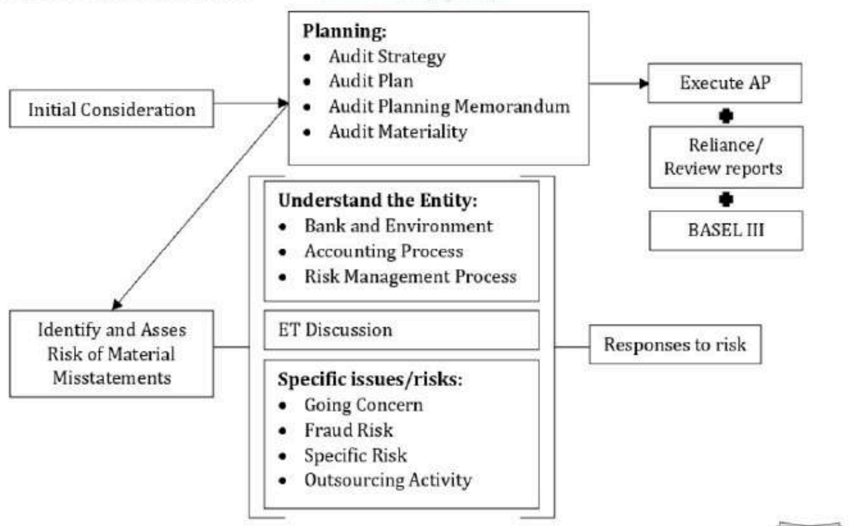
APPOINTMENT OF AUDITOR

Types of Bank	Appointed by	Remuneration
Commercial Banks	Members in AGM with prior approval of RBI.	Members in AGM.
Nationalized Banks	BOD with prior approval of RBI.	RBI in consultation with Central Government.
Regional Rural Banks	Bank with approval of Central Government.	Bank with approval of Central Government.

- **Long Form Audit Report (LFAR)**

  The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India. The Statutory Central Auditors are required to submit the long form audit report to the banks latest by 30th June every year.

CONDUCTING AN AUDIT:



- **UNDERSTANDING RISK MANAGEMENT PROCESS:**
  - **(1)** Oversight & involvement in control process by those charged with governance – Those charged with governance should approve written RM policies as per business objectives.
  - **(2)** Identification, measurement & monitoring risks that significantly impact achievement of bank's goals.
  - **(3)** Control activities.
  - **(4)** Monitoring activities – Risk Management models, methodologies & assumptions used to measure & mitigate risks.
  - **(5)** Reliable information systems – To provide adequate financial, operational & compliance information on a timely & consistently basis.
- **ASSESS RISK OF FRAUD INCLUDING MONEY LAUNDERING:**
  - **(1)** Identify & assess risk of material misstatement due to fraud;
  - **(2)** Obtain Sufficient appropriate audit evidence on those risk & respond appropriately;
  - **(3)** Professional skepticism should be maintained;
  - **(4)** Follow SA 240;
  - **(5)** RBI has issued prevention of money laundering and KYC (KYC – Anti-Money Laundering Standards) guidelines for it.

ADVANCES:

- **MEANING:** Core business of banks is accepting deposits for onward lending. It means money or credit given as a loan to another party with an agreement that money will be repaid.
- **COMPOSITION OF ADVANCES:** Term loans; cash credit; overdrafts demand loans; bills discounted & purchased; participation on risk sharing basis; interest-bearing staff loans.
- **TYPES OF ADVANCES:**
  - **(1) Funded loans:** Actual transfer of funds from bank to borrower (Term loans, Cash Credits, overdrafts);
  - **(2) Non-Funded Loans** does not involve such transfer. (Letters of credit, bank guarantees).
- **CLASSIFICATION OF ADVANCES:**
  - **(a) Sector wise classification:**
    - **(i) Priority sector:** Loan given to Agriculture, MSME, Education, Housing sector, etc.
    - **(ii) Non-priority sector:** Other than above.
  - **(b) Security wise classification:**
    - **(i) Secured:** Loan which is backed by a security. For *example*, home loan (Secured by property).
    - **(ii) Unsecured:** Loan for which bank do not have any security (Personal loans).
  - **(c) PRUDENTIAL NORMS:**
    - **(i) Standard Regular**- On or before due date.
    - **(ii) SMA Accounts:** Overdue not more than 90 days.
      - **SMA-0**: 1-30 days overdue;
      - **SMA-1**: 31-60 days overdue;
      - **SMA-2**: 61-90 days overdue.
    - **(iii) Substandard Assets:** NPA ≤ 12 months.
    - **(iv) Doubtful Assets:** Substandard category for period of 12 months.
      - Doubtful up to 1 Year (D1).
      - Doubtful 1 to 3 Years (D2).
      - Doubtful more than 3 Years (D3).
    - **(v) Loss Assets:** Loss has been identified by bank or, internal or external auditors or RBI inspection but amount has not been written off wholly.
- **NATURE OF SECURITY:**
  - **(1) Primary Security:** Offered by borrower or one against which credit has been extended by bank.
  - **(2) Collateral Security:** Additional security be in any form.

