

What's Financial Audit?

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

Objectives of auditor as per **SA-200** "Overall Objectives of Independent Auditor and Conduct of Audit in accordance with Standards on Auditing" are:

In conducting an audit of F.S., overall objectives of the auditor are:

- (a) To **obtain Reasonable Assurance** about whether F.S. as a whole
- are **free from material misstatement**, whether due to fraud or error,
 - enabling auditor to express an **opinion**
 - on whether **F.S. are prepared**, in all *material respects*,
 - as per **applicable FRF** and
- (b) To **report on FS** and **communicate** as per SAs, as per auditor's findings.

Reasonable Assurance

- In context of audit of F.S, a **HIGH, but not absolute**, level of assurance.
- To obtain **reasonable assurance** → auditor shall **obtain SAAE** to **reduce audit risk to an acceptably low level** and draw reasonable **conclusions** on which to base auditor's **opinion**.

Financial statements(F.S.)

Structured representation of

- **historical financial info.**, including related **notes**, to communicate
- entity's **economic resources or obligations** at a **point in time** or
- **changes** therein for a **period of time** as per FRF.

"Historical financial info" means info. expressed in **financial terms**

- of particular entity,
- derived from **entity's accounting system**,
- about **economic events** occurring in past time periods or
- about **economic conditions or circumstances** at points in time in the past.

Applicable financial reporting framework (FRF) - FRF **adopted** by mgt and, where appropriate, TCWG in preparation and presentation of F.S. that's **acceptable** in view of nature of entity and objective of F.S., or is required by law or regulation.

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Misstatement

Difference

- b/w amount, classification, presentation, or disclosure (A/C/P/D) of reported F.S. item &
- A/C/P/D required as per applicable FRF. **Can arise from error /fraud.**

Those charged with governance (TCWG) - Person(s) or organisation(s) (e.g., a corporate trustee) with responsibility for **overseeing the strategic direction** of entity and obligations related to the **accountability** of entity. (Executive Members-CEO/CFO/MD)

Audit- Mandatory OR Voluntary?

- Not mandatory for all.
- **Companies compulsorily** required to get accounts audited under law.
- Non-corporate entities **may get audit** of accounts **under tax laws**. For eg, in India, accounts audited if t/o crosses threshold limit under income tax law.
- Some entities like schools may be required to get their accounts audited for purpose of obtaining grant or assistance from Govt. Audit is **not always mandatory**.
- Many entities may get accounts audited voluntarily because of benefits from audit.

Who appoints Auditor?

Auditor is appointed by **owners or in some cases by constitutional or govt authorities** as per applicable laws and regulations.

For eg,

- ✓ Companies → Appointed by members (shareholders) in AGM.
- ✓ Govt companies → Comptroller and Auditor General of India (CAG),
- ✓ Firm → partners of firm.

To whom Report is Submitted by Auditor?

Report is submitted to **person making the appointment**.

- Companies → shareholders
- Firm → partners

Benefits of Audit-Why audit is needed?

- Point out deficiencies: Audit **reviews** existence and operations of various **controls** operating in entity. Hence, it's useful at pointing out deficiencies.
- Detection: Audit may also detect **fraud or error** or both.
- Moral Check on Employees: Audit acts as moral check on employees **from committing frauds** for fear of being discovered by audit.

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- High Quality: Audited accounts provide **high quality information**. Gives **confidence to users** that info on which they are relying is qualitative & outcome of exercise carried out by following Auditing Standards.
- Safeguarding Shareholder's Interest: In case of companies, shareholders may/may not be involved in the daily affairs. FS are prepared by mgt consisting of directors. As shareholders are owners of Co, they **need an independent mechanism** so that financial info is qualitative and reliable. Hence, their interest is safeguarded by audit.
- Help to Govt: Audited FS are helpful to govt authorities for **determining tax liabilities**.
- Creditors/lenders: Audited FS can be relied upon by lenders, bankers for **making their credit decisions** i.e. whether to lend or not to lend to a particular entity.

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How Auditor ensures F.S. don't mislead anybody?

This he can do honestly by satisfying himself that: [MTP-Oct'21]

- accounts have been drawn up with **reference to entries in books of a/c**
- entries** in books of a/c are adequately **supported by sufficient and appropriate evidence**
- none of the entries** in books of a/c has been **omitted** in process of compilation and nothing which is not in books of a/c has found place in the statements
- information** conveyed by the statements is **clear and unambiguous**
- F.S amounts are properly classified, described and disclosed **in conformity with a/c std**
- statement of a/c present **true and fair picture** of operational results & assets & liabilities

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Note: Auditing provides assurance. Providing confidence to users of FS. Lends credibility to FS. Confidence to users that financial info. reflected in FS can be relied upon.

Inherent Limitations of Audit [ILA]

Auditor is not expected to, and **can't, reduce audit risk to zero** and cannot therefore obtain absolute assurance that F.S. are free from M.M. due to fraud or error.

This is because there are ILA.

The inherent limitations of an audit arise from:

(i) Nature of Financial Reporting:

- ✓ Preparation of F.S. involves **judgment by mgt.**
- ✓ These judgments may involve **subjective decisions** or a degree of **uncertainty.**
- ✓ **Internal Controls** may not operate to provide reliable financial info. due to their own limitations.

(ii) The Nature of Audit Procedures: [RTP Nov-21/22]

There are practical and legal limitations on auditor's ability to obtain audit evidence. For eg:

Auditor **doesn't test all** transactions and balances. He forms his opinion only by testing samples. It's an eg. of practical limitation on auditor's ability to obtain audit evidence.

Mgt may not provide complete info. as requested by auditor. No way by which auditor can force mgt to provide complete info. as may be requested by auditor. In case he isn't provided with info, he **can only report.** It is eg of **legal limitation** on auditor's ability to obtain audit evidence.

Mgt may consist of **dishonest and unscrupulous people** and may be involved in **fraud.** It may be engaged in **concealing fraud** by designing **sophisticated and carefully organized schemes** hard to detect by auditor.

Examples:

- ⇒ It may produce **fabricated documents** to make him believe that audit evidence is valid. However, in reality, fake or non-genuine.
- ⇒ Entity may enter into **transactions with related parties.** Such transactions may be **only paper transactions & not actually** occurred. Auditor may not be aware of such related party relationships or audit procedures may be unable to detect probable wrong doings in such transactions.

(iii) Not in nature of investigation.

- ✓ Audit is **not official investigation into alleged wrong doing.**
- ✓ He **doesn't have specific legal powers** of search or recording statements of witness on oath which may be necessary for carrying out official investigation.
- ✓ Audit is **distinct** from investigation.
- ✓ **Investigation** is a **critical examination** of accounts with a **special purpose.** For eg, if fraud is suspected and it's specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.

- ✓ **Objective of audit**, on other hand, is to **obtain reasonable assurance** about whether FS as whole are free from material misstatement, whether due to fraud/error, enabling auditor to express an opinion.

(iv) **Timeliness of Financial Reporting and Balance between Benefit and Cost:**

Relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between reliability of information and its cost.

Eg. Auditor conducting audit of since last 2 years. During these 2 years, he has sought detailed info. from mgt regarding various matters. During 3rd year, he chooses to rely upon some info. obtained in 2nd year audit. It could be possible that something new has happened and that info. isn't relevant. So, information being relied upon by auditor is not timely and may have lost its reliability.

(v) **Future events**

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

Therefore auditor **can't provide guarantee** that FS are free from MM due to frauds/errors

Whether auditor has performed an audit as per SAs is determined by

- **audit procedures** performed in the circumstances,
- sufficiency & appropriateness of **audit evidence** obtained and
- **suitability of audit report** based on evaluation of evidence in light of overall objectives of auditor.

Professional Skepticism [RTP Nov-22]

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
- **critical assessment** of audit evidence.

Auditor shall plan & perform audit with professional skepticism recognising that circumstances may exist that cause FS to be materially misstated.

Professional skepticism includes being alert to, for example:

- Audit evidence that **contradicts** other audit evidence obtained.
- Info. that brings into **question reliability of documents** & responses to inquiries to be used as audit evidence.

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- Conditions that may indicate **possible fraud**.
- Circumstances that suggest **need for audit procedures in addition** to those required by SAs.

Maintaining professional skepticism throughout audit for auditor to reduce risks of:

- **Overlooking** unusual circumstances.
- **Over-generalising** when drawing conclusions from audit observations.
- **Using Inappropriate assumptions** in determining nature, timing, and extent of audit procedures and evaluating the results thereof.

Notes:

- ✓ It also includes **consideration of sufficiency and appropriateness of audit evidence** obtained in light of circumstances, for eg in case **where fraud risk factors exist** and a **single document**, of a nature **susceptible to fraud**, is sole supporting evidence for a material F.S. amount.
- ✓ Auditor may accept records and documents as **genuine unless reason** to believe contrary.
- ✓ Auditor is required to **consider reliability of information** to be used as audit evidence.
- ✓ In cases of doubt or indications of possible fraud, SAs require auditor to **investigate further** & determine **modifications or additions** to audit procedures are necessary to resolve the matter.
- ✓ Auditor **can't disregard past experience** of honesty and integrity of entity's mgt and TCWG.
- ✓ Nevertheless, a belief that mgt and TCWG are honest and have integrity **doesn't relieve auditor of need to maintain professional skepticism**.

What's an Engagement?

An arrangement to do something.

Auditing → Formal agreement b/w auditor & client under which auditor agrees to provide auditing services. It takes the shape of engagement letter [SA 210]

Assurance Engagement

Engagement in which

- practitioner expresses a **conclusion**
- to enhance degree of **confidence**
- of **intended users** other than responsible party
- about **outcome** of **evaluation** or measurement of
- a **subject matter against criteria**.

Practitioner **gives opinion** about specific info due to which users are able to make **confident decisions** that chance of info. being incorrect is diminished.

Parties
3 party relationship involving a **practitioner**, a **responsible party**, and **intended users**

1. Practitioner is a person **who provides the assurance**. Term practitioner is **broader than auditor**. Audit is related to historical info. whereas practitioner may provide assurance **not necessarily related to historical financial info**.
2. Responsible party is the party responsible for **preparation of subject matter**.
3. Intended users are persons **for whom assurance report is prepared**. These persons may use report in making decisions.

Subject matter

It refers to **info. to be examined by practitioner**. For eg, financial info. contained in FS while conducting audit of FS.

Suitable criteria

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

Sufficient appropriate evidence [SAAE]

- ✓ Practitioner performs an assurance engagement to obtain SAAE.
- ✓ It is on basis of evidence that conclusions are arrived and opinion is formed by auditor.
- ✓ **"Sufficient"** relates to **quantity** of evidence obtained by auditor.
- ✓ **"Appropriate"** relates to **quality** of evidence obtained by auditor. One evidence may be providing more comfort to auditor than other evidence.
- ✓ Evidence should be both sufficient and appropriate.

Written assurance report in appropriate form

Written report is provided **containing conclusion** that conveys assurance about subject matter.

A written assurance report is outcome of an assurance engg.

Audit Vs. Review

- ✓ Audit is a **reasonable assurance** engg.
- ✓ Review is a **limited assurance** engg. It provides **lower level of assurance than audit** i.e. Moderate assurance.
- ✓ Further, review involves **fewer procedures** and gathers **sufficient appropriate evidence** on basis of which **limited conclusions** can be drawn up.
- ✓ However, both "audit" and "review" are related to FS prepared on basis of historical financial info.



Reasonable assurance engagement	Limited assurance engagement
High level of assurance.	Lower level of assurance than reasonable assurance engg.
Elaborate & extensive procedures to obtain SAAE.	Fewer procedures as compared to reasonable assurance engg.
It draws reasonable conclusions on basis of SAAE.	It involves obtaining SAAE to draw limited conclusions.
Eg. of reasonable assurance engg is audit engg.	Eg of limited assurance engg is review engg.

Prospective financial info. means financial info. based on assumptions about events that may occur in future and possible actions by entity. Can be in form of a forecast or projection or combination of both.

- In assurance reports involving PFI, practitioner obtains SAAE to effect that mgt's assumptions on which PFI is based are not unreasonable, PFI is properly prepared on basis of assumptions & it's properly presented and all material assumptions adequately disclosed.
- PFI relates to future events. While evidence may be available to support assumptions on which PFI is based, such evidence is itself generally future-oriented.
- Auditor is not in a position to express an opinion as to whether results shown in PFI will be achieved. Therefore practitioner provides a report assuring that nothing has come to practitioner's attention to suggest that these assumptions don't provide a reasonable basis for projection.
- Hence, such type of assurance engagement provides only a "moderate" level of assurance.

Examples of assurance engagements

Example of assurance engagement	Type of assurance engagement
Audit of FS	Reasonable assurance engg.
Review of FS	Limited assurance engg.
Examination of PFI	Provides assurance regarding reasonability of assumptions forming basis of projections.
Report on controls operating at organisation.	Provides assurance regarding design and operation of controls

Engagement & Quality Control Standards

Following Standards are collectively known as Engagement Standards: -

1. Standards on auditing (SAs) which apply in audit of historical financial info.
2. Standards on review engagements (SREs) which apply in review of historical financial info.
3. Standards on Assurance engagements (SAEs) which apply in assurance engg. other than audits and review of historical financial info.



4. Standards on Related Services (SRSs) which apply in agreed upon procedures to info, compilation engg. and other related service engagements.

Purpose of these standards is to establish high quality standards & guidance in areas of FS audits and other types of assurance services.

Why are Standards needed?

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

Duties in relation to Engagement and Quality Control Standards

- Duty of professional accountants follow the Standards in engagements.
- Situation may arise when specific procedure required in Standards would be ineffective.
- In such case, document how alternative procedures performed to achieve required purpose.
- Also, reason for departure to be documented unless it's clear.
- Further, report should draw attention to such departures.
- Mere disclosure in report doesn't absolve professional accountant from complying with applicable Standards.

Interdisciplinary Nature of Audit - Relation with diverse subjects

- Auditing and Accounting: Auditing reviews FS which are nothing but a result of overall accounting process.
- Auditing and Law: Auditor should have a good knowledge of business laws affecting the entity.
- Auditing and Economics: Auditor is expected to be familiar with overall economic environment of client. Auditing and Behavioural Science: Knowledge of human behaviour is essential for auditor to effectively discharge his duties.
- Auditing and Statistics & Mathematics: Also expected to have knowledge of statistical sampling for meaningful conclusions and mathematics for verification of inventories.
- Auditing and Data Processing: EDP auditing in itself is developing as a discipline in itself.
- Auditing and Financial Management : Auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc.
- Auditing and Production: Good auditor is one who understands client and his business functions such as production, cost system, marketing etc.



Qualities of Auditor

- Auditor is concerned with reporting on financial matters of business and other institutions. Financial matters are set with problems of **human fallibility; errors and frauds** are frequent.
- Tact, caution, firmness, good temper, integrity, etc are some qualities which auditor should have.
- In short, all **personal qualities** that make a **good businessman** contribute to making of a **good auditor**.
- In addition, he must have **shine of culture** for attaining a great height.
- He must have highest degree of **integrity** backed by adequate **independence**.
- Auditor, holds a position of **trust**, must have **basic human qualities** apart from technical requirement of professional training and education.
- He **critically reviews FS** and useless for him to attempt that task unless he has **expert knowledge**.
- **Exhaustive knowledge of accounting is must for auditor. Must know all a/c principles and techniques.**

"Harder you work, the BETTER you get"

SA 210: Agreeing the Terms of Audit Engagement

Objective of auditor is to accept or continue an audit engg. **only when basis** upon which it is to be performed has been **agreed**, through:

- A. Establishing whether **preconditions for audit are present** and
- B. Confirming that there is a **common understanding b/w auditor and mgt** and, where appropriate, TCWG of terms of the audit engg.