- **Examples of Securities**: Guarantor Personal Security; Good/Stocks/Debtors/Trade Receivables; Gold Ornaments & Bullion; Immovable Property; Third Party Guarantees; Life Insurance Policies
- **Mode of creation of security:**
  - **(i) Mortgage:** It is of two types:
    - **Registered:** Created by Registered instrument *i.e.*, mortgage deed.
    - **Equitable:** Created by mere delivery of title deeds.
  - **(ii) Pledge:** Bailment or delivery of goods by borrower to the lending bank. Charge on goods is created as security. Legal ownership remains with the pledger.
  - **(iii) Hypothecation:** Equitable charge on movable security in favour of lending bank by execution of hypothecation agreement. Ownership/possession is not transferred. Borrower holds physical possession of the goods as an agent/trustee of the bank.
  - **(iv) Assignment:** Transfer of an existing/future debt, right or property belonging to person infavour of another person. Only actionable claims (book debts & life insurance policies) areaccepted by banks as security.
  - **(v) Set off:** Statutory right of adjustment to set off/adjust two accounts - deposit account &loan account, provided both accounts are in the same name and same right.
  - **(vi) Lien:** Legal charge with consent of owner, which gives lender a legal right to seize anddispose /liquidate the asset under lien.
- **Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances:**
  - Provision to advances as per prudential norms:

Asset Classification	Period of NPA	Provisioning %	
		Secured	Unsecured
Sub Standard	Up to 12 months	15	15
Doubtful	Up to 1 Year	25	100
	1-3 Years	40	100
	More than 3 years	100	100
Loss Assets	Classification date onward	100	

  - **Non-Performing Assets (NPA):** Asset ceases to generate income for bank. NPA in case of: (1) **Term Loan**: Instalment (Principal or Interest) overdue > 90 days; (2) **Bill Discounted**: Bill overdue > 90 days; (3) **CC/OD**: "Out of Order".
  - **Overdue:** If it is not paid on the due date fixed by bank.
  - **Out Of Order:** Outstanding balance remains continuously in excess of sanctioned limit/drawing power for 90 days or Outstanding balance is within sanctioned limited/ Drawing power but there is no credit continuously for 90 days as on Balance Sheet date or Credit are there but not enough to cover interest debited during the same period.

    Notes:
    - Asset classification would be borrower-wise and not facility-wise.
    - **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.
  - **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.
  - **Government Guaranteed Advances:** Central government guaranteed advances not to be classified as NPA. However, for income recognition purpose, it is considered NPA.

- **Advances Under Consortium:** Loans to borrower by two or more Banks jointly. Bank with a higher share will lead the consortium. Remittances by borrower are pooled with one bank and/or where bank receiving remittances is not parting with share of other member banks, account should be treated as an NPA.

➢ **ACCOUNTS WHERE THERE IS EROSION IN THE VALUE OF SECURITY/FRAUDS COMMITTED BY BORROWERS:**

- If realisable value of the security is less than 50 per cent of the value assessed, classified under **Doubtful Category.**
- If the realisable value of the security is less than 10 per cent of the outstanding in the borrowal accounts, classified as **Loss Asset.**

➢ **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.**

➢ **AGRICULTURAL ADVANCES:**

(1) Long Duration Crop Advances: Advances longer than one year. NPA: principal/interest overdue > one crop seasons.

(2) Short Duration Crop Advances which are not 'Long duration'. NPA: principal/interest overdue > two crop seasons.

✍ **COMPUTATION OF DRAWING POWER:** Limit up to which borrower can withdraw.

Other points to be noted are:

(a) **Bank's Duties: Drawing power** is covered by adequate CA & current stock statement. For large borrowers, stock statements not be older than **3 months.** If more than 3 months, it is irregular.

(b) **Auditor's Concern:** Check returns like stock statements, quarterly returns & other statements are as per the borrowers annual audited accounts.

(c) **Computation of Drawing power is done** as per BOD guidelines with auditor. Check deductions of Sundry creditors.

(d) **Stock Audit:** Mandatory for accounts having funded exposure > **5 Crores.** Auditor to check stock, audit report, stock valuation and **Drawing power** computation.

(e) **Formula: [(Stock-creditors)- margin] +[Debtors-margin]**

✍ **AUDIT OF ADVANCES:**

➢ **What to obtain**

- Advances outstanding at BS date.
- Advances amount due.
- Amounts due are appropriately supported by loan & other documents.
- There are no unrecorded advances.
- Valuation of advances is appropriate & properly applied.
- Advances are disclosed, classified & described as per rules & regulations.
- Appropriate provisions made as per RBI norms, AS & GAAP.

➢ **How to obtain:**

- Study & evaluation of internal control;
- Examining validity of recorded amounts;
- Examining loan documentation;
- Reviewing operation of accounts;

- Examining existence, enforceability & valuation of security;
- Checking compliance with RBI norms including appropriate classification & provisioning; and
- Carrying out appropriate analytical procedures.

➢ **Evaluation of Internal Control over Advances to ensure:**
- Advance given after ensuring credit worthiness & obtaining sanction.
- Necessary documents should be executed before advances made.
- Compliance with terms of sanction letter & end use of funds.
- Sufficient margin should be maintained.
- Securities transferred or requiring registration should be registered in the nameof bank.
- DP Register to be updated every month for value of securities hypothecated.
- Accounts should be kept within both Drawing power & Sanctioned limit. If exceeds, inform controlling authority.
- Operation of each advance account to be reviewed once in a year & more frequently for large advances.

AUDIT OF REVENUE ITEMS:

➢ **INCOME**
- **AUDIT APPROACH AND PROCEDURES:**
  - (a) Auditor is primarily concerned about occurrence, completeness, measurement and presentation and disclosure of Income.
  - (b) Any income (gross) > 1% of total income or income (net) > 1% of profit before tax is material. Should be recorded on accrual basis. Rest can be recorded on cash basis.
  - (c) Entries for interest income on advances are automatically generated through a batch process in the CBS system.
  - (d) For bills purchased and outstanding at the end of year, part of receipt comprising discount charges on bills purchased relate to the period beyond the year-end, should be recorded as "Other Liabilities".

- **AUDIT OF REVERSAL OF INCOME:**
  - (a) On becoming NPA, entire interest accrued & credited to income account in past periods, should be reversed/provided for.
  - (b) Any uncollected fees should also be reversed.
  - (c) Wrongly recognised income in past should be reversed or provided if recognised as income in current year.
  - (d) Enquire for any large debits in Interest Income account.
  - (e) Enquire for any communications from borrowers for differences in interest charged & whether appropriate action has been taken.

- **Expenses Audit of Interest Expense:**
  - (a) Assess reasonableness of interest expense;
  - (b) Obtain analysis of various types of deposits outstanding at each quarter end.
  - (c) Compute weighted average interest rate from it & compare with actual average rate of interest paid & enquire difference.
  - (d) Compare average rate of interest paid with previous years rate & analyse material differences.
  - (e) Analyse month on month (or quarter on quarter) cost & document reasons for the variances.
  - (f) Check interest expense cost agrees with general ledger.
  - (g) Obtain interest card & check for any changes in interest rates.

(h) Re-compute interest on borrowings & reconcile with books of accounts.

(h) Re-compute interest on borrowings & reconcile with books of accounts.

(i) On a test check basis, verify calculation of interest: Interest for deposits provided; Interest rates, interest on savings accounts & interest on inter-branch balances are in accordance with bank's internal regulations, the RBI directives & agreements.

- **Audit of Provision:** Obtain understanding as how bank compute provision on standard & non-performing asset; obtain tax provision computation from bank's management & verify nature of items debited & credited to P&L to ascertain that same is appropriately considered in tax provision computation; other provisions for expenses should be examined *vis-à-vis* circumstances warranting provisioning & adequacy of the same.
- **Audit of Operating Expense:** Study & evaluate internal control system - authorization procedures- to determine the nature, extent and timing of audit procedures.
  - Check any divergent trends.
  - Perform substantive analytical procedures.
  - Check reasonableness of expenses by doing ratio analysis, comparison with previous year.
  - Check supporting documents and check the calculations.