Preconditions for Audit [RTP May-21]

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

- (a) Determine whether **FRF is acceptable**; and
- (b) Obtain **agreement of mgt** that it acknowledges and understands its responsibility:
 - (i) For **preparation of F.S.** as per applicable **FRF**
 - (ii) For **internal control** as mgt considers necessary and
 - (iii) To **provide auditor** with:
 - ✓ **Access to all information** such as records, documentation and other matters
 - ✓ **Additional information** that auditor may request from mgt for audit &
 - ✓ **Unrestricted access** to persons within entity from whom auditor determines it necessary to obtain audit evidence.

What if Pre-conditions not Present?

If preconditions for audit not present, **discuss the matter with mgt**.

Unless required by L/R, auditor shall **not accept proposed audit engg**: -

- a) If auditor has determined that **FRF** to be applied in preparation of FS is **unacceptable** or
- b) If **agreement of mgt is not obtained** on matters relating to **understanding of responsibility** of preparation of FS, internal controls for preparation of FS, providing access to all info. and unrestricted access to persons within entity.

Contents of Engagement Letter [May-17]

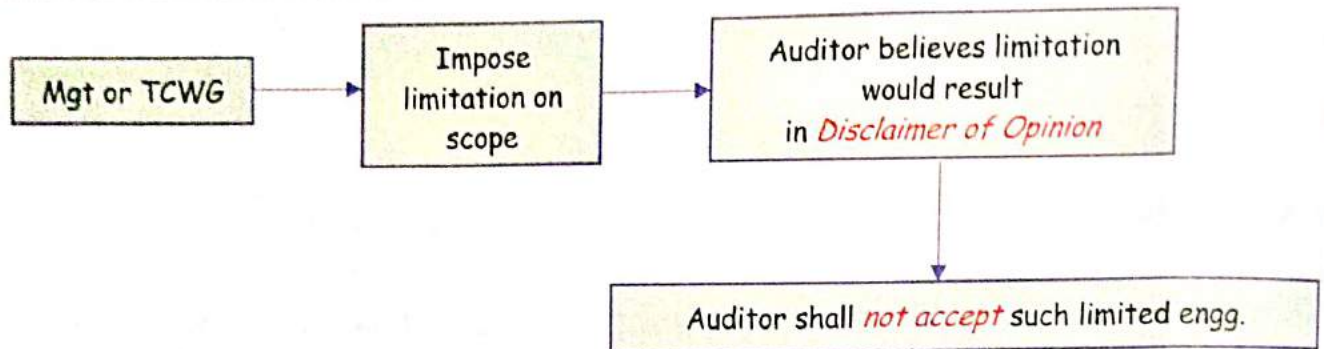
Agreed terms of audit engg shall be recorded in an audit engg. letter or other suitable form of written agreement. EL is **sent by auditor to his client**.

It shall include:

- a) **Objective and scope of audit** of FS
- b) **Responsibilities of the auditor**
- c) **Responsibilities of management**
- d) Identification of **applicable FRF** for preparation of FS and
- e) Reference to **expected form and content of reports to be issued by auditor** & a statement that there may be circumstances in which report may differ from its expected form and content.

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

Limitation on Scope Prior to Audit Engagement Acceptance



Acceptance of Change in Terms of Audit Engg.

Auditor shall not agree to change in terms of audit engg where there's no reasonable justification.

Request from Entity to change Terms of Audit Engg-When Reasonable Justification Exists?

Request from entity for auditor to change terms of audit engg may result from

- ✓ change in circumstances affecting need for service,
- ✓ misunderstanding as to nature of an audit as originally requested or
- ✓ restriction on scope of audit engg, whether imposed by mgt or caused by other circumstances.

Auditor considers justification given, particularly implications of a restriction on scope of audit engg.

Change in circumstances that affect entity's requirements or misunderstanding concerning nature of service originally requested may be considered a reasonable basis for requesting a change in audit engg.

In contrast, a change may not be considered reasonable if it appears that change relates to information that's incorrect, incomplete or otherwise unsatisfactory. An eg. might be where auditor unable to obtain SAAE regarding receivables & entity asks for audit to be changed to review engagement to avoid a qualified opinion or a disclaimer of opinion.

What should auditor consider before agreeing to change audit engg to engg. providing lower level of assurance?

If, prior to completing audit engg, auditor is requested to change audit engg. to an engg. that conveys lower level of assurance, determine whether there is reasonable justification for doing so.

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Before agreeing to change an audit engg. to a review or a related service, auditor who was engaged to perform audit as per SAs may also need to **assess legal or contractual implications of change**.

If auditor **concludes there's reasonable justification** to change audit engg. to a review or a related service, **audit work performed till date of change may be relevant** to changed engagement.

However, **work required to be performed and report** to be issued would be those **appropriate to the revised engg.**

In order to **avoid confusing reader**, report on related service would not include reference to:

(a) **Original audit engg** or

(b) **Any procedures that may have been performed in original audit engg,**

No reference
to original

except where audit engagement is changed to **engg. to undertake agreed-upon procedures** and thus **reference to procedures performed is a normal part of report.**

If terms of audit engg are changed, auditor and mgt shall agree and record new terms of engg. in an engg letter or other suitable form of written agreement.

Recurring Audit Engagements → New Engg Letter? [RTP May-21]

Auditor shall assess whether circumstances require terms of audit engg. to be revised and whether there is a need to remind entity of existing terms of audit engg. Auditor may decide not to send new audit engg letter.

Following factors may make it appropriate to revise terms of audit engg. or remind entity of existing terms:

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

SQC-1 & SA 220 "Quality Control for an Audit of Financial Statements"

Elements of a System of Quality Control

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

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



Leadership Responsibilities for Quality on Audits

Engagement partner (EP) shall take responsibility for overall quality on each audit engg to which that partner is assigned.

Actions of EP and appropriate msgs to other members of engg team, in taking responsibility for overall quality on each audit engagement, emphasise:

- (a) The **importance to audit quality** of:
 - i) Performing work that **complies** with **Professional stds, Regulatory and Legal requirements (PRL)**
 - ii) Complying with **firm's quality control policies and procedures** as applicable
 - iii) Issuing **auditor's reports that are appropriate** in the circumstances and
 - iv) The engagement team's ability to **raise concerns without fear** of reprisals and
- (b) Fact that **quality is essential** in performing audit engg.

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

Ethical Requirements

Fundamental principles of professional ethics

(a) Integrity

- Requires auditor to be **straight forward and honest** in all professional & business relationships.
- Implies **fair dealing and truthfulness**.
- It effectively means that he shall **not be associated with reports, returns, communications or other info** which he believes contains a
 - **materially false or misleading** statement
 - contains statements or info. **provided recklessly or**

- **omits** required info. where such omission could be misleading.

(b) Objectivity

Requires auditor **not to compromise professional judgment** because of **bias, conflict of interest or undue influence** of others.

(c) Professional competence and due care

Requires auditor to **attain and maintain professional knowledge and skill** at the level required to render competent professional service and also to **act diligently** and as per technical & professional **standards**.

(d) Confidentiality: Requires auditor to **respect confidentiality** of info. acquired as result of professional or business relationships.

(e) Professional behaviour

It requires an auditor to **comply with relevant laws and regulations** and **avoid any conduct** that he knows or should know **might discredit the profession**.

Auditor should be Independent of the entity subject to Audit.

Independence comprise of both: **Independence of Mind & Independence in Appearance**.

1. Independence of mind - state of mind that permits provision of opinion **without being affected by influences** allowing individual to act with integrity, exercise objectivity and professional skepticism
2. Independence in appearance - avoidance of facts and circumstances that are so significant that a **3rd party would reasonably conclude** an auditor's integrity, objectivity or professional skepticism had been compromised.

It enhances auditor's ability to act with integrity, be objective and maintain attitude of professional skepticism.

Types of Threats to Independence

5 types of threats:

1. Self-interest threats, which occur when an auditing firm, its partner or associate could benefit from a **financial interest** in an audit client.

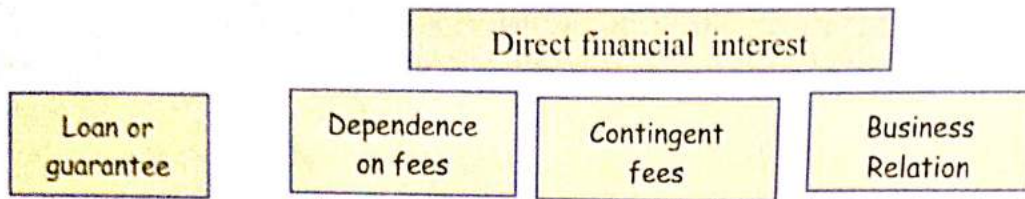
Examples include:

- i) **direct financial interest** or materially significant indirect financial interest in a client,
- ii) **loan or guarantee** to or from the concerned client,
- iii) **undue dependence on a client's fees** and, hence, concerns about losing engg,
- iv) **close business relationship** with an audit client,

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- v) **potential employment** with the client, and
- vi) **contingent fees** for audit engagement.



2. Self-review threats, which occur when during a **review of judgement or conclusion** reached in a previous audit or non-audit engg or when **audit team member was previously director or senior employee** of client.

(**Non-audit services** include any professional services provided, other than audit or review of FS. These include mgt services, internal audit, investment advisory service, design and implementation of IT systems etc.),



Instances where such threats come into play are:

- i) when an auditor having **recently been a director or senior officer** of company, and
- ii) when auditors perform **services that are subject matters of audit**.

3. Advocacy threats, which occur when auditor **promotes, or is perceived to promote, a client's opinion to a point** where people may believe that **objectivity is getting compromised**.

Examples:

Auditor dealing in shares or securities of Co.

Auditor becomes advocate in litigation or 3rd party disputes

4. Familiarity threats occur when auditors **form relationships** with client end up being **too sympathetic** to client's interests.

This can occur in many ways:

- i) **close relative** of audit team working in a senior position in client company
- ii) **former partner** of audit firm being a director/senior employee of client
- iii) **long association** b/w auditors and client counterparts and
- iv) acceptance of **significant gifts or hospitality** from client, its directors or employees.

5. Intimidation threats, which occur when auditors are **deterred from acting objectively** with an adequate degree of professional skepticism.

Basically, these could happen because of

- o **threat** of replacement over disagreements with application of a/c principles or
- o **pressure** to disproportionately reduce work in response to reduced audit fees or

- o being threatened with litigation.

Safeguards to Independence

Following are the guiding principles in this regard: -

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

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Independence

Policies and procedures should enable firm to: -

(a) **Communicate its independence requirements** to its personnel

(b) Identify and evaluate

- ⇒ **circumstances and relationships** that create **threats** to independence,
- ⇒ Obtain info on **identified breaches**, if any, of firm's P&P, check if they create threat 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.

EPs provide firm with relevant info about client 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.

Its objective is to ensure that independence requirements are satisfied.

At least **annually**, firm should **obtain written confirmation** of compliance with P&P on independence from **all firm personnel** required to be independent in terms of requirements of the Code.

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Acceptance and Continuance of Client Relationships and Audit Engagements [MTP Nov-21]

EP shall be satisfied that appropriate procedures regarding acceptance and continuance of client relationships and audit engagements have been followed.

Information such as following assists EP in determining whether decisions regarding acceptance and continuance of audit engagements are appropriate:

- **Integrity of principal owners, key management and TCWG** of entity
- Whether engg. team is **competent** to perform audit and has necessary **capabilities**, including **time and resources**
- Whether firm & engg. team can comply with relevant **ethical requirements** &
- **Significant matters** that have arisen during current or previous audit engg, and their implications for continuing the relationship

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Evaluating the Integrity of Client

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

- ✓ Identity and business **reputation** of client's principal owners, key mgt, related parties and TCWG.
- ✓ **Nature of client's operations**, including business practices.
- ✓ Info. concerning **attitude** of client's principal owners, key mgt and TCWG towards matters such as aggressive interpretation of a/c stds and internal control environment.
- ✓ Whether client is **aggressively** concerned with maintaining firm's fees as low as possible.
- ✓ Indications of **inappropriate** limitation in scope of work.
- ✓ Indications that client might be involved in **money laundering** or other criminal activities.
- ✓ Reasons for **proposed** appointment of firm and non-reappointment of previous firm.

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Withdrawal from engg.

If there's **conflict of interest** b/w firm & client, it should be **properly resolved** before accepting engg. Where firm obtains info that would have caused it to decline an engg if obtainable earlier, policies and procedures on continuance of engg. and client relationship should consider:

- Professional and legal responsibilities** that apply to circumstances, including requirement for firm to **report** to person(s) who made **appointment** or, in some cases, to **regulatory authorities** &
- Possibility of withdrawing** from engg. or from both engg. and client relationship.

Human Resource [RTP Nov-21/22]

Establish P&P to provide reasonable assurance that it has **sufficient personnel** with **capabilities, competence, and commitment** to ethical principles necessary to achieve Audit Quality.

Such policies and procedures address following personnel issues:

- Recruitment
- Performance evaluation
- Capabilities
- Competence
- Career development
- Promotion &
- Compensation

Engagement Performance

EP Responsibility

- EP responsible for **direction, supervision & performance** of audit engg as per PRL requirements.
- Responsible for **auditor's report being appropriate** in circumstances.
- Further, **review of audit documentation before issue of audit report** is his responsibility.
- To **ensure that SAAE obtained** to support conclusions reached for issuing auditor's report.
- Also responsible for ensuring appropriate **consultation on difficult or contentious matters** taken by engg. team not only within team but also with others within or outside the firm.

Engagement Quality Control Review for Listed Entities

For audits of FS of listed entities, and those other audit engagements, if any, for which firm has determined that EQCR is required, EP shall:

- Determine that **engagement quality control reviewer** has been **appointed**.
- Discuss significant matters** arising during audit engg, including those identified during EQCR, with engagement quality control reviewer.
- Not **date auditor's report** until completion of EQCR.

Ch-1 Intro to Auditing

Significant judgments made in engg should be **reviewed by EQCR** for taking an objective view before report is issued.

Extent of review depends on complexity of engg. and risk that report might not be appropriate in circumstances. **Review doesn't reduce responsibilities** of EP.

Difference of Opinion

If differences of opinion

- arise within engg team,
- with those consulted or
- b/w EP and EQCR,

engg team shall **follow firm's P&P** for dealing with and resolving differences of opinion.

Assembly of audit file

Assembly of engg files should be completed in **not more than 60 days after date of auditor's report** in case of audit engg and in other cases within limits appropriate to engg. Policies designed to **maintain confidentiality, safe custody, integrity, accessibility & retrievability** of engg documentation.

Unless specified by L/R, **engg documentation is property of the firm**. Firm may, at its **discretion, make portions, or extracts** from, engg documentation **available to clients**, provided such disclosure

- ⇒ **doesn't undermine validity of work** performed, or,
- ⇒ in case of **assurance engg**, independence of firm or its personnel.

Retention of documentation

Audit engagements → retention period ordinarily is no shorter than **7 years from date of auditor's report, or, if later, date of group auditor's report**.

Monitoring [Nov-23]

Provide firm with reasonable assurance that its P&P relating to system of quality control are relevant, adequate, and operating effectively.

EP should document following matters pertaining to an audit engg: -

- Issues** identified wrt **compliance with ethical requirements** and **how they were resolved**.
- Conclusions** on **compliance with independence requirements** that apply to audit engg, and any relevant discussions with firm that support these conclusions.
- Conclusions** reached regarding **acceptance & continuance** of client relationships and engg.
- Nature and scope of, & conclusions** resulting from **consultations** taken during course of audit engg.

"Work hard in silence, let your SUCCESS be your Noise"

SA 300- Planning an audit of FS

Objective of auditor is to plan the audit so that it will be performed in an effective manner.

Involvement of key engg. team members in planning audit

- EP & other key members of engg team shall be involved in planning.
- Involvement of EP and other key members in planning draws on their experience and insight, thereby enhancing effectiveness and efficiency of planning process.

Discussion of elements of planning with entity's mgt

Auditor may decide to discuss elements of planning with entity's mgt to facilitate audit engg.

When discussing matters included in overall audit strategy or audit plan, care is required to not compromise effectiveness of audit.

Benefits of Audit Planning

Adequate planning benefits audit of F.S. in several ways, including the following:

- a) Helping auditor to devote appropriate attention to important areas of audit.
- b) Helping auditor identify & resolve potential problems on timely basis.
- c) Helping auditor properly organize and manage audit engg. so that it's performed in effective & efficient manner.
- d) Assisting in selection of engg. team members with capabilities and competence to respond to anticipated risks, and proper assignment of work to them.
- e) Facilitating direction & supervision of engg. team members & review of their work.
- f) Assisting in coordination of work done by auditors of components and experts.

When audit work is adequately and properly planned, it reduces risk of inappropriate opinion by auditor. Therefore, planning an audit ensures audit risk is reduced to an acceptable low level.

Audit Planning- A Continuous Process [RTP May-21]

Planning is not a discrete phase of audit, but rather a continual and iterative process that begins shortly after completion of previous audit & continues until completion of current audit.

Planning includes consideration of timing of certain activities and audit procedures that need to be completed prior to performance of FAP.

For eg, planning includes need to consider, prior to auditor's identification and assessment of ROMM, such matters as:

1. Analytical procedures to be applied as risk assessment procedures.
2. Obtaining a general understanding of legal and regulatory framework applicable to entity & how entity is complying with that framework.

Ch-2 Audit Strategy, Planning & Programme

3. Determination of **materiality**.
4. **Involvement of experts**.
5. Performance of **other risk assessment procedures**.

Planning Process- Elements of Planning

Elements of planning can be categorized as under: -

(I) Preliminary engagement activities (II) Planning activities

I. Preliminary engagement activities

Auditor considers whether relationship with client should be continued and whether ethical requirements including independence continue to be complied with.

It includes: -

- A. Performing procedures regarding continuance of the client relationship
- B. Evaluating compliance with ethical requirements, including independence
- C. Establishing an understanding of terms of engagement

II. Planning activities involve: -

- A. Establishing the overall audit strategy
- B. Developing an audit plan

A. Overall Audit Strategy - Assistance to auditor

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

Establishment of Overall Audit Strategy

Factors to be taken into consideration by auditor for establishing audit strategy:

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

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

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

(b) Ascertain **reporting objectives** of engg to plan **timing** of audit and nature of **communications** reqd.

Some of the instances are given under: -

- Entity's **timetable** for reporting
- **Organization of meetings** to discuss of NTE of audit work with mgt

Ch-2 Audit Strategy, Planning & Programme



- o Discussion with mgt regarding expected **type & timing of reports** to be issued including auditor's report
- o Discussion with mgt regarding expected communications on **status of audit work** throughout engg.
- o Expected **nature & timing of communications among engg team members**, including nature and timing of team **meetings** and timing of **review** of work performed.

(c) Consider factors that, in auditor's professional judgment, significant in directing engg team's efforts: Preliminary identification of material ABCD help auditor in establishing overall audit strategy. More energies need to be devoted to significant matters to obtain desired outcomes.

Few eng are listed as under: -

- o **Volume of transactions** which may determine whether it is **more efficient** for auditor to **rely on internal control**
- o **Significant industry developments** eg. changes in industry regulations & new reporting requirements.
- o **Significant changes in FRF**, such as changes in accounting standards.
- o **Other significant relevant development**, eg. changes in legal environment affecting the entity.

(d) Consider **results of preliminary engagement activities** and, where applicable, whether **knowledge gained on other engagements** performed by EP for the entity is relevant

Examples are listed as under: -

- o Results of **previous audits** that involved evaluating operating effectiveness of **internal control**, including the nature of **identified deficiencies** and **action taken to address** them.
- o Manner in which auditor emphasizes to engg team members **need to maintain a questioning mind** and to **exercise professional skepticism** in gathering and evaluating audit evidence.

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

- o Selection of engg team & assignment of work is a significant factor.
- o **Experienced team members** may be assigned in areas where there is higher RoMM.
- o Similarly, engg budgeting and devotion of **more time** to areas of higher RoMM.

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Benefits of Audit Strategy [RTP May 20]

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

1. Deployment of Quality of Resources: Resources to deploy for specific audit areas, such as use of **experienced team members** for **high risk areas** or involvement of **experts on complex matters**
2. Allocation of Quantity of Resources: Amount of resources to allocate to specific audit areas, such as no. of team members assigned to observe inventory count at material locations, extent of review of other auditors' work in case of group audits, or audit budget in hours to allocate to high risk areas
3. Timing of Deployment: When these resources are to be deployed, such as whether at an **interim audit stage** or at **key cut-off dates**
4. Management of Resources: How such resources are **managed, directed and supervised**, such as when **team meetings** are expected to be held, how EP and manager **reviews** are expected to take place and whether to complete EQCRs.

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Description/Contents of Audit Plan

SA-300 states that Auditor shall develop audit plan that shall include a description of

- a) **NTE of planned risk assessment procedures** (NTE of RAP)
 - b) **NTE of planned further audit procedures** at assertion level (NTE of FAP)
 - c) **Other planned audit procedures** required to be carried out so that the engagement complies with SAs (Other Audit Procedures)
- o **Audit plan is more detailed than overall audit strategy** that includes NTE of audit procedures to be performed by engg. team members.
 - o **Planning** for audit procedures takes place over course of audit as audit plan for engg. develops.

Example

- ✓ Planning of auditor's **RAP** occurs **early** in audit process.
- ✓ However, planning **NTE of specific FAP** depends on **outcome of those RAP**.
- ✓ In addition, auditor may **begin execution of FAP** for some ABCD **before planning remaining FAP**.

Changes to Planning Decisions during Course of Audit (RTP May-20)

Auditor shall update and change overall audit strategy and plan as necessary during course of audit.

As a result of

- unexpected events,
- changes in conditions, or
- audit evidence obtained from results of audit procedures,

Auditor may need to modify overall audit strategy and audit plan and thereby resulting planned NTE of FAP, based on revised consideration of assessed risks.

[RoMM (Increase) → NTE of FAP (Increase) → Modify strategy & plan]

This happens when info comes to auditor's attention that differs significantly from info available when auditor planned audit procedures.

For eg, audit evidence obtained through performance of substantive procedures may contradict audit evidence obtained through TOCs.

Direction, Supervision & Review [RTP Nov-20/22]

NTE of DSR of work of engg team members vary depending on many factors, including:

1. Size and complexity of the entity.
2. The area of the audit.
3. The assessed RoMM
4. The capabilities and competence of individual team members performing audit work.

Documenting the Audit Plan (RTP Nov 20)

The auditor shall document:

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

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

Example

- Auditor may summarize it in the form of memorandum that contains key decisions regarding overall scope, timing and conduct of audit.

Ch-2 Audit Strategy, Planning & Programme



Documentation of audit plan is *record of planned NTE of RAP and FAP* at assertion level in response to assessed risks.

- It also serves as *record* of proper planning of audit procedures that can be *reviewed* and *approved prior to performance*.
- Auditor may use *standard audit programs and/or audit completion checklists*, tailored as needed to reflect engg circumstances.

A record of significant changes to

- overall audit *strategy* and audit *plan*, and
- *resulting changes to planned NTE of audit procedures*,
- explains *why* significant changes were made, and
- overall audit strategy and plan *finally adopted* for audit.

It also reflects appropriate response to significant changes occurring during audit.

Audit Programme

It consists of

- a series of *verification procedures*
- to be *applied* to the F.S. and accounts of a given company
- for the *purpose* of obtaining sufficient evidence to
- enable the auditor to *express an informed opinion* on such statements.

Construction of Audit Program (Nov-19/RTP Nov-22)

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

1. Stay within *scope and limitation* of assignment.
2. Include *audit objectives for each area* & sufficient details which serve as a *set of instructions* for assistants involved in audit & help in controlling proper execution of work.
3. Prepare a written audit programme setting for *procedures needed to implement audit plan*.
4. Apply *only those steps & procedures useful* in accomplishing purpose in specific situation.
5. Determine the *evidence* reasonably available & identify best evidence for deriving necessary satisfaction.
6. Consider *all possibilities of error*.
7. *Co-ordinate* the procedures to be applied to related items.

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Advantages & Disadvantages of Audit Program

Advantages of an audit prog. are:

- a) **Selection of assistants** for jobs on basis of capability becomes easier when work is rationally planned, defined and segregated.
- b) It provides assistant with **total & clear set of instructions** of work to be done.
- c) It is essential to provide a **total perspective of work to be performed**.
- d) Without a written and pre-determined prog., work is necessarily to be carried out based on some 'mental' plan. In such a situation there is always a **danger of ignoring or overlooking certain books and records**. Under a properly framed prog., such danger is significantly less.
- e) Assistants, by putting their signature on programme, accept **responsibility for work** carried out by them individually and work done may be traced back to assistant.
- f) Principal can **control progress** of various audits in hand by examination of audit prog. initiated by assistants deputed to the jobs for completed work.
- g) It **serves as a guide** for audits to be carried out in the succeeding year.

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Disadvantages are:

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

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Evolving One Audit Programme - Not Practicable For All Businesses [Nov-20]

- Businesses **vary in nature, size and composition**
- work which is suitable to one business may not be suitable to others
- Efficiency and operation of **internal controls** and
- exact **nature of service to be rendered by auditor** are other factors that vary from assignment to assignment.

On account of such variations, evolving one audit prog. applicable to all business under all circumstances is **not practicable**.

The Assistant Engaged - Be Encouraged To Keep An Open Mind

To start with, an auditor having regard to

- nature, size and composition of **business** and
- dependability of **internal control** and
- given **scope of work**,

should frame a programme which should aim at providing for a **minimum essential work** which may be termed as a **standard programme**.

- ✓ As **experience is gained** by carrying out the work, programme may be **altered** to take care of **situations which were left out originally**, but found relevant later on.
- ✓ If any work originally provided for proves to be **unnecessary or irrelevant**, it may be **dropped**.
- ✓ Assistant engaged in job should be **encouraged to keep an open mind** beyond the audit programme.
- ✓ He should be instructed to **note & report significant matters** coming to his notice, to his **seniors or partners or proprietor** of firm engaged for doing audit.

Periodic review of audit programme

- To **assess** whether same continues to be **adequate** for obtaining requisite knowledge and evidence about the transactions.
- Unless this is done, any **change in business policy** of client may not be known, and consequently, audit work may be carried on, on the basis of an **obsolete programme** and, for this **negligence**, whole audit may be held as **negligently conducted** and auditor may have to face **legal consequences**.
- **Utility** of audit programme can be **retained and enhanced** only by keeping programme as also the client's operations and internal control under **periodic review** so that **inadequacies or redundancies** of programme may be **removed**.
- However, as a basic feature, audit programme **not only lists the tasks** to be carried out but also contains a **few relevant instructions**, like **extent of checking, sampling plan**, etc.
- So long as **programme is not officially changed** by principal, **every assistant** should unfailingly **carry out work** as per the instructions. Many persons believe that this **brings rigidity** in audit programme.

- This is **not true** provided **periodic review** is done to **keep the programme up-to-date** as possible and **encouraging assistants to observe** all salient features of various a/c functions of the client.

Audit Programme- Designed to provide Audit Evidence

- ✓ **Evidence** is the very basis for formulation of **opinion** and audit programme is designed to provide for that by prescribing **procedures** and techniques.
- ✓ What is **best evidence** for testing accuracy of any assertion is a matter of expert **knowledge & experience**.
- ✓ This is **primary task** before auditor when he draws up audit programme.
- ✓ **Transactions are varied** in nature and impact; **procedures** to be **prescribed** depend on **prior knowledge** of what evidence is reasonably available in respect of each transaction.
- ✓ For **assertions no. of evidences be drawn** and each one should be **considered and weighed** to ascertain its weight to **prove or disprove** the assertion.
- ✓ In this process, auditor would be in a position to **identify** the **evidence** that **brings highest satisfaction** to him **about appropriateness or otherwise of assertion**.

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

- a) Documentary **examination**
- b) Physical **examination**
- c) **Statements** and explanation of management, officials and employees
- d) **Statements** and explanations of 3rd parties
- e) State of **internal** controls and internal checks
- f) **Inter**-relationship of the various accounting data
- g) Subsidiary and memorandum records
- h) Subsequent action by the client and by others
- i) Arithmetical calculations by auditor
- j) Minutes

Examples

1. For cash in hand, best evidence is 'count'.
2. For investment pledged with a bank, the banker's certificate.
3. For verifying assertions about book debts, client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to customers are all evidence: some of these are corroborative, other being complementary. In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction about the reliability of the assertion.

"It always seems Impossible, unless DONE"



SA 230: Audit Documentation

Audit Documentation refers to

- record of **audit procedures** performed,
- relevant **audit evidence** obtained, and
- **conclusions** the auditor reached.

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

Objective of the Auditor:

Objective of auditor is to prepare documentation that provides:

- a. Sufficient and appropriate record of the basis for auditor's report and
- b. Evidence that audit was planned & performed as per SAs & applicable legal & regulatory requirements.

Nature of Audit Documentation

Audit documentation provides:

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

Purpose of Audit Documentation [RTP-May'21]

Following are the purpose of Audit documentation:

1. Assisting ET to **plan and perform** the audit.
2. Assisting members of ET to **direct and supervise audit work**, and discharge review responsibilities.
3. Enabling ET to be **accountable** for its work.
4. Retaining a record of matters of continuing significance to **future audits**.
5. Enabling conduct of **quality control reviews** and inspections in accordance with SQC 1.
6. Enabling conduct of **external inspections** as per applicable legal, regulatory or other requirements.

Retain for future >> Plan >> D/S/R *2 >> Accountable

Prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with audit, to understand:

- a. NTE of **audit procedures** performed.
- b. Results of audit procedures performed and **audit evidence** obtained and

Ch-3 Audit Documentation



- c. **Significant matters** arising during audit and **conclusions reached** thereon and **significant professional judgements** made in reaching those conclusions.

Documenting NTE of audit procedures performed, auditor shall record:

- Identifying characteristics of specific **items or matters tested**.
- Who performed** audit work and **date** such work was completed; and
- Who reviewed** audit work performed and **date** and extent of such review.

Factors affecting Form, Content & Extent of Documentation [RTP Nov-18]

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

- ✓ **Size and complexity** of the entity.
- ✓ Identified **risks of material misstatement**.
- ✓ Nature and extent of **exceptions** identified.
- ✓ Nature of the **audit procedures** to be performed.
- ✓ **Audit methodology** and tools used.
- ✓ Significance of the **audit evidence** obtained.
- ✓ 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.

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Documentation of Significant Matters and Related Significant Professional Judgements (RTP Nov-20/22)

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

Examples of significant matters include:

- Matters that give rise to **significant risks**.
- Results of audit procedures** indicating
 - that ***F.S. could be materially misstated***, or
 - need to ***revise auditor's previous assessment of ROMM and auditor's responses to those risks***.
- Circumstances causing auditor **significant difficulty** in applying necessary audit procedures.
- Findings that could result in a **modification to audit opinion** or inclusion of **EOM Para** in auditor's report.

Ch-3 Audit Documentation

Some eg. of circumstances in which it is appropriate to prepare audit documentation relating to use of professional judgement include, where matters and judgements are significant:

- **Rationale for auditor's conclusion** when a requirement provides auditor 'shall consider' certain information or factors, and that's significant in particular engagement.
- **Basis for auditor's conclusion** on reasonableness of areas of subjective judgements (for eg. reasonableness of significant a/c estimates).
- **Basis for auditor's conclusions** about authenticity of a document when further investigation (such as use of expert or confirmation procedures) undertaken in response to conditions that caused auditor to believe document may not be authentic.