Question Solver Points:

1. RBI has been entrusted with the responsibility of regulating the activities of commercial and other banks and NBFC's. **(PP Book C/I-Q.1)**
2. In the computerized environment, it is imperative that the auditor is familiar with and is satisfied that all the norms/parameters as per the latest applicable RBI guidelines are incorporated and built into the system that generates information/data having a bearing on the classification/provisions and income recognition. **(PP Book C/I-Q.2)**
3. 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 . Collateral security is additional security required. **(PP Book C/I-Q.4)**
4. A registered mortgage can be affected by a registered instrument called the 'mortgage deed'. Equitable mortgage, on the other hand, is affected by mere delivery of title deeds or other documents of title with intent to create security thereof. **(PP Book C/I-Q.5)**
5. An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'. **(PP Book C/I-Q.12)**
6. Income from non-performing assets (NPA) is not recognized on an accrual basis due to its uncertainty but is booked as income only when it is actually received. **(PP Book C/I-Q.8)**
7. Classification of 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 the purpose of treating an advance as NPA or otherwise. Asset classification would be borrower-wise and not facility-wise. All facilities, including investments in securities, would be termed as NPA. **(PP Book C/I-Q.10)**
8. 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. **(PP Book C/I-Q.11)**
9. A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest there on remains overdue for two crop seasons. 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. **(PP Book C/I-Q.15)**
10. Central Government guaranteed Advances, where the guarantee is not invoked or repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose. **(PP Book C/I-Q.18)**

PERFECT REVISION QUESTIONS

Q. No.	Questions and Answers
1.	**What are the general requirements for an effective Risk Management System in Banks?**
Ans.	**An effective Risk Management System should include 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 the bank's goals should be identified, measured and monitored against pre-approved limits and criteria.
	(c) Control activities: A bank should have appropriate controls to mitigate its risks, including effective segregation of duties (particularly between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting up limits, reporting and approval of exceptions, physical security and contingency planning.
	(d) Monitoring activities: Risk management models, methodologies and assumptions used to measure and mitigate risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.
	(e) Reliable information systems: Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.
2.	**Explain the audit approach you would follow to check the Operating Expenses of a Bank?**
Ans.	**Auditing the Operating Expenses of a Bank:**
	(a) Internal Controls: 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.
	(b) Divergent Trends: The auditor should examine whether there are any divergent trends in respect of major items of expenses.
	(c) Substantive Analytical Procedures: The auditor should perform substantive analytical procedures in respect of these expenses. *For example*, assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.
	(d) Vouching & Verification: The auditor should also verify expenses with reference to supporting documents and check the calculations wherever required.
3.	**"The engagement team should hold discussions to gain a better understanding of the bank and its environment, including internal control, and also assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference". Explain.**

Ans. The engagement team should hold discussions to gain a better understanding of the bank

Ans.	The engagement team should hold discussions to gain a better understanding of the bank and its environment, including internal control, and also assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference. The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's branch financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit. **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)** The 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 indicate that a material misstatement may have occurred (*e.g.*, the bank's application of accounting policies in the given facts and circumstances).
4.	**Write *a* short note on the reversal of income under bank audit.**
Ans.	**(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 the income account in the past periods should be reversed or provided for if the same is not realized. 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, the case of banks which have wrongly recognized income in the past should reverse the interest if it was recognized as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous years. **(d)** Further more, 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 an interest charge and whether appropriate action has been taken in this regard.
5.	**Advances generally constitute the major part of the assets of the bank. There is a large number of borrowers to whom a variety of advances are granted. The audit of advances requires major attention from the auditors. Explain.**
Ans.	Advances generally constitute the major part of the assets of the bank. There is a large number of borrowers to whom a variety of advances are granted. The audit of advances requires major attention from the auditors. **In carrying out the audit of advances, the auditor is primarily concerned with obtaining evidence about the following:** • Amounts included in the Balance Sheet in respect of advances that are outstanding at the date of the Balance Sheet. • Advances represent the amount due to the bank.

	• Amounts due to the bank are appropriately supported by loan documents and other documents as applicable to the nature of advances. • There are no unrecorded advances. • The stated basis of valuation of advances is appropriate and properly applied, and the recoverability of advances is recognized in their valuation. • The advances are disclosed, classified and described in accordance with recognized accounting policies and practices and relevant statutory and regulatory requirements. • Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.
6.	**The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. Explain this statement.**
Ans.	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 the following:** **(a)** 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. **(b)** All the necessary documents (*for example*, agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made. **(c)** Compliance with the terms of sanction and end-use of funds should be ensured. **(d)** 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. **(e)** If the securities that are 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 the documentation. **(f)** All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give the title to the bank. **(g)** In the case of goods in possession of the bank, the 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. **(h)** Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer. **(i)** The accounts should be kept within both the drawing power and the sanctioned limit. **(j)** 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. **(k)** 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.