Completion Memorandum or Audit Documentation Summary [May-19]

- Auditor may consider it helpful to prepare and retain as part of AD a summary (sometimes known as a completion memorandum) that describes-
 - ⇒ the **significant matters identified** during audit and
 - ⇒ how they were **addressed**.
- Such summary **facilitate effective & efficient review** of AD, for large & complex audits.
- Further, **assist auditor's consideration of significant matters**.
- Also help auditor to consider whether there any **SA objective that auditor can't achieve** that would prevent auditor from achieving overall objectives of auditor.

Audit File [Nov-19]

Audit file may be defined as

- one or more **folders or other storage media**,
- in **physical or electronic** form,
- containing **records** that comprise
- **audit documentation** for a specific engagement.

Time limit: Complete assembly of audit file in not more than 60 days after date of auditor's report.

Admin. process that doesn't involve performing new audit procedures or drawing new conclusions.

Changes may, however, be made to the audit documentation during the final assembly process, if they are **administrative in nature**.

Examples of such administrative changes include:

- i) **Deleting** or discarding superseded documentation.
- ii) **Sorting, collating and cross-referencing** working papers.
- iii) **Signing off on completion checklists** relating to the file assembly process.
- iv) **Documenting audit evidence** auditor has obtained, discussed and agreed with relevant members of engg. team before date of A/R.

Ch-3 Audit Documentation



- ✓ After assembly of final audit file has been completed, auditor shall not delete or discard audit documentation of any nature before end of its retention period.
- ✓ SQC 1 → **Retention period** for audit engg is **no shorter than 7 years** from date of A/R, or, if later, date of group A/R.

Ownership of Audit Documentation

- SQC 1 provides that, unless specified by law or regulation, **AD is property of auditor**.
- May at his **discretion**, make portions, or extracts available to clients, provided such disclosure
 - ✓ **doesn't undermine validity of work performed**, or,
 - ✓ in case of assurance engagements, **independence of auditor or of his personnel**.

*"Success is the **sum of small efforts**, repeated day in and day out"*

Understanding the Entity & its Environment

SA 315 states that auditor shall obtain an understanding of the following: -

(a) Relevant industry, regulatory, and other external factors including the applicable FRF

Relevant industry factors include industry conditions such as **competitive** environment, **supplier & customer** relationships, and **technological** developments.

✓ Eg of matters auditor may consider include **market & competition**, whether entity is engaged in **seasonal activities**, **product technology** relating to entity's products.

Relevant regulatory factors include **regulatory environment**. Regulatory environment includes **applicable FRF** and **legal & political environment**.

✓ Examples of matters include **a/c principles** and **industry specific practices**, **regulatory framework** for a regulated industry, **legislation & regulation** that significantly affect entity's operations.

✓ Including **direct supervisory activities**, **taxation**, **govt policies** affecting entity's business.

Examples of other external factors include **general economic conditions**, **interest rates** & availability of **financing**, and **inflation** etc.

(b) Nature of entity, including: -

i) its **operations**

ii) its **ownership and governance structures**

iii) types of **investments** entity is making and plans to make, including investments in special-purpose entities &

iv) Way **entity is structured** and **financed**; enable auditor understand ABCD to be expected in FS.

Notes:

✓ Enables auditor to **understand** whether entity has **complex structure** for eg, whether it has **subsidiaries**.

✓ Complex structures often introduce **issues** that may give rise to **RoMM**.

✓ Also helps in understanding matters relating to **ownership**, and **relations between owners** and other people or entities. This understanding assists in determining whether **RPTs** have been **identified and accounted** for appropriately.

Eg. of matters that auditor may consider while obtaining understanding of nature of entity: -

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

✓ **Investment** and investment activities such as capital investment activities and planned or recently executed acquisitions

✓ **Financing** & financing activities such as major subsidiaries, debt structure etc.

✓ **Financial reporting** such as a/c principles and revenue recognition practices.

(c) Entity's selection and application of a/c policies, including reasons for changes thereto
Auditor shall evaluate whether entity's a/c policies are **appropriate** and **consistent with FRF**.

(d) Entity's objectives and strategies, and those related business risks that may result in RoMM.

Eg. of matters that auditor may consider when obtaining understanding of entity's objectives, strategies and related business risks that may result in a RoMM of FS include: -

- **Industry developments** (a potential related business risk might be, for eg, that entity doesn't have personnel or expertise to deal with changes in industry).
- **New products & services** (a potential related business risk might be, for eg, that there is increased product liability).
- **Expansion of business** (a potential related business risk might be, for eg, that the demand has not been accurately estimated).

Measurement and review of entity's financial performance

Understanding entity's **performance measures** assists auditor in considering whether **pressures to achieve performance targets** may result in **mgt actions** that increase RoMM, including fraud.

Eg. for measuring and reviewing financial performance which may be used by auditor: -

- **Key performance indicators** (financial & non-financial) & key ratios, trends & operating statistics.
- **Period-on-period** financial performance analyses.
- **Budgets, forecasts**, variance analyses, and departmental or other level performance reports.
- **Credit rating agency** reports

Understanding the entity-a continuous process

Obtaining an understanding of entity is a continuous process of gathering, updating and analysing info throughout audit. This understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when: for eg, when:

- Assessing **Romm** of the F.S.
- Determining **Materiality** in accordance with SA 320
- Considering **Appropriateness** of selection and application of **Accounting policies**
- Identifying areas where **Spl audit consideration** may be necessary, for eg, RPTs, appropriateness of mgt's use of **GC** assumption, or considering business purpose of transaction
- **Developing expectations** when performing **Analytical procedures**
- Evaluating **Sufficiency and appropriateness of audit evidence** obtained, such as appropriateness of assumptions and of management's oral and written representations.

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Romm	
Materiality	
Spl. Audit Considerations	
Appropriateness of a/c policies	
Analytical procedures	
Sufficiency & Appropriateness of A.E.	

Audit Risk

Risk that auditor expresses **inappropriate audit opinion** when F.S. are materially misstated. Audit risk is function of RoMM and Detection risk.

Risk of material misstatement (ROMM) - Risk that FS are materially misstated prior to audit.

Consists of 2 components, described as follows:

Inherent Risk	Control Risk
<p>Susceptibility of an assertion about a ABCD to a misstatement that could be material, either individually or when aggregated with other misstatements, before considering any related controls.</p> <p>Examples:</p> <ol style="list-style-type: none"> A/c standard guiding on a complex issue might not be understood by mgt. Recording of this issue in FS carries inherent risk of being misstated. Large no. of business failures in an industry. Assertions in FS of entity in such industry carry inherent risk of being misstated. 	<p>Risk that a misstatement that could occur in an assertion about a ABCD and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by entity's internal control.</p>

There exists **inverse relation b/w Control Risk & Efficiency of Internal Control**.

When efficiency of internal control is high → control risk is low and when efficiency of internal control of that entity is low → control risk is high.



ROMM may exist at two levels:

Overall F.S. level i.e. relate to F.S. as a whole potentially affecting many assertions	Assertion level for classes of transactions, account balances, and disclosures → Determine NTE of Further Audit Procedures → Obtain SAAE
-----------------------------------------------------------------------------------------	------------------------------------------------------------------------------------------------------------------------------------------

ROMM at assertion level are assessed to determine NTE of further audit procedures to obtain SAAE. This evidence enables auditor to express opinion on FS at an acceptably low level of audit risk.

Detection risk - Risk that procedures performed by auditor to reduce audit risk to acceptably low level will not detect a misstatement that exists and that could be material, individually or when aggregated with other misstatements i.e. Risk of not detecting a material misstatement.

Summary: Audit Risk = Risk of Material Misstatement x Detection Risk

What is not included in Audit Risk?

- Risk that auditor might express an opinion that F.S. are materially misstated when they are not. This risk is ordinarily insignificant.
- It doesn't refer to auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with audit of F.S.

Assessment of risks- A matter of professional Judgment

- Audit risk is a function of RoMM and detection risk.
- Assessment of risks is based on audit procedures & evidence obtained throughout audit.
- It's a matter of professional judgment, rather than a matter capable of precise measurement.
- PJ is exercised by auditor whose training, knowledge & experience assisted in developing necessary competencies to achieve reasonable judgments.

Risk assessment procedures refer to audit procedures performed

- ✓ to obtain an understanding of entity and its environment, including entity's internal control,
- ✓ to identify and assess RoMM, whether due to fraud or error,
- ✓ at F.S. and assertion levels.

For the purpose of Identifying and assessing RoMM, auditor shall: [RTP Nov-20]

- Identify risks throughout process of obtaining understanding of entity and its environment, including relevant controls that relate to the risks, and by considering the ABCD in F.S.
- Assess identified risks, and evaluate whether they relate more pervasively to F.S. as a whole and potentially affect many assertions



Ch-4 Risk Assessment & Internal Control

- c) Relate identified risks to what can go wrong at assertion level, taking account of relevant controls that auditor intends to test and
- d) Consider likelihood of misstatement, including possibility of multiple misstatements, and whether potential misstatement is of a magnitude that could result in a material misstatement.

Identify → Assess → WCGW & Controls → Likelihood & Magnitude

RoMM- Greater for Significant Non-Routine Transactions arising from matters such as following:

- Greater management intervention to specify the accounting treatment.
- Greater manual intervention for data collection and processing.
- Complex calculations or accounting principles.
- The nature of non-routine transactions, which may make it difficult for entity to implement effective controls over the risks.

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RoMM- Greater for Significant Judgmental Matters that require development of accounting estimates, arising from matters such as following:

- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex, or require assumptions about effects of future events, for eg, judgment about fair value. [RTP Nov-21]

Internal Control

Internal control may be defined as

"process designed, implemented and maintained (DIM) by TCWG, management and other personnel to provide reasonable assurance about achievement of an entity's objectives w.r.t

- reliability of financial reporting,
- effectiveness and efficiency of operations,
- safeguarding of assets, and
- compliance with applicable laws and regulations."

Benefits of Understanding of Internal Control [RTP May-21]

An understanding of internal control assists the auditor in :

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

Limitations of Internal Control [MTP Apr-19]

- (i) Internal control can provide only reasonable assurance about achieving financial reporting objectives. Likelihood of their achievement is affected by inherent limitations of internal control.
- (ii) Human judgment in decision-making: Reality is that human judgment in decision-making can be faulty & breakdowns in IC can occur because of human error. Eg There may be an error in the design of, or in the change to, a control.
- (iii) Lack of understanding the purpose: Operation of a control may not be effective, such as where info. produced for purposes of IC (Eg exception report) is not effectively used because individual responsible for reviewing info. doesn't understand its purpose or fails to take appropriate action.
- (iv) Collusion among People: Additionally, controls can be circumvented by collusion of 2 or more people or inappropriate mgt override of internal control.
 - o For eg, mgt may enter into **side agreements with customers** that alter terms and conditions of entity's std sales contracts, which may result in **improper revenue recognition**.
 - o Also, **edit checks in a software program** that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.
- (v) Judgements by Management: Further, in designing and implementing controls, mgt may make judgments on nature and extent of controls it chooses to implement, and risks it chooses to assume.
- (vi) Limitations in case of Small Entities: Smaller entities often have fewer employees due to which segregation of duties(SODs) is not practicable. However, in a small owner-managed entity, owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for generally more limited opportunities for SODs.

Components of Internal Control

1. Control Environment [RTP Nov-19 + Nov-22]

Auditor shall obtain understanding of control environment.

Auditor shall evaluate whether:

- i) Mgt has created and maintained a **culture of honesty & ethical behavior** &
- ii) Strengths in control environment elements collectively provide appropriate **foundation for other components** of internal control.

What is included in Control Environment ? [Nov-22]

Control environment includes:

- i) Governance and mgt functions and
- ii) Attitudes, Awareness, and Actions of TCWG and mgt.
- iii) Control environment sets tone of organization, influencing control consciousness of its people.

Elements of control environment that may be relevant when obtaining an understanding of control environment include following: [MTP Apr-20]

- a. Communication and enforcement of integrity and ethical values: Effectiveness of controls cannot rise above integrity & ethical values of people who create, administer, & monitor them. Eg. Policy statements, codes of conduct etc.
- b. Commitment to competence- Matters such as mgt's consideration of competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
- c. Participation by TCWG: Attributes of TCWG such as:
 - Their independence from mgt.
 - Experience and stature.
 - Extent of their involvement and info. they receive, & scrutiny of activities.
- d. Management's philosophy and operating style- Characteristics such as management's:
 - Attitudes and actions toward financial reporting.
 - Attitudes toward information processing and accounting functions and personnel.
- e. Organisational structure-Framework within which entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
- f. Assignment of authority and responsibility- Matters such as how authority & responsibility are assigned and how reporting relationships & authorisation hierarchies are established.
- g. Human resource policies and practices- Policies and practices that relate to, for eg, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Existence of a satisfactory control environment-not absolute deterrent to fraud

- Existence of satisfactory control environment **can be positive factor** when auditor assesses RoMM.
- However, it **may help reduce risk of fraud**, satisfactory control environment is not absolute deterrent to fraud.
- Conversely, **deficiencies** in control environment may **undermine effectiveness of controls**, in particular in relation to fraud.
- For eg, mgt's failure to commit sufficient resources to address **IT security risks** may adversely affect internal control by allowing **improper changes** to computer programs or data, or unauthorized transactions to be processed.
- **Control environment** in itself **doesn't prevent, or detect and correct**, a material misstatement.
- It may, however, **influence** auditor's **evaluation of effectiveness of other controls** (for eg, monitoring of controls & operation of specific control activities) and thereby, auditor's assessment of RoMM.

2. Entity's Risk Assessment Process- Component of Control Environment

Auditor shall obtain an understanding of whether entity has a process for:

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

3. Information system, including the related business processes, relevant to financial reporting and communication- Component of Control Environment [RTP May-21]

Auditor shall obtain understanding of information system, including related business processes, relevant to financial reporting, including following:

- a. **SCoTs**: Classes of transactions in entity's operations that are significant to F.S.
- b. **Procedures**: Procedures by which those transn are initiated, recorded, processed, corrected as necessary, trfd to general ledger and reported in F.S.
- c. **Accounting Records**: Related accounting records, supporting information and specific accounts in F.S. that are used to initiate, record, process and report transactions;
- d. **How?**: How information system captures events and conditions that are significant to F.S

Ch-4 Risk Assessment & Internal Control



- e. FRP: Financial reporting process used to prepare entity's F.S
- f. Controls: Controls surrounding journal entries.

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Control Activities- Component of Internal Control [RTP May-21]

Auditor shall obtain an understanding of control activities relevant to audit.

Examples of specific control activities include those relating to the following:

- **Performance Reviews** (reviews of actual performance with budgets)
- **Information Processing** (for example controls over checking arithmetical accuracy of records, program change controls etc)
- **Physical Controls** (like controls over physical security of assets)
- **Segregation of Duties** (controls ensuring that different people are assigned responsibilities of authorising transactions, recording transactions and maintaining custody of assets)

Significant Risks [RTP Nov-21]

In deciding as to which risks are significant risks, auditor shall consider at least the following:

- a. Whether the risk is a risk of **fraud**
- b. Whether the risk is related to recent **significant** economic, accounting, or other **developments** like changes in regulatory environment, etc., and, therefore, requires specific attention
- c. **Complexity** of transactions
- d. Whether the risk involves significant transactions with **related parties**
- e. **Degree of subjectivity** in measurement of financial info. related to risk, especially those measurements involving wide range of measurement uncertainty &
- f. Whether risk involves significant transactions that are **outside normal course of business** for entity, or otherwise appear to be **unusual**

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Monitoring of Controls - Component of Internal Control [Nov-20 + RTP Nov-22]

Auditor shall obtain understanding of major activities that entity uses to MONITOR Internal Controls over financial reporting:

- i) **Monitoring of controls Defined:** Monitoring of controls is a process to assess effectiveness of internal control performance over time.
- ii) Helps in assessing effectiveness of controls on a timely basis and take remedial actions.
- iii) Mgt accomplishes through ongoing activities, separate evaluations or a combination of two. Ongoing monitoring activities are built into normal recurring activities of entity & include regular mgt & supervisory activities.
- iv) Mgt's monitoring activities include using info. from communications from external parties such as **customer complaints & regulator comments** that indicate problems or highlight areas of improvement.

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Controls Relevant to Audit [RTP May-21]

Factors relevant to auditor's judgment about whether a control is relevant to audit include:

- **Materiality.**
- Nature & **Complexity** of systems part of IC, including use of service organisations.
- **Diversity** and complexity of entity's operations.
- Nature of entity's **Business**, including its organisation and ownership characteristics.
- **Significance** of the related risk.
- **Size** of the entity.
- **Circumstances** and applicable component of internal control.
- Applicable **legal and regulatory** requirements.
- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

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Materiality	
Complexity	
Diversity	
BaSiC	
Legal & Regulatory	

Benefits of Evaluation of Internal Control to the Auditor [RTP May-19/Nov-22]

Review of internal controls will enable the auditor to know:

- i) whether **errors and frauds are likely to be located** in ordinary course of operations of business
- ii) whether an **adequate internal control system** is in use and operating as planned by mgt
- iii) whether an effective **internal auditing department** is operating
- iv) whether any **administrative control** has a bearing on his work (for eg, if control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in wages sheet and this is relevant for auditor)
- v) whether the controls adequately **safeguard the assets**
- vi) how far and how adequately mgt is discharging its function in so far as **correct recording of transactions** is concerned
- vii) how **reliable the reports, records and certificates** to the management can be
- viii) **extent and depth of examination** that he needs to carry out in different areas of accounting
- ix) what would be **appropriate audit technique** and the audit procedure in the given circumstances
- x) what are **areas where control is weak** and where it is excessive
- xi) whether some **worthwhile suggestions** can be given to improve the control system.

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Methods of Evaluating Internal Control

Narrative Record (Nov-17)

This is a **complete and exhaustive description of system** as found in operation by auditor. Actual testing and observation are necessary before such a record can be developed.

It may be recommended in cases where **no formal control system is in operation** and would be more suited to **small business**.

Disadvantages of narrative records are:

- (i) To **comprehend the system** in operation is quite difficult.
- (ii) To **identify weaknesses** or gaps in the system.

(iii) To **incorporate changes** arising on account of reshuffling of manpower, etc.

Check List

This is a **series of instructions and/or questions** which a member of auditing staff must follow and/or answer. When he completes instruction, he **initials the space against instruction**. Answers to check list instructions are usually **Yes, No or Not Applicable**. This is again **on the job requirement** and instructions are framed having regard to desirable elements of control.

A few examples of check list instructions are given hereunder:

1. Are tenders called before placing orders?
2. Are the purchases made on the basis of a written order?
3. Is the purchase order form standardised?
4. Are purchase order forms pre-numbered?
5. Are inventory control accounts maintained by persons who have nothing to do with custody of work, receipt of inventory, inspection of inventory and purchase of inventory?

The complete check list is studied by the Principal/Manager/Senior to ascertain existence of internal control and evaluate its implementation and efficiency.

Internal Control Questionnaire

This is a **comprehensive series of questions** concerning internal control. This is most widely used form for collecting info. about existence, operation and efficiency of internal control in an organisation.

Flow Chart

- It's a **graphic presentation** of each part of Co's system of internal control.
- Flow chart is considered to be **most concise way** of recording auditor's review of system.
- It **minimises narrative explanation** and achieves a presentation not possible in any other form.
- It gives **bird's eye view of system** and flow of transactions, deficiencies can be easily spotted and improvements can be suggested.

"Work hard enough that even Luck steps in to Support you"

Risk assessment procedures refer to audit procedures performed

- ✓ to obtain an **understanding** of entity and its environment, including entity's internal control,
- ✓ to **identify and assess RoMM**, whether due to fraud or error,
- ✓ at F.S. and assertion levels.

For the purpose of Identifying and assessing RoMM, the auditor shall: [RTP Nov-20]

- Identify risks** throughout process of obtaining understanding of entity and its environment, including relevant controls that relate to the risks, and by considering the ABCD in F.S.
- Assess identified risks**, and evaluate whether they relate **more pervasively** to F.S. as a whole and potentially affect many assertions
- Relate identified risks** to **what can go wrong** at assertion level, taking account of **relevant controls** that auditor intends to test and
- Consider **likelihood of misstatement**, including possibility of multiple misstatements, and whether potential misstatement is of a **magnitude** that could result in a material misstatement.

Identify → Assess → WCGW & Controls → Likelihood & Magnitude

What is included in Risk Assessment Procedures? [RTP May-18]

(a) **Inquiries of management and of others within entity** who in auditor's judgment may have info. that is likely to assist in identifying ROMM due to fraud or error.

Example of Inquiries: [RTP Nov-20]

- Inquiries to **Marketing or sales personnel** may provide info. about changes in entity's marketing strategies, sales trends, or contractual arrangements with its customers.
- Inquiries to **Risk mgt function** (or those performing such roles) may provide info about operational & regulatory risks that may affect financial reporting.
- **Inquiries to TCWG** may help auditor understand the environment in which FS are prepared.
- Inquiries directed to **Information systems personnel** may provide info. about system changes, system failures, or other related risks.
- Inquiries to **Internal audit personnel** may provide info. about internal audit procedures performed during the year.
- Inquiries to **In-house legal counsel** provide info. about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud.
- Inquiries of **Employees** involved in initiating, processing or recording complex or unusual transactions to evaluate appropriateness of selection & application of certain a/c policies.

(b) Analytical procedures.

Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware. Explain [RTP Nov-23]

- Analytical procedures performed as RAP may identify aspects of entity of which auditor was unaware and may assist in assessing RoMM in order to provide a basis for designing and implementing responses to assessed risks. [Nayi baatein → Respond]
- Analytical procedures performed as RAP may include both financial and non-financial information, for eg, relationship between sales and square footage of selling space or volume of goods sold. [Financial/Non-Financial info]
- Analytical procedures may help identify existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. [Atpata]
- Unusual or unexpected relationships that are identified may assist the auditor in identifying RoMM, especially RoMM due to fraud. [Fraud]
- However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as RAP), results of those analytical procedures only provide a broad initial indication about whether a MM may exist. [Aggregated Data]
- Accordingly, in such cases, consideration of other info gathered when identifying RoMM together with such analytical procedures may assist in understanding & evaluating results of analytical procedures.

(c) Observation and inspection [July-21]

- The entity's operations
- The entity's premises and plant facilities.
- Documents (business plans and strategies), records, and internal control manuals.
- Reports prepared by mgt (quarterly mgt reports and interim F.S) and TCWG (such as minutes of BOD's meetings)

SA 330 Auditor's responses to assessed risks deals with auditor's responsibility to design and implement responses to RoMM identified and assessed by auditor as per SA 315, "Identifying and Assessing RoMM Through Understanding the Entity and Its Environment" in a FS audit.

Objective of auditor is to obtain SAAE about assessed RoMM, through designing and implementing appropriate responses to those risks.

SA 330 states that: -

- a. Auditor shall design and implement overall responses to address assessed RoMM at FS level.
- b. Auditor shall design and perform further audit procedures whose NTE are based on and are responsive to assessed RoMM at assertion level.

In designing further audit procedures to be performed, auditor shall:

- (a) Consider **reasons for assessment** given to RoMM at assertion level for each ABCD, including:
 - (i) **Likelihood of material misstatement** due to particular characteristics of relevant ABCD (i.e., inherent risk) and
 - (ii) Whether risk assessment **takes into account relevant controls** (i.e., control risk), thereby requiring auditor to **obtain audit evidence** to determine whether controls are operating effectively (i.e., auditor intends to rely on operating effectiveness of controls in determining NTE of substantive procedures) and
- (b) Obtain **more persuasive audit evidence** the higher auditor's assessment of risk.

Further Audit Procedures comprise of:

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

Auditor shall design and perform TOCs to obtain SAAE as to operating effectiveness of relevant controls when:

- a. Auditor's assessment of RoMM at assertion level includes an **expectation** that controls are operating effectively (i.e., auditor **intends to rely on operating effectiveness of controls** in determining NTE of substantive procedures) or
- b. **Substantive procedures alone can't provide SAAE** at assertion level.

In designing and performing TOCs, auditor shall obtain **more persuasive audit evidence greater the reliance** auditor places **on effectiveness of a control**.

Test of controls may include:

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

Nature & Extent Test of Controls

In designing and performing test of controls, auditor shall:

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

- (i) **How** the controls were applied at relevant times during the period under audit.
- (ii) The **consistency** with which they were applied.
- (iii) **By whom** or by what means they were applied.

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

Inquiry alone is not sufficient to test operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry.

In this regard, **inquiry combined with inspection or reperformance may provide more assurance** than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.

Extent of Testing of Internal Controls

When more persuasive audit evidence is needed regarding effectiveness of a control, it may be appropriate to increase extent of testing of control as well as degree of reliance on controls.

Matters auditor may consider in determining extent of TOCs include following: [RTP Nov'20]

- **Frequency** of performance of control by entity during the period.
- **Length of time** during audit period that auditor is relying on the operating effectiveness of control.
- **Expected rate of deviation** from a control.
- **Relevance and reliability** of audit evidence to be obtained regarding operating effectiveness of control at assertion level.
- **Extent to which audit evidence** is obtained from tests of other controls related to assertion.

Timing of Test of Controls

- For particular time, or throughout the period, for which auditor intends to rely on controls.
- Audit evidence pertaining to a point in time serve auditor's purpose, for eg, when testing controls over entity's physical inventory counting at period end.
- For control over a period → Appropriate tests may include tests of the entity's monitoring of controls.

Using Audit Evidence Obtained in Previous Audits [Nov-19]

In determining whether it is appropriate to use audit evidence about operating effectiveness of controls obtained in previous audits, and, if so, length of the time period that may elapse before retesting a control, auditor shall consider the following:

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

If auditor plans to use audit evidence from previous audit → establish continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to previous audit.

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Evaluating Operating Effectiveness of Controls

- Auditor shall evaluate whether misstatements detected by substantive procedures indicate that controls are not operating effectively.
- Absence of misstatements detected by substantive procedures → doesn't provide audit evidence that controls are effective.
- A **M.M. detected** by auditor's procedures is a **strong indicator of existence of a significant deficiency** in internal control.

Q. XYZ & Associates, Chartered Accountants, while evaluating the operating effectiveness of internal controls, detects deviation from controls. In such a situation, state the specific inquiries to be made by an auditor to understand these matters and their potential consequences. [MTP Mar-21]

Specific inquiries by auditor when deviations from controls are detected:

Ch-5 Audit Procedures



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

- TOCs that have been performed provide an **appropriate basis for reliance on the controls**;
- Additional test** of controls are necessary; or
- Potential risks of misstatement** need to be addressed using substantive procedures.

Substantive Procedures

Audit procedure designed to detect material misstatements at the assertion level.

Substantive procedures comprise:

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

Tests of Details

TODs are further classified into:

tests of transactions i.e., vouching & tests of balances i.e., verification.

Nature and extent of Substantive procedures

Depending on circumstances, auditor may determine that:

- Performing **only substantive analytical procedures** will be sufficient to reduce audit risk to acceptably low level. For eg, where auditor's assessment of risk is supported by audit evidence from test of controls. [Only Analytical Enough]
- Only tests of details** are appropriate. [Only TOD enough]
- Combination of SAP and TODs** are most responsive to the assessed risks. [Analytical + TOD]

Because **assessment of RoMM** takes account of internal control, extent of substantive procedures may need to be **increased** when results from **TOCs are unsatisfactory**.

In designing TODs, extent of testing is ordinarily thought of in terms of the **sample size**.

Substantive Procedure compulsory?

Irrespective of assessed RoMM, design and perform substantive procedures for each material ABCD.

This requirement reflects the facts that:

- auditor's assessment of **risk is judgmental** and so may **not identify all RoMM** &
- there are **inherent limitations to internal control**, including management override.



Ch-6 Materiality/Sampling/Evaluation of Misstatements

SA 320 "Materiality in Planning & Performing an Audit"

Misstatements, including omissions considered to be material

- if they, individually or in aggregate,
- could reasonably be expected to **influence economic decisions**
- **of users** taken on basis of FS.

Remember the overall objective of Auditor? 🧐

Q. Is materiality a matter of size (₹)?

Materiality is **not always a matter of relative size.**

For eg small amount loss of fraud by certain employees indicate serious flaw in internal controls requiring immediate attention to avoid greater losses in future.

In certain cases, quantitative limits of materiality is specified.

Few cases are given below [Division I of Schedule III]:

(a) Co. should disclose by way of notes add. info regarding any item of income or exp. which **exceeds**

- **1% of revenue from operations or**
- **1,00,000 [whichever is higher]**

(Refer general Instructions for preparation of Statement of P&L in Schedule III).

(b) A Co. should disclose in Notes to Accounts, shares in the Co. held by each shareholder **holding more than 5% shares** specifying no. of shares held.

SA 320 on "Materiality in Planning and Performing an Audit" deals with auditor's responsibility to apply concept of materiality in planning and performing an audit of F.S.

SA 450 explains how materiality is applied in evaluating effect of identified misstatements on audit and of uncorrected misstatements on F.S.

FRFs often discuss concept of materiality in context of PPFs [RTP May-21]

Although they may discuss materiality in different terms, they generally explain that:

1. Misstatements are material if expected to influence economic decisions of users taken on basis of F.S: Misstatements, including omissions, are material if they, individually or in the aggregate, could reasonably be expected to **influence economic decisions** of users taken on basis of F.S.
2. Judgments about materiality are affected by **size or nature of a misstatement or both.**
3. Judgments about matters that are material are based on a consideration of **common financial info. needs** of users as a group.

Ch-6 Materiality/Sampling/Evaluation of Misstatements



Note: Such **discussion**, if present in applicable FRF, **provides** a frame of **reference** to auditor in determining materiality for audit.

If applicable **FRF does not include a discussion** of materiality, **characteristics** referred above provide auditor with such a frame of **reference**.

Auditor's Assumptions [RTP May-21]

Determination of materiality is a **matter of professional judgment**, and is affected by auditor's perception of financial information needs of users of F.S.

In this context, it is reasonable for auditor to assume that users:

- Have a reasonable **knowledge of business and economic activities** and accounting and a **willingness to study information in F.S.** with reasonable diligence
- Understand that F.S. are prepared, presented and audited to levels of **materiality**
- Recognize the **uncertainties** inherent in measurement of amounts based on use of estimates, judgment and consideration of future events and
- Make **reasonable economic decisions** based on information in F.S.

Determining Materiality and Performance Materiality when Planning the Audit

- When establishing overall audit strategy → determine **materiality for F.S. as a whole**.
- If for a **ABCD**, misstatements of lesser amounts than materiality for F.S. as a whole expected to influence economic decisions of users → determine **materiality level(s) for those particular ABCD**. [ABCD => Account balance, Classes of Transaction & Disclosures]

Performance Materiality (PM):

- Amount or amounts set by auditor
- at **less than materiality** for F.S. as a whole
- to **reduce** to an appropriately low-level **probability**
- that aggregate of uncorrected and undetected misstatements
- exceeds materiality for F.S. as a whole.

If applicable, **PM** also refers to amt or amts set by auditor at less than materiality level or levels for particular **ABCD**.