7. **Depending on the nature of the item concerned, the creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien. Explain with specific reference to Audit of Banks.**

Ans. **(a) Mortgage:** Mortgage are of several kinds, but the most important is 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 security.
- **Equitable mortgage,** on the other hand, is affected by mere delivery of title deeds or other documents of title with the intent to create security thereof.

(b) Pledge: A pledge 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.

(c) Hypothecation: The hypothecation is the creation of an equitable charge (*i.e.,* a charge created not by an express enactment but by equity and reason), which is created in favour of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.

(d) Assignment: Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favour of another person. Only actionable claims (*i.e.,* claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.

(e) 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).

(f) Lien: Lien is the creation of a legal charge with the consent of the owner, which gives the lender a legal right to seize and dispose of or liquidate the asset under lien.

8. **The auditor can obtain sufficient appropriate audit evidence about advances by studying and evaluating internal controls relating to advances. Explain in the context of Audit of Banks.**

Ans. The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

(a) Examining the validity of the recorded amounts.
(b) Examining loan documentation.
(c) Reviewing the operation of the accounts;
(d) Examining the existence, enforceability and valuation of the security;
(e) Checking compliance with RBI norms, including appropriate classification and provisioning; and
(f) Carrying out appropriate analytical procedures.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to

be problem accounts, however, need to be examined in detail unless the amount involved

	be problem accounts, however, need to be examined in detail unless the amount involved is insignificant. Advances that are sanctioned during the year or which are adversely commented on by the RBI inspection team, concurrent auditors, bank's internal inspection, etc., should generally be included in the auditor's review.
9. Ans.	**Explain "Advances under Consortium" in the context of Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.** **Consortium advances** should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA. The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get express consent from the lead bank for the transfer of their share of the recovery, to ensure proper asset classification in their respective books.
10. Ans..	**The Cash Credit Facility by XYZ Bank Ltd. to N Ltd. is ₹1 crore. The drawing power as per the Stock Statements furnished for the last quarter is ₹80 Lakhs, but the outstanding balance in the account is ₹75 Lakhs. Also, the interest charged to the account is ₹3.5 Lakhs and the total credit into the account for the quarter is ₹2.5 Lakhs. As an Auditor, how will you report this account in your report?** **Out of order:** An account shall be treated as 'out of order' if: **(a)** The outstanding balance remains continuously in excess of the sanctioned limit/drawing power; or **(b)** 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 the Balance Sheet; or **(c)** Credits are there but are not enough to cover the interest debited during the same period. **Facts of the case:** The Cash Credit Facility by XYZ Bank Ltd. to N Ltd. is ₹1 crore. The drawing power as per the Stock Statements furnished for the last quarter is ₹80 Lakhs, but the outstanding balance in the account is ₹75 Lakhs. Also, the interest charged to the account is ₹3.5 Lakhs and the total credit into the account for the quarter is ₹2.5 Lakhs. **Conclusion:** In the present case, the drawing power of N Ltd. is ₹80 Lakhs, although the outstanding balance in the account is ₹75 Lakhs; still, the account would be reported as out of order because credits in the account are not sufficient to cover the interest debited during the same period.
11. Ans.	**Discuss outline of audit approach including audit procedures while auditing "provisions and contingencies" in financial statements of a bank.** **For audit of Provisions and Contingencies the auditor should:** **(a)** Ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled. **(b)** 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. **(c)** Obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger. **(d)** 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. **(e)** Examine the other provision 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.

CHAPTER 11-ETHICS AND TERMS OF AUDIT ENGAGEMENT

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.
- Ethics is the science of morals in human conduct.

PRINCIPLES BASED APPROACH VS. RULES BASED APPROACH TO ETHICS (ETHICAL OR LEGAL)

Principles-based approach to ethics requires compliance with spirit of ethics. Accountants should use professional judgment to evaluate situation and come to conclusion. ***Rules-based approach*** to ethics strictly follows clearly established rules.

FUNDAMENTAL PRINCIPLES OF PROFESSIONAL ETHICS

- **INTEGRITY:** Auditor should be straight forward and honest. He should not be associated with any report, return or communication which contains any materially false statement.
- **OBJECTIVITY:** Auditor should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.
- **PROFESSIONAL COMPETENCE AND DUE CARE:** Perform professional services with due care, competence and diligence and has duty to maintain professional knowledge and skill.
- **CONFIDENTIALITY:** Respect the confidentiality of information acquired during the course of audit and should not use or disclose any such information.
- **PROFESSIONAL BEHAVIOUR:** Refrain from any conduct which might bring discredit to the profession.

INDEPENDENCE OF AUDITOR - The judgement of a person shall not be based on the wishes or direction of another person.

Definition includes:

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.
Independence in Appearance	The avoidance of facts and circumstances that are appearable to third parties and would help them conclude that the honesty, objectivity or professional skepticism had been compromised.

THREATS TO INDEPENDENCE

- **Self-Interest Threats**: Firm or Partner benefit from Financial Interest in client. May not work objectively for the fear of losing client.
- **Self-Review Threats**: Either auditor had been a director/senior officer of the client or judgement reached in a previous audit or non-audit engagement.
- **Advocacy Threat:** Auditor promotes the company, like becoming the client's advocate inlitigation and third-party disputes, where his objectivity is getting compromised.
- **Intimidation Threats**: Auditor is deterred from acting objectively by threats.
- **Familiarity Threats:** Auditors form relationships with client ending up being too sympathetic to the client's interests like close relative of audit team working in a senior position in the client's company.

SAFEGUARDS TO INDEPENDENCE

- 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.
- If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

PROFESSIONAL SKEPTICISM

It refers to an attitude that includes questioning mind & being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
It includes remain alert for condition indicating possible misstatement including: **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.**

SA: 210 AGREEING THE TERMS OF AUDIT ENGAGEMENTS

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 of the terms of the audit engagement.

A. Preconditions for an audit

The auditor shall:

(i) Determine whether Financial reporting framework is acceptable.
(ii) Obtain agreement of management that it acknowledges & understands its responsibility:

- For **preparation of financial statements** as per applicable **Financial reporting framework.**
- For **internal control** as management consider necessary.
- To provide auditor with:
  - **Access to all information** such as records, documents, etc.
  - **Additional information** that auditor may require.
  - **Unrestricted access** to any person within entity.

B. Agreement on Audit Engagement Terms

Engagement Letter (EL) Contents:

- Objective and scope of audit.
- Responsibility of auditor & management.
- Identify applicable Financial reporting framework.
- Form and content of audit report.
- Engagement letter must be in writing and signed by appropriate authority- specifying the scope of work properly.
- It should be sent by auditor to client not by client to auditor.

LIMITATION ON SCOPE PRIOR TO AUDIT ENGAGEMENT ACCEPTANCE

If management or those charged with governance **impose limitation** on scope in proposed term and auditor believes that it will **result in disclaiming the opinion**, he **shall not accept** such engagement unless required by law.

CHANGE IN TERMS AFTER ACCEPTANCE OF AUDIT

✍ CHANGE IN TERMS AFTER ACCEPTANCE OF AUDIT

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.

Request justified and audit work complied with SA: Agree & record new terms, issue new engagement letter and issue report for the revised engagement. Do not include any reference of original audit engagement or work performed in original audit engagement.

Request not justified: If management does not allow auditor to work on old terms and auditor is not able to agree change of terms then:

- Withdraw from engagement.
- Determine any obligation by contractual or otherwise, to report to those charged with. governance, management or other parties.

✍ RECURRING AUDIT- WHERE THE CURRENT AUDITOR HAS ALSO DONE AUDIT OF PREVIOUS YEAR

No new engagement letter to be issued every year. In following situation, engagement letter should be issued:

- Change in law or regulation.
- Change in Financial reporting framework adopted in preparation of financial statements.
- Significant change in nature or size of entity's business.
- Significant change in ownership.
- Change in senior management of entity.
- Entity misunderstands objective and scope of audit.
- Revised or special term of engagement.
- Change in other reporting requirement (Example: CARO).