Materiality Level or Levels for Particular ABCD

Factors that may indicate existence of one or more particular **ABCD** for which misstatements of lesser amounts than materiality for FS as a whole could reasonably be expected to influence economic decisions of users taken on basis of FS include the following:

- Whether **law, regulations or applicable FRF** affect users' expectations regarding measurement or disclosure of certain items like in case of **related party transactions, & remuneration of mgt & TCWG**.

Ch-6 Materiality/Sampling/Evaluation of Misstatements

2. **Key disclosures** in relation to industry in which entity operates. For eg, **R&D costs** for a **pharmaceutical Co.**
3. Whether attention is focused on a particular aspect of entity's business that's separately disclosed in FS like in case of **newly acquired business.**

Use of Benchmarks in Determining Materiality for F.S. as a whole [Nov-20]

Determining materiality involves exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for F.S. as a whole.

Factors that may affect identification of an appropriate benchmark include the following:

- The **elements of F.S.** (eg Assets, Liabilities, equity, expenses, revenue)
- Whether there are items on which **attention of the users** of particular entity's F.S. tends to be focused (Users may focus on Revenue, Profit or Net Assets)
- Nature of entity, where entity is at in its **life cycle**, and industry & economic environment in which entity operates
- Entity's **ownership structure** and the way it is financed (If financed solely by debt then more emphasis on assets & charge on them)
- The relative **volatility** of the benchmark

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

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

Profit-oriented entities → PBT from continuing operations

PBT from continuing operations is volatile → gross profit or total revenues.

Chosen Benchmark - Relevant financial data

In relation to chosen benchmark, relevant financial data ordinarily includes -

- **prior periods'** financial results and financial positions,
- **period to-date** financial results and financial position, and
- **budgets** or forecasts for current period,



adjusted for significant changes in circumstances of entity (for eg, significant business acquisition) and changes in industry or economic environment in which entity operates.

Revision in Materiality as Audit Progresses [MTP Oct-19]

Materiality for F.S. as a whole (and, if applicable, materiality level or levels for particular ABCD) may need to be revised as a result of a

- **change in circumstances** that occurred during audit (for eg, a decision to dispose of major part of entity's business),
- **new information**, or
- **change in auditor's understanding** of entity and its operations as a result of performing FAP.

Eg: If during audit actual financial results are likely to be substantially different from anticipated financial results used initially to determine materiality for F.S. as a whole, auditor revises materiality.

If auditor concludes lower materiality for F.S. as a whole (and, if applicable, materiality level or levels for particular ABCD) than initially determined, auditor shall **determine whether it is necessary to revise performance materiality**, and whether NTE of FAP remain appropriate.

Documenting the Materiality

Audit documentation shall include following amounts and factors considered in their determination:

- a. **Materiality** for **FS** as a whole
- b. If applicable, materiality level or levels for particular **ABCD**
- c. **Performance materiality** and
- d. Any **revision** of (a)-(c) as audit progressed

Materiality and Audit Risk

Concept of materiality is applied by auditor both in

- **planning and performing audit**, and
- in evaluating **effect of identified misstatements** on audit & **uncorrected misstatements**, if any, on FS and in forming opinion in auditor's report.

Materiality and Audit Risk are considered throughout audit, in particular, when:

- a. Identifying and assessing the risks of material misstatement;
- b. Determining the nature, timing and extent of further audit procedures; and
- c. Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

*"Habits are built over time, develop the **RIGHT** ones"*



SA 530: Audit Sampling

Sampling: An Audit Procedure

No conscious effort in human society is divested of economic considerations and auditing is no exception. Explain.

Traditional Approach [100% checking]

Growing realisation that it's **economically wasteful** because all efforts are directed to **check all transactions without any exception**.

Leading to **more emphasis on routine checking**, often not necessary in view of time & cost involved.

Modern Approach of Sampling

With **shift in favour of formal internal controls** possibilities of routine errors & frauds greatly diminished i.e internal controls fulfil **purpose of Prevention, Detection & Correction of Frauds/Errors**.

Thus auditors often **find extensive routine checking as nothing more than a ritual** because it seldom reveals anything material.

Now,

- approach to audit and
- extent of checking

are undergoing a progressive change in favour of **more attention towards Ques of principles & controls** with a reduction in nonconsequential routine checking.

By routine checking we traditionally think of **extensive checking and vouching of all entries**, ignoring concept of materiality.

Extent of checking is primarily a matter of judgment of auditor, nothing statutorily stated anywhere that specifies

- what is to be done,
- how it is to be done and
- to what extent it has to be done.

➤ Also **not obligatory** that auditor must **adopt sampling technique**.

Conclusion:

➤ Auditor has to **express opinion on F.S.** To ensure good & reasonable std of work, he should adopt **stds & techniques** that help him make informed professional opinion.

Ch-6 Materiality/Sampling/Evaluation of Misstatements



- If he decides to do part checking (i.e sampling), he should **adopt standards & techniques which are widely followed** and which have a recognised basis.
- Since **statistical theory of sampling is based on a scientific law**, it can be relied to a greater extent than any other technique which lacks in basis and acceptability.
- This **enables auditor to make conclusions** and express **fair opinion** without having to check all of items within FS.

Audit sampling

Refers to

- **application** of audit procedures
- to **less than 100% of items** within a population relevant under audit,
- such that all sampling units (i.e all the items in the population)
- have **equal chance of selection**.

To ensure that items selected represent entire population enabling auditor to draw conclusions & express his opinion.

Objective of auditor is to provide a **reasonable basis to draw conclusions** about population from which sample is selected.

Sampling and Non-Sampling Risk [MTP Apr-21/Jan-21]

Sampling Risk: Risk that auditor's **conclusion based on a sample may be different** from conclusion if entire population were subjected to same audit procedure.

This risk will always be in existence when auditor uses sampling technique in conducting his audit.

If acceptable Sampling risk is LOW → LARGER sample size needed [OBVIOUSLY 😊]

Sampling risk can lead to 2 types of erroneous conclusions:

(i) In case of TOCs concluding controls are more effective than they actually are, or in case of TODs concluding material misstatement doesn't exist when in fact it does.

- It **affects audit effectiveness** and is more likely to **lead to inappropriate audit opinion**.
- This is because of **over reliance** on internal controls.

(ii) In the case of TOCs concluding controls are less effective than they actually are, or in case of TODs concluding material misstatement exists when in fact it does not.

- This type of erroneous conclusion **affects audit efficiency** as it would usually lead to additional work to establish that initial conclusions were incorrect.

Ch-6 Materiality/Sampling/Evaluation of Misstatements

- This is because of **under reliance** on test of controls and detailed substantive procedures performed by auditor.
- Here risk of giving wrong opinion is minimum but it will lead to more detailed checking which is time consuming.

Non-Sampling Risk

Risk that auditor reaches an erroneous conclusion for any reason not related to sampling risk. It can never be mathematically measured.

Sources of Non Sampling risk are:

- Human Mistakes
- Misinterpreting the sample results
- Applying audit procedures not appropriate to the objectives of audit
- Relying on erroneous information e.g. erroneous confirmation

POPULATION

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

Characteristics of Population

1. Appropriateness: Population should be appropriate for specific audit objective i.e. **Relevant**.

Why? Samples drawn are subjected to Audit procedures & conclusions projected to population.

Eg. If auditor's objective

- To test **overstatement** of a/c receivable, then population → accounts receivable **listing**.
- When testing for **understatement** of a/c payable, population would not be accounts payable listing, but rather **subsequent disbursements**, unpaid invoices, suppliers' statements, unmatched receiving reports, or other populations would provide audit evidence of the same.

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

3. Reliable: Information upon which the audit sampling is performed is sufficiently complete and accurate. If population is not reliable wrt accuracy and source, sample drawn will not be relevant for specific audit objective.



Sampling Unit

Individual items that make up population are known as sampling units. Population can be divided into sampling units in a variety of ways.

Example: If auditor's objective were to test validity of a/c receivables, sampling unit could be defined as customer balances or individual customer invoices.

Sample must be representative:

Closely similar to whole population although not necessarily exactly same. Sample must be large enough to provide statistically meaningful results.

Approaches to Sampling

Audit sampling can be applied using either:

Statistical sampling → Approach to sampling that has

- ✓ **random selection** of sample units; &
- ✓ **use of probability theory** to evaluate sample results.

Sample is chosen by applying certain **mathematical and statistical methods**.

Non-statistical

Sampling approach that doesn't have above features is considered as non-statistical sampling.

Statistical Sampling- More Scientific

- More scientific than testing based on auditor's own judgment because it involves use of **mathematical laws of probability** in determining sample size.
- It has reasonably wide application where population consists of **large no. of similar items** and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.
- There is **no personal bias** of auditor. Since it is scientific, results can be evaluated and projected on population in a more reliable manner.

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

For Example: If there are more than 45k purchase transactions in a year, in such case, statistical sampling will be highly recommended in audit program. Random Sampling is the method you decide to choose sample in such a situation.

Advantages of statistical sampling may be summarized as follows - [MTP Oct-20]

1. Sample selection is **More Objective** and thereby more defensible.
2. May provide **better description of a large MAAss of data** than a complete examination of all data, since non-sampling errors such as processing and clerical mistakes not as large.
3. Method provides a means of **estimating MInimum sample size** associated with a specified risk and precision.
4. Amount of **testing (sample size) doesn't increase** in proportion to increase in size of area (universe) tested.
5. It is **widely accepted** way of sampling as it is more scientific, without personal bias & result can be evaluated and projected in more reliable way.
6. It provides a means for **deriving a "calculated risk"** & corresponding precision (sampling error) i.e. probable difference in result due to use of a sample instead of examining all records in the group (universe), using same audit procedures.

The screenshot shows a software interface for calculating sample size. It includes the following fields and controls:

- Client Name:** Text input field.
- Year End:** Text input field.
- Tolerable Error:** Text input field.
- Nature of Substantive Test:** Text input field.
- Population Value:** Text input field.
- Combined Risk Assessment:** Dropdown menu.
- Assurance From Other Substantive Procedures:** Dropdown menu.
- Key Items Section:**
 - Cutoff:** Text input field.
 - Total Dollar Amount:** Text input field.
 - Number:** Text input field.
 - Description:** Text area with scrollbars.
- Sample Analysis Section:**
 - Number of Key Items:** Text input field.
 - Representative Sample Size:** Text input field.
 - Total Items to be Tested:** Text input field.
- Sample Selection Technique:** Dropdown menu.
- Number of Errors Planned For:** Dropdown menu.
- Calculate Sample Size:** Button.
- Exit:** Button.

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O Momma!



Sample DESIGN, SIZE & SELECTION of items for testing

Sample Design

When designing an audit sample,

- Purpose:** Auditor's consideration includes **specific purpose to be achieved** and **combination of audit procedures** that is likely to best achieve that purpose.
- Nature of Audit Evidence:** Consideration of **nature of audit evidence sought** and **possible deviation or misstatement** conditions that will assist auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.
- Completeness:** As per SA 500 "Audit Evidence", when performing audit sampling, auditor performs audit procedures to obtain evidence that population is complete.

Example : TODs relating to **existence of accounts receivable** [PURPOSE].

Using External Confirmation Procedure to get **confirmation** [Audit Procedure & Evidence].

- If payments made by customer before confirmation date but received shortly after that date by client → NOT considered a misstatement.
- Also, a wrong posting between customer accounts does not affect total a/c receivable balance.

Therefore, not consider this as misstatement in evaluating sample results of this audit procedure, though it may have **important effect on other areas** of audit, such as assessment of **risk of fraud** or **adequacy of allowance for doubtful accounts**.

Stratification and Value-Weighted Selection [RTP Nov-21]

In considering characteristics of population from which sample will be drawn, auditor may determine that stratification or value-weighted selection is appropriate.

Stratification: Audit **efficiency may be improved** if auditor stratifies a population by dividing it into discrete sub-populations (Stratum) which have identifying characteristics.

Objective is to **reduce variability of items within each stratum** and therefore allow sample size to be reduced without increasing sampling risk.

- When performing TODs, population is often **stratified by monetary value**. This allows greater audit effort to be directed to larger value items, as these items may contain greatest potential misstatement in terms of overstatement.
- Similarly, population may be stratified according to a **particular characteristic that indicates a higher RoMM**, for eg, when testing allowance for doubtful accounts in valuation of a/c receivable, balances may be stratified by age.
- Results of samples drawn under each sub population are **projected to that respective stratum**.
- To draw opinion on overall population, **combine results of all stratum**s to check for possible deviation or RoMM.

Ch-6 Materiality/Sampling/Evaluation of Misstatements

- Projected misstatements of each stratum will be combined together to consider possible effect of misstatement in account balances and class of transactions.

Example: 20% of items in population may make up 90% of value of a/c balance. Auditor may decide to examine a sample of these items. Results of this sample allow conclusion on 90% of value separately from remaining 10% (on which a further sample maybe taken or considered immaterial).

Value-Weighted Selection: When performing TODs it may be efficient to **identify sampling unit as individual monetary units** that make up population.

- Selecting specific monetary units** from population, for eg, a/c receivable balance, auditor may examine individual balances, that contain those monetary units.
- One benefit is that audit **effort is directed to larger value items** as they have greater chance of selection & can result in **smaller sample sizes**.
- This approach may be **used in conjunction with systematic method of sample selection** & is **most efficient** when selecting items using random selection.

Sample Size

- Sample size should sufficient to **reduce sampling risk to an acceptably low level**.
- Level of sampling risk that auditor is willing to accept affects the sample size required.
- Lower the risk auditor is willing to accept, greater the sample size will need to be.

Factors affecting sample size for TOC & TOD

TOCs

- An increase in extent to which auditor's risk assessment takes into account relevant controls: Increase
- An increase in tolerable rate of deviation: Decrease.
- An increase in expected rate of deviation of population to be tested: Increase
- Increase in auditor's desired level of assurance that tolerable rate of deviation is not exceeded by actual rate of deviation in population: Increase
- An increase in number of sampling units in population: Negligible effect

TODs

- Increase in auditor's assessment of RoMM: Increase
- Increase in use of other substantive procedures directed at same assertion: Decrease
- Increase in auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in population: Increase
- Increase in tolerable misstatement: Decrease
- Increase in amount of misstatement auditor expects to find in population: Increase
- Stratification of the population when appropriate: Decrease

Extent of Checking on Sampling Plan [RTP May-19/Nov-20]

Factors that should be considered for deciding extent of checking on a sampling plan are:

1. **Size of organisation** under audit.
2. State of the **internal control**.
3. Adequacy and **reliability of books** and records.
4. **Tolerable error** range.
5. Degree of the **desired confidence**.

Selection of Items for Testing

- Select items for sample such that each sampling unit in population has a chance of selection.
- Statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected.
- Non-statistical sampling, judgment is used to select sample items.

Sample Selection Methods

Some of the important methods of selecting the sample are discussed below -

1. **Random Sampling**: It ensures all items in population or within each stratum have a known chance of selection. It may involve **use of random number tables**.

Random sampling includes 2 very popular methods which are discussed below-

(i) **Simple Random Sampling**: Each unit of whole population has **equal chance of selection**.

- ✓ Considered **simple, easy to use** & provide assurance that **auditors' bias doesn't affect selection**.
- ✓ Each item is selected using random number table with computer or picking up a number in a random way (may be randomly from a drum).
- ✓ Considered appropriate provided population consists of **reasonably similar units** & fall within **reasonable range** i.e its suitable for a homogeneous population having similar range.

Example

Population can be considered homogeneous, if say, trade receivables balances fall within range of ₹55,000 to ₹2,25,000 and not in the range between ₹525 to ₹10,50,000.

(ii) **Stratified Sampling**: Involves dividing whole population to be tested in a **few separate groups called strata** & taking a sample from each of them.

- ✓ **Each stratum** treated as a **separate population** & **proportionate items** selected from each stratum.
- ✓ **No. of groups** into which whole population is divided is based on **auditor judgment**.



Ch-6 Materiality/Sampling/Evaluation of Misstatements

Example

In above case, trade receivables balances may be divided into 4 groups as follows:-

- (a) balances in excess of ₹10,00,000; [100% testing]
- (b) balances in the range of ₹7,75,001 to ₹10,00,000; [50% testing]
- (c) balances in the range of ₹5,50,001 to ₹7,75,000; [25% testing]
- (d) balances in the range of ₹ 2,25,001 to ₹5,50,000; [10% testing]
- (e) balances ₹2,25,000 and below [2% testing]

- ✓ **Random sample is chosen** from each stratum using random number tables.
- ✓ Reasoning behind stratified sampling is that for a **highly diversified population, weights should be allocated** to reflect these differences.
- ✓ This is **achieved by selecting different proportions** from each strata.
- ✓ It is **extension** of simple random sampling.

(2) **Interval Sampling or Systematic Sampling:** No. of sampling units in population is divided by sample size to give a sampling interval.

Eg. In a population of 5,000 units with 100 samples to be selected. Sampling interval will be 50, and having determined a starting point within first 50, each 50th sampling unit thereafter is selected.

- ✓ Although **starting point** may be determined **haphazardly**, sample is likely to be **truly random** if its determined by use of a computerized random number generator or random number tables.
- ✓ Ensure that **sampling units** within population are **not structured** in such a way that **sampling interval corresponds** with a **particular pattern** in population.
- ✓ **Multiple random starting points** taken because it **minimises risk** of **interval sampling pattern** with that of the population being sampled.

(3) **Monetary Unit Sampling:** It is a type of **value-weighted selection** in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(4) **Haphazard sampling:** Auditor selects sample **without following structured technique**.

- Although no structured technique is used, auditor would **avoid conscious bias** (for eg, avoiding difficult to locate items, or always choosing or avoiding first or last entries on a page) and thus attempt to ensure that all items in population have a chance of selection.
- Haphazard selection is **not appropriate when using statistical sampling**.

(5) **Block Sampling:** Involves selection of **block(s) of contiguous items** within population. **Cannot ordinarily be used in audit sampling** because most populations structured such that items in a sequence can have **similar characteristics to each other**, but **different characteristics from items elsewhere in population**.



Example: Either Take 1st 200 sales invoices from sales day book in month of Sep; OR take any 4 blocks of 50 sales invoices. Therefore, once the first item in block is selected, rest of the block follows items to completion.

There is a close similarity between this method and non-statistical sampling. Consequently it has similar characteristics, namely, simplicity and economy. On other hand there is a **risk of bias and establishing a pattern of selection** which may be noted by auditees.

Performing Audit Procedures

Perform audit procedures, appropriate to the purpose, on each item selected.

"If audit procedure is not applicable to selected item, auditor shall perform the procedure on a replacement item"

Examples:

1. Cancelled cheque is selected as evidence of payment authorization. If auditor is satisfied that cheque has been properly cancelled then it does not constitute a deviation. Replacement would mean a proper and valid cheque through which payment has been made.

2. If all transactions of computerized sales are being checked, for eg sales recorded through a bar code scanner, and incidentally a sample of manual billing gets selected, then such item can be replaced after adequately checking the correctness of the manual bill with the supporting documents available. If replacement is not possible or reasonable, alternative audit procedure can be applied.

If auditor is **unable to apply**

- designed audit **procedures**, or suitable alternative procedures,
- to a selected item, auditor shall treat that item as a **deviation** from prescribed control, in case of TOCs, **or misstatement**, in case of tests of details.

Eg.

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

2. No reply received in response to positive confirmation request. Suitable alternative procedure might be examination of subsequent cash receipts together with evidence of their source and items they are intended to settle.

Nature and Cause of Deviations and Misstatements

Common Feature → Check All:

- ✓ In analyzing identified deviations and misstatements, auditor may observe they have a common feature, for eg, type of transaction, location, product line or period of time.
- ✓ In such cases, auditor may decide to identify all items that possess common feature, & extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate possibility of fraud.

"Will it be always possible to check all?"

Investigate [Representative misstatement or Anomaly]

- ✓ Auditor shall investigate nature and cause of any deviations or misstatements identified, and evaluate possible effect on audit procedures and other areas of audit.
- ✓ In extremely rare circumstances when auditor considers a misstatement or deviation to be an anomaly, auditor shall obtain high degree of certainty that such misstatement or deviation is not representative of population. Auditor shall perform additional audit procedures to obtain SAAE that misstatement or deviation does not affect remainder of population.

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

Projecting Misstatements [Nov-20]

- ✓ Auditor project misstatements for population to obtain broad view of scale of misstatement but this projection may not be sufficient to determine amount to be recorded.
- ✓ When misstatement is considered anomaly, its excluded when projecting misstatements to population. However, effect of such misstatement, if uncorrected, still needs to be considered in addition to projection of non-anomalous misstatements.
- ✓ For TOD, auditor shall project misstatements to population whereas for TOCs, no explicit projection of deviations is necessary since sample deviation rate is also projected deviation rate for population.

Evaluating Results of Audit Sampling

Auditor shall evaluate-

- a. Results of sample; and
- b. Whether use of audit sampling has provided a reasonable basis for conclusions (RBFC) about population tested.

Precautions to be taken while applying test check techniques are: [July-21]

- Thorough study of accounting system should be done before adopting sampling
- Proper study of internal control systems.

Ch-6 Materiality/Sampling/Evaluation of Misstatements



- **Areas which are not suitable** for sampling should be carefully considered. Eg: compliance with statutory provisions, transactions of unusual nature etc.
- **Proper planning** for Sampling methods to be used and explaining the staff,
- Transactions and balances have to be properly classified (**stratified**)
- **Sample size** should be appropriately determined.
- Sample should be chosen in **unbiased way**,
- **Errors located** in the sample should be analysed properly.

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Proper planning	
Errors	
internal Control Systems	
Accounting Systems	
Areas not suitable	
Unbiased way	
Transactions	
Sample Size	

Tolerable misstatement - **Monetary amount** set by auditor in respect of which auditor seeks to **obtain an appropriate level of assurance** that monetary amount set by auditor is **not exceeded by actual misstatement** in population.

Tolerable rate of deviation - Rate of deviation from prescribed internal control procedures set by auditor in respect of which auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.



Objective

Objective of auditor is to evaluate:

- Effect of identified misstatements on audit and
- Effect of uncorrected misstatements, if any, on F.S

Accumulation of Identified Misstatements

Auditor shall accumulate misstatements identified during audit, **other than clearly trivial**.

- Misstatement may arise from variety of factors.
- For eg, **inaccuracy in gathering or processing data** from which FS prepared **or omission** of amount or disclosure can result into a misstatement.
- An entity has **wrongly capitalized machinery repair expenses** ₹5 lacs resulting in overstatement of profits. It is eg. of misstatement.

Consideration of Identified Misstatements as Audit Progresses

Auditor shall determine whether overall audit strategy and audit plan need to be revised if:

- Nature** of identified misstatements and **circumstances** of their occurrence **indicate** that **other misstatements may exist** that, when aggregated with accumulated ones, could be material or
- Aggregate of misstatements accumulated approaches materiality** determined as per SA 320.

Auditor may **request management** to **examine a ABCD** for **mgt** to

- **understand cause of misstatement** identified by auditor,
- **perform procedures** to determine amount of **actual misstatement** in the ABCD, and
- **make appropriate adjustments** to FS.

Such a request may be made, for eg, based on auditor's projection of misstatements.

If, at auditor's request, **mgt examined & corrected** misstatements that were detected, auditor shall **perform additional audit procedures** to determine **whether misstatements remain**.

Communication and Correction of Misstatements

- Auditor shall communicate all misstatements accumulated during audit with appropriate level of mgt. Requesting mgt to correct those misstatements.
- If mgt refuses, obtain understanding of reasons for not making corrections and evaluate whether F.S. as whole are free from material misstatement. [Maybe an indicator of mgt bias]



Uncorrected misstatements
Misstatements that auditor has accumulated during audit and not corrected.

Prior to evaluating effect of uncorrected misstatements, auditor shall reassess materiality determined in **as per SA 320**, to confirm whether it remains appropriate in context of entity's actual financial results.

Auditor shall **determine whether uncorrected misstatements are material**, individually or in aggregate. In making this determination, auditor shall consider- (size & effect)
(i) **Size & nature of misstatements**, both in relation to particular ABCD and F.S. as whole, and particular **circumstances** of their occurrence &
(ii) **Effect of uncorrected misstatements related to prior periods** on relevant ABCD, and F.S. as a whole.

Communication with TCWG:

Auditor shall **communicate with TCWG** uncorrected misstatements and effect on opinion in auditor's report, unless prohibited by law or regulation.

Auditor's communication shall **identify material uncorrected misstatements individually**.

Auditor shall **request** that **uncorrected misstatements be corrected**.

Written Representation

Auditor shall **request** for **WR** from mgt and TCWG that they believe effects are immaterial to FS. as a whole. A summary of such items shall be included in or attached to the WR.

Documentation regarding misstatements identified during audit

Audit documentation shall include: -

- Amount below which misstatements would be regarded as clearly **trivial**
- All **misstatements accumulated** during audit and whether they have **been corrected** and
- Auditor's **conclusion** as to **whether uncorrected misstatements are material**, individually or in aggregate, and **basis** for that conclusion.

"Only thing between YOU & SUCCESS is Discipline"

Ch-7 Automated Environment

Automated environment refers to business environment where

- ✓ processes,
- ✓ operations,
- ✓ accounting and
- ✓ even decisions

are carried out by using computer systems - also known as Information Systems (IS) or Information Technology (IT) systems.

Key features of an Automated Environment

- ✓ Enable **Faster** Business Operations
- ✓ **Connectivity & Networking** Capability
- ✓ Accuracy in **Data** Processing & Computation
- ✓ Ability to process **Large Volumes** of Transn
- ✓ **Better Security** & Controls
- ✓ **Less** prone to **Human Errors**

[RTP Nov-19]

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Understanding and Documenting Automated Environment [RTP Nov-19/22]

Some points that an auditor should consider to obtain an understanding of Cos's A/E:

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

Understanding → documented (SA 230: Audit Documentation] using any std format or template.

Risks arising from use of IT Systems

Given below are some such risks that should be considered:

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

Impact of IT related risks

If IT Risks not mitigated, such risks, could have an impact on audit in different ways discussed as under: -

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 substantive checking

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

Impact on reporting

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

Types of Controls in an automated environment

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

- A. General IT controls
- B. Application controls
- C. IT-dependent controls

Ch-7 Automated Environment

(A) General IT controls

General IT controls are **policies and procedures** that relate to **many applications** and **support effective functioning of application controls**.

General IT-controls that **maintain integrity** of information and **security of data** commonly include controls over the following:

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

These are IT controls generally implemented to mitigate IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, **General IT controls** are known as "**pervasive**" or "**indirect**" controls.

(a) Controls over Data centre and network operations

Objective: Ensure that production systems are processed to meet financial reporting objectives.

Activities:

- ✓ **Overall Management** of Computer Operations Activities
- ✓ **Batch jobs** - preparing, scheduling and executing
- ✓ **Backups** - monitoring, storage & retention
- ✓ **Performance Monitoring** - operating system, database and networks
- ✓ **Recovery from Failures** - BCP (Business Continuity Plan), DRP (Data Recovery Plan)

(b) Program Change

Objective: Ensure that modified systems continue to meet financial reporting objectives.

Activities:

- ✓ Change management process
- ✓ Change Requests - record, manage, track
- ✓ Making & Testing Changes

(c) Access Security

Objective: Ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.

Activities:

- ✓ Security Organization & Management
- ✓ Security Policies & Procedures



Ch-7 Automated Environment

- ✓ Application Security
- ✓ Data Security
- ✓ Operating System Security
- ✓ Network Security
- ✓ Physical Security

(d) Application system acquisition, development, and maintenance

Objective: Systems are developed, configured and implemented to meet financial reporting objectives.

Activities:

- ✓ Overall Mgmt. of Development Activities
- ✓ Project Initiation
- ✓ Analysis & Design
- ✓ Construction
- ✓ Testing & Quality Assurance

Application Controls include both automated or manual controls that **operate at a business process level**. These are **embedded into IT applications** viz., ERPs and help in ensuring **completeness, accuracy and integrity of data** in those systems.

Eg of automated applications include

- ✓ **edit** checks and validation of input data,
- ✓ **sequence** number checks,
- ✓ **user** limit checks,
- ✓ **reasonableness** checks,
- ✓ **mandatory** data fields.

IT dependent Controls are basically **manual controls** that make use of some form of data or information or report produced from IT systems and applications.

- ✓ Even though control is **performed manually**, design and effectiveness of such controls **depends on reliability of source data**.

Conclusion:

Due to inherent dependency on IT, effectiveness and reliability of Automated application controls and IT dependent controls require General IT Controls to be effective.

General IT Controls vs. Application Controls

These two categories of control over IT systems are **interrelated**.

Relationship b/w the application controls and General IT Controls is such that

- ✓ General IT Controls are needed to **support functioning of application controls**, and
- ✓ **both are needed** to ensure **complete and accurate information processing** through IT systems.

Testing Methods [MTP Oct-18]

There are basically 4 types of Audit Tests used:

- ✓ Inquiry
- ✓ Observation
- ✓ Inspection
- ✓ Reperformance

Inquiry is the **most efficient** audit test but it also gives the **least audit evidence**. Hence, inquiry should always be **used in combination** with any one of other audit testing methods. Inquiry **alone is not sufficient**.

Reperformance is **most effective** as an audit test and gives the best audit evidence. However, testing by reperformance could be very **time consuming** and **least efficient** most of the time.

Applying **inquiry in combination with inspection** gives **most effective and efficient audit evidence**.

Which audit test to use, when and in what combination is **matter of professional judgement** and will **vary depending on several factors** including risk assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business, assertions being addressed, etc.

Auditor should **document nature of test** (or combination of tests) + **judgements** in audit file as per SA 230.

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

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

Characteristics of Manual & Automated Elements of Internal Control
Relevant to Auditor's Risk Assessment

An entity's **system of internal control** contains **manual and automated elements**.

Characteristics of manual or automated elements are **relevant** to auditor's **risk assessment** and **further audit procedures** based thereon.

Use of manual or automated elements in internal control also **affects manner in which transactions** are **initiated, recorded, processed, and reported**:

(a) Controls in a manual system may include such procedures as **approvals** and **reviews** of transactions, and **reconciliations** and **follow-up** of reconciling items.

Alternatively, an entity may use **automated procedures** to **initiate, record, process, and report transactions**, in which case records in electronic format replace paper documents.

(b) Controls in IT systems consist of a **combination of automated controls** (for eg, controls embedded in computer programs) and **manual controls**.

Further, **manual controls** may

- ✓ be **independent of IT**,
- ✓ **use info. produced by IT**, or
- ✓ be limited to **monitoring effective functioning of IT** and automated controls, and **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 for the following circumstances:

- ✓ **Large, unusual or non-recurring transactions**.
- ✓ **Circumstances** where errors are difficult to define, anticipate or predict.
- ✓ In **changing circumstances** that require a control response outside the scope of an existing automated control.
- ✓ In **monitoring** the effectiveness of automated controls.

Manual control elements may be **less suitable** for following circumstances:

- ✓ **High volume or recurring transactions** or
- ✓ in situations where **errors that can be anticipated or predicted** can be **prevented, or detected and corrected**, by automated controls
- ✓ **Control activities** where ways to perform the control can be adequately **designed and automated**.



Data Analytics for Audit [RTP May-21]

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

Data analytics is used to perform the following:

- ✓ Check **completeness of data** and population used in either TOCs or substantive audit tests.
- ✓ Selection of **audit samples** - random sampling, systematic sampling.
- ✓ **Re-computation of balances** - reconstruction of trial balance from transaction data.
- ✓ **Reperformance** of mathematical calculations - depreciation, bank interest calculation.
- ✓ **Analysis of journal entries** as required by SA 240.
- ✓ **Fraud investigation.**
- ✓ Evaluating **impact of control deficiencies.**

Let's learn ☺			

Documenting the Risk

Auditor shall document:

- a. **Discussion** among the engagement team and the significant decisions reached
- b. Key elements of **understanding** obtained regarding each of the aspects of entity and its environment and each of internal control components, sources of info. from which understanding was obtained; and RAP performed
- c. Identified and assessed **ROMM** at the F.S. level and at the assertion level and
- d. **Risks identified, and related controls** about which the auditor has obtained an understanding.

Assess & Report Audit Findings [July-21]

At conclusion of each audit, findings or exceptions in IT environment & controls need to be assessed and reported to mgt and TCWG viz., BODs, Audit committee.

Some points to consider are as follows:

- ✓ Are there **any weaknesses** in IT controls?
- ✓ What is **impact of these weaknesses** on overall audit?
- ✓ **Report deficiencies to mgt** - Internal Controls Memo or Management Letter.
- ✓ **Communicate in writing any significant deficiencies to TCWG.**

Auditor assess each finding or exception to determine impact on audit and evaluate if exception results in deficiency in internal control.

SA 500: Audit Evidence

- Audit evidence is **info used by auditor** in arriving at **conclusions** on which auditor's **opinion** is based.
- Includes both info. contained in accounting records underlying the FS and other information.

Q. Auditor of Fresh and Well Ltd explained to the audit team members about relationship b/w Audit Evidence and Opinion of Auditor. Explain.

While conducting audit of a Co, auditor obtains audit evidence and basis that auditor forms an audit opinion on F.S. of that Co.

Explaining this further, audit evidence includes:-

(1) Information contained in the accounting records: Accounting records include

- ✓ records of initial a/c entries and supporting records, such as checks and records of EFTs
- ✓ invoices
- ✓ contracts
- ✓ general and subsidiary ledgers, JEs and other adjustments to F.S. not reflected in JEs and
- ✓ records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

(2) Other information that authenticates a/c records and also supports auditor's rationale behind true and fair presentation of F.S.

For example

- ✓ **minutes** of meetings,
- ✓ **written confirmations** from trade receivables and trade payables,
- ✓ **manuals** containing details of internal control etc.

Combination of tests of a/c records & other information is generally used by auditor to support his opinion on the FS.

Sufficiency and Appropriateness of Audit Evidence [SAAE]

- Auditor shall design and perform audit procedures for purpose of obtaining SAAE.
- Audit evidence is necessary to support auditor's opinion and report.
- It also includes information obtained from other sources such as previous audits.
- In addition to other sources entity's a/c records are an important source of audit evidence.
- Also, audit evidence may have been prepared using work of a mgt's expert.
- Audit evidence comprises both info. that supports and corroborates mgt's assertions, and any info. that contradicts such assertions.



- In some cases, absence of info (for eg, mgt's refusal to provide a requested representation) is used by auditor, and therefore, also constitutes audit evidence.

Sufficiency of Audit Evidence [RTP Nov-20]

- ⇒ It is **measure of quantity** of audit evidence.
- ⇒ It is affected by
 - ✓ auditor's assessment of **risks of material misstatement** (higher the assessed risks, more the audit evidence required) and
 - ✓ **quality** of such audit evidence (higher the quality, the less may be required).

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

(a) **Materiality**: It may be defined as significance of ABCD to users of FS. Less evidence would be required in case assertions are less material to users of FS. If assertions are more material to users of F.S, more evidence would be required.

(b) **RoMM**: Risk that FS are materially misstated prior to audit.

Consists of 2 components at assertion level:

- **Inherent risk**- Susceptibility of an assertion to a misstatement that could be material before consideration of related controls.
- **Control risk**- 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 entity's IC.

Lower ROMM → Less evidence & Higher ROMM → More evidence

(c) **Size of a population**: It refers to no. of items included in population. Less evidence would be required in case of smaller, more homogeneous population but on other hand in case of larger, more heterogeneous populations, more evidence would be required.

Appropriateness of Audit Evidence

It's the **measure of quality** of audit evidence; i.e., its **relevance and reliability** in providing support for conclusions on which auditor's opinion is based.

Relevance

Relevance deals with **logical connection** between purpose of audit procedure and assertion under consideration.

Example

- Purpose of audit procedure is to **test overstatement** in existence or valuation of creditors, **testing recorded creditors** maybe relevant audit procedure.

- But, if testing for **understatement** in existence or valuation of accounts payable, testing recorded accounts payable may not be relevant, but testing information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.
- Given set of audit procedures may provide audit evidence that's relevant to certain assertions, but not others.
- Audit evidence regarding existence of inventory is not substitute for obtaining audit evidence regarding valuation of inventory.

Reliability [RTP May-18]

Reliability of audit evidence is influenced by **source & nature, and circumstances** under which it is obtained, including controls over its preparation and maintenance where relevant.

While recognising that exceptions may exist, following generalisations about reliability of audit evidence may be useful:

- Reliability of audit evidence is increased when it is **obtained from independent sources** o/s entity. Reliability of A.E. that is **generated internally** is increased when **related controls** over its preparation and maintenance are **effective**.
- Audit evidence obtained **directly by auditor** (for eg, observation of application of a control) is more reliable than A.E. obtained indirectly or by inference (for eg, inquiry about application of a control).
- A.E. in **documentary form**, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for eg, a contemporaneously written record of a meeting is more reliable than subsequent oral representation of matters discussed).
- A.E. provided by **original documents** is more reliable than one provided by photocopies or facsimiles, or that have been filmed, digitised or transformed into electronic form, reliability of which may depend on controls over preparation and maintenance.

Independent Sources/Internally → Directly → Documentary → Original

Audit procedures for obtaining Audit Evidence

(i) Inspection:

Examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a **physical examination** of an **asset**.

Discussion:

- Inspection of records and documents provides audit evidence of **varying degrees of reliability**, depending on their **nature and source** and, in the case of internal records and documents, on the effectiveness of controls over their production.
- An eg of inspection used as a **TOCs** is inspection of **records for evidence of authorisation**.

Ch-8 SA 500/501/505/510

- In addition, inspecting an **executed contract** may provide audit evidence relevant to entity's application of a/c policies, such as **revenue recognition**.
- **Inspection of tangible assets** may provide reliable audit evidence with respect to their **existence**, but **not necessarily** about entity's **rights and obligations** or the **valuation** of assets.
- **Inspection of individual inventory items** may accompany the observation of inventory counting.

(ii) Observation: **Looking at a process or procedure** being performed by others.
Eg. Auditor's observation of inventory count by entity's person, or performance of control activities.

(iii) External Confirmation: Evidence obtained by auditor as **direct written response** from a 3rd party (confirming party), in paper or electronic form or other medium.

(iv) Recalculation: **Checking mathematical accuracy** of documents or records. May be performed manually or electronically.

(v) Reperformance: Auditor's **independent execution of procedures or controls** that were originally performed as part of entity's IC. Eg. Re-performing reconciliation of bank statement, re-performing aging of accounts receivable.

(vi) Analytical Procedures: Evaluations of financial info made by a **study of plausible relationships among both financial and non- financial data**.

Also includes **investigation of identified fluctuations and relationships that are inconsistent** with other relevant info. or deviate significantly from predicted amounts.

(vii) Inquiry: [RTP May-18]

- Inquiry consists of **seeking info of knowledgeable persons**, both financial and non- financial, within or outside entity.
- Inquiries may range from **formal written inquiries to informal oral inquiries**.
- Inquiry is **used extensively** throughout the audit in addition to other audit procedures.
- Evaluating responses to inquiries is an **integral part** of the inquiry process
- Responses to inquiries may provide auditor with **info. not previously possessed or corroborative** audit evidence. Alternatively, responses might provide info. that **differs significantly** from info already obtained, for eg, info regarding possibility of mgt override of controls.
- In some cases, responses to inquiries provide a **basis for auditor to modify or perform additional audit procedures**.
- Although **corroboration** of evidence obtained through inquiry is **important**, in the case of **inquiries about mgt intent**, info. available to support mgt's intent may be limited.

In these cases, **understanding** mgt's **past history** of carrying out its stated intentions, management's stated **reasons** for choosing a particular course of action, & mgt's **ability** to pursue a specific course of action may provide relevant info. to corroborate the evidence obtained through inquiry.

- Auditor may consider it necessary to **obtain WR** from mgt and, where appropriate, TCWG to confirm responses to oral inquiries.

Management Expert [MTP Nov-21]

Who is mgt's expert?

Individual or organisation possessing **expertise in a field other than accounting or auditing**, whose **work is used by entity** in preparing the FS.

When audit evidence has been prepared using work of a mgt's expert, auditor shall:

- Evaluate the **competence, capabilities and objectivity** of that expert
- Obtain an **understanding** of the work of that expert and
- Evaluate the **appropriateness** of that **expert's work** as audit evidence for relevant assertion.

CCO → Understanding → Appropriateness as Audit Evidence

Matters affecting NTE of Audit Procedures in case of info. produced using work of mgt expert

- ✓ The **nature and complexity of matter** to which mgt's expert relates.
- ✓ The **ROMM** in the matter.
- ✓ The availability of **alternative sources of audit evidence**.
- ✓ The **nature, scope and objectives** of mgt's expert's work.
- ✓ Whether mgt's expert is **employed** by entity, or party engaged to provide relevant services.
- ✓ **Extent** to which mgt can exercise **control** or influence over work of mgt's expert.
- ✓ Nature and extent of **controls** within entity over mgt's expert's work.
- ✓ Whether mgt's expert is subject to **technical performance standards** or other professional/industry requirements.
- ✓ **Auditor's knowledge and experience** of mgt's expert's **field of expertise**.
- ✓ Auditor's **previous experience** of work of that **expert**.

Information produced by Entity [IPE Testing]

When using info is produced by entity, auditor shall evaluate whether info. is sufficiently reliable for auditor's purposes:

- Obtaining audit **evidence about accuracy & completeness** of the info. and
- Evaluating whether the info. is sufficiently **precise & detailed** for auditor's purposes.

Inconsistency or Doubts over Reliability of Audit Evidence

If: (a) audit evidence obtained from 1 source is **inconsistent** from another or

(b) auditor has **doubts over reliability** of info. to be used as audit evidence,

→ auditor shall determine what **modifications or additions to audit procedures** are necessary to resolve the matter and consider effect on other aspects of audit.

*"If you can **DREAM** it, you can **DO** it"*

SA 501- "Audit Evidence- Specific Considerations for Selected Items"

Objective of auditor is to obtain SAAE regarding:

- a. Existence and condition of **inventory**
- b. Completeness of **litigation and claims** involving entity and
- c. Presentation and disclosure of **segment information** in accordance with applicable FRF.

Inventory [MTP May-20]

When inventory is **material** to F.S, auditor shall obtain SAAE regarding **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 results of entity's physical inventory counting;
 - (ii) **Observe performance** of mgt's count procedures;
 - (iii) **Inspect** the inventory; and
 - (iv) Perform **test counts**.
- (b) Performing audit procedures over entity's **final inventory records** to determine whether they accurately reflect actual inventory count results.

Evaluate instructions → Observe → Test check + Inspect → Final results recorded

Matters Relevant in Planning Attendance at Physical Inventory Counting [RTP May-20]

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

- ✓ **Locations** at which inventory is held, including **Materiality** of inventory and RoMM at different locations, in deciding at which locations attendance is appropriate
- ✓ **Nature** of inventory.
- ✓ The nature of the **internal cOntrol** related to inventory.
- ✓ Whether adequate **Procedures** are expected to be established and proper instructions issued for physical inventory counting.
- ✓ Whether the entity maintains a **Perpetual inventory system**.
- ✓ The **Romm** related to inventory.
- ✓ **Stages of completion** of work inprogress.
- ✓ The **Timing** of physical inventory counting.
- ✓ Whether assistance of an **auditor's experT** is needed.



Physical Inventory Counting Conducted Other than at the Date of F.S.

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

Relevant **matters for consideration** when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between count date, or dates, and final inventory records are properly recorded include:

- Whether perpetual inventory **records are properly adjusted**.
- **Reliability** of entity's perpetual inventory records.
- **Reasons for significant differences** between info. obtained during physical count & perpetual inventory records.

If Auditor unable to Attend Physical Inventory Counting due to Unforeseen Circumstances

Auditor shall observe physical counts on **alternative date** & perform audit procedures on intervening transactions.

Attendance at Physical Inventory Counting Is Impracticable

Auditor shall perform **alternative audit procedures** to obtain SAAE regarding existence and condition of inventory.

If not possible → **modify opinion** as per SA 705.

Explanation:

This may be due to factors such as **nature and location** of inventory, for eg, inventory is held in a location that may pose **threats to the safety of auditor**.

Persuasive Evidence is MUST

Matter of **general inconvenience** to auditor → **not sufficient** to support a decision by auditor that attendance is impracticable.

As per **SA 200**, matter of **difficulty, time, or cost** is **not valid basis** for auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

Perform Alternate Audit Procedures

For eg inspection of documentation of

- ✓ **subsequent sale** of inventory items acquired or
- ✓ **purchased prior** to physical inventory counting

Modified Opinion

If SAAE not Possible → **Modify Opinion as per SA 705** as a result of scope limitation.

Inventory under custody of 3rd Party

When inventory under custody and control of 3rd party is material to F.S., auditor shall:

- (a) **Request confirmation** from 3rd party as to qty and condition of inventory.
- (b) Perform **inspection** or other audit procedures appropriate in the circumstances.

Other audit procedure may include -

- o **Attending, or arranging for another auditor to attend**, the third party's physical counting of inventory, if practicable.
- o **Obtaining another auditor's report, or a service auditor's report**, on the adequacy of the 3rd party's internal control for ensuring inventory is properly counted & adequately safeguarded.
- o **Inspecting documentation** regarding inventory held by 3rd parties, for eg, warehouse receipts.
- o **Requesting confirmation** from other parties when inventory has been pledged as collateral.

Litigation & Claims [MTP Apr-21]

Q. Pride India Ltd is a manufacturer of various FMCG products. Co. is having several cases of litigation pending in courts. Auditor wanted to identify litigation and claims resulting to risk of material misstatements. Required Suggest the auditor with reference to SAs.

Auditor shall design and perform audit procedures in order to identify litigation and claims involving entity which may give rise to a RoMM, including:

- a. **Inquiry of management** and others within entity, including **in-house legal counsel**;
- b. Reviewing **minutes of meetings** of TCWG and **correspondence** between entity and its **external legal counsel** &
- c. Reviewing **legal expense accounts**.

If auditor assesses RoMM in L/Cs identified, or audit procedures indicate other material L/Cs may exist, auditor shall **seek direct communication with the entity's external legal counsel**.

Further if:

Mgt refuses to permit

Or

External Legal Counsel refuses to respond

AND

Auditor is unable to obtain SAAE by performing alternative audit procedures



Modify opinion in auditor's report as per SA 705

Written Representations:

Auditor shall request WR that all known actual or possible L&Cs that affect F.S. have been disclosed to auditor & accounted for and disclosed as per applicable FRF.

Learn with Fun 😊

Meeting the Legal Counsel

Auditor may judge it necessary to meet entity's external legal counsel to discuss likely outcome of litigation or claims.

This may be the case, for example, where:

- Auditor determines that the matter is a **significant risk**.
- The matter is **complex**.
- There is **disagreement** between mgt & entity's external legal counsel.

Such meetings require mgt's permission and held with a representative of mgt in attendance.

Segment Information [MTP Mar-21]

Auditor shall obtain SAAE regarding presentation and disclosure of segment information in accordance