✍ SQC 1, "Quality Control For Firms That Perform Audits And Reviews Of Historical Financial Information, And Other Assurance And Related Services Engagements"

and

Sa 220- "Quality Control For An Audit Of Financial Statements"

Elements of a system of Quality Control	SQC 1	SA 220
1. Leadership responsibilities for quality within the firm.	Establish policies and procedures designed to promote culture that quality is essential in performing engagements. Firm's chief executive officer or the firm's managing partners should take responsibility for the firm's system of quality control.	The engagement partner should highlight the crucial nature of quality in audit engagements and emphasize on: • Adherence to professional standards, regulatory and legal requirements. • Compliance with the firm's quality control policies. • Issuance of auditor's reports suitable for the circumstances. • The engagement team's ability to raise concerns without fear of reprisals.
2. Ethical requirements.	Establish policies and procedures should enable the firm to	Responsibilities of Engagement partner are identifying threat to

	communicate its independence	independence and reporting by

	communicate its independence requirements to its personnel and identify threats to independence, and to take appropriate action to eliminate those threats.	independence and reporting by partner to relevant person and taking action.
3. Acceptance and continuance of client relationships and specific engagements.	**Check following in determining acceptance of audit engagements:** • The **integrity** of the **principal owners, key management and those charged with governance** of the entity; • Competency, capability, time and resources; • **Compliance with relevant ethical requirements.** With regard to the integrity of a client, matters that the firm considers the identity and business reputation of the client's principal owners, key management, attitude of above people, the nature of the client's operations, indications of an inappropriate limitation in the scope of work.	
4. Human Resources	Policies and procedures to ensure sufficient personnel with capability and competence should address issues like recruitment, compensation, training, career development, performance evaluation etc.	The engagement partner must verify that the entire team, including external experts, has the necessary competence to meet professional, regulatory, and legal standards, ensuring the quality and compliance of the audit process.
5. Engagement Performance	Consistency in engagement quality is maintained through clear team briefings on objectives, adherence to standards, supervision, and training. Significant judgments undergo objective review by an engagement quality control reviewer, mandatory for listed entities' audits. Resolving differences of opinion among the reviewer, partner, and team is crucial before issuing the audit report.	The engagement partner directs and supervises audits, ensuring adherence to professional standards. In listed entity audits or engagements needing a quality control review, the partner must appoint a reviewer, discuss key matters, and withhold dating the auditor's report until the review is complete.
6. 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.	Effective quality control involves monitoring to ensure policies are relevant and operational. The engagement partner must document: **(a)** Resolved ethical compliance issues, **(b)** Independence conclusions, **(c)** Client relationship and audit acceptance decisions, and **(d)** Details of consultations conducted.

Question Solver Points:

1. Fundamental principles of professional ethics include integrity, objectivity, professional

Question Solver Points:

1. Fundamental principles of professional ethics include integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. **(PP Book-Q.6)**
2. The auditor should maintain the confidentiality of the client's financial information and should not disclose it to other persons. However, the auditor can disclose the information to other persons if permitted by his client or required by law or court. **(PP Book- C/I-Q.2)**
3. 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.
4. There are two inter-linked perspectives of independence of auditors; *one*, independence of mind and *two*, independence in appearance. **(PP Book Q.3)**
5. Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.
6. Threats to independence of auditors include self-interest threats, self-review threats, advocacy threats, familiarity threats and intimidation threats. **(PP Book Q.2)**
7. 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.
8. 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.
9. SA 210 deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management.
10. Preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.
11. The agreed terms of the audit engagement shall be recorded in an audit *engagement letter* or other suitable form of written agreement.
12. If law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in the written agreement, except for the fact that such law or regulation applies and that the management acknowledges and understands its possibilities. **(PP Book-C/I-Q.3)**
13. The audit engagement letter is sent by the auditor to his client. It is in the interest of both the auditor and the client to issue an engagement letter sothat the possibility of misunderstanding is reduced to a great extent. **(PP Book-C/I-Q.3)**
14. The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so.
15. 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 withdraw from the audit engagement.
16. 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, and on the other hand SA 220 applies to audit engagements only. SQC 1 applies to entire firm. However, SA 220 applies to a particular audit engagement.
17. 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.

PERFECT REVISION QUESTIONS

Q. No.	Questions and Answers
1.	**"An auditor who before the completion of the engagement is requested to change the engagement to one which provides a lower-level of assurance should consider the appropriateness of doing so." Discuss.**
Ans.	The management can request the auditor to change the engagements. The change shall occur before the completion of the engagement. **The management can request changes due to the following:** **(a)** a change in circumstances, or **(b)** a misunderstanding as to the nature of the audit, or related services, or **(c)** a restriction on the scope of the management. The auditor shall check the justifications for the change in engagements. If the changes in the engagement are justified, then the auditor shall obtain the revised engagement letter. If, after the change, the work is done in compliance with the standards on auditing, then the auditor shall issue a report which would not give any reference to the previous scope or procedures. If, after the change, the work is not done in compliance with the standards on auditing, then the auditor shall give effect in the audit report about the non-compliance of the SA. If the changes in the engagement are not justified, then the auditor may ask the management to work on the original terms. If the management agrees to work on the original terms, the work shall be continued in the manner as earlier it was. If the management disagrees with working on the original terms, then the auditor shall withdraw from the engagement, if possible under applicable law or regulation and communicate or inform to appropriate person including regulators, management, those charged with governance etc.
2.	**"The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants, identifies *five types* of threats". Explain.**
Ans.	**(a) Self-Interest Threats:** They occur when an auditing firm, its partner, or its associate could benefit from a financial interest in an audit firm. *For example*, direct financial interest or a significant indirect financial interest in a client. **(b) Self-Review Threats:** They occur when an auditor had been a director or senior officer of the company and the audit is the subject matter to the auditor themselves due to the conclusions or judgements reached in the previous audit or non-audit engagements. **(c) Advocacy Threats:** They occur when an auditor promotes a client's opinion to a point where people may believe that the objectivity is getting compromised. *For example*, an auditor dealing with shares and securities of the audited company. **(d) Familiarity Threats:** They occur when an auditor is related to the client and becomes too sympathetic to the client's interests. *For example*, a close relative of an auditor is the senior officer in the audited company. **(e) Intimidation Threats:** They occur when an auditor is stopped or deterred from acting objectively with a sufficient degree of professional skepticism.
3.	**"Independence of mind and independence in appearance are interlinked perspectives of independence of auditors." Explain.**
Ans.	Independence generally means objectivity and integrity of the auditor. Professional integrity and independence are the essential characteristics of all professions. The judgement of a person shall not be based on the wishes or direction of another person. **The Code of Ethics for Professional Accountants issued by the International Federation of Accountants (IFAC) defines independence as the following:** **(a) Independence of Mind:** The state of mind that is free to express an opinion without being affected by the influences of any individual.

	(b) Independence in Appearance: The avoidance of facts and circumstances that are appearable to third parties and would help them conclude that the honesty, objectivity or professional skepticism had been compromised.

	(b) Independence in Appearance: The avoidance of facts and circumstances that are appearable to third parties and would help them conclude that the honesty, objectivity or professional skepticism had been compromised. The auditor shall be independent of mind as well as in appearance also. If auditor is independent in mind but not in appearance he cannot be said to be independent.
4.	**The auditor shall plan and perform an audit with professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated. Discuss examples of professional skepticism.**
Ans.	**The following are the examples that professional skepticism being alert to:** **(a)** Audit evidence that contradicts other audit evidence obtained. **(b)** Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. **(c)** Conditions that may indicate possible fraud. **(d)** Circumstances suggest the need for audit procedures in addition to those required by the SAs. **Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risk of:** **(a)** Overlooking unusual circumstances. **(b)** Over generalising when drawing conclusions from audit observations. **(c)** Using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.
5.	**The firm should establish policies and procedures designs to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements. Explain in the above context, the documentation to be maintained by the auditor of monitoring compliance with quality control policies and procedures.**
Ans.	**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.
6.	**As per SA 220, "Quality Control for an Audit of Financial Statements", the auditor should obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement and when considering acceptance of a new engagement with an existing client. Explain.**
Ans.	**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.

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

With regard to the integrity of a client, matters that the firm considers include, for example:

(a) The identity and business reputation of the client's principal owners, key management, related parties and those charged with governance.

(b) The nature of the client's operations, including its business practices.

(c) 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.

(d) Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.

(e) Indications of an inappropriate limitation in the scope of work.

(f) Indications that the client might be involved in money laundering or other criminal activities.

(g) The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

7. **Briefly outline how principles-based approach differs from rules-based approach to ethics.**

Ans. **Principles Based Approach *Vs.* Rules Based Approach to Ethics**

Ethical guidance may follow principles-based approach or rules-based approach. The essence of principles-based approach to ethics is that it requires compliance with spirit of ethics. It requires accounts to exercise professional judgement in every situation based upon their professional knowledge, skill and expertise. It requires that accountants should use professional judgment to evaluate every situation to arrive at conclusions.

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 right 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.

8. **How does SQC 1 ensure that independence in engagements is not breached by an audit firm?**

Ans. As per SQC 1, 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. Leadership responsibilities for quality within the firm.

The Code establishes the fundamental principles of professional ethics which include integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel (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.

	Firm should have a mechanism by which engagement partners provide the firm with relevant information about client engagements and personnel of firm promptly notify firm of circumstances and relationships that create a threat to independence. All breaches of independence should be promptly notified to firm for appropriate action. At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent in terms of the requirements of the Code.

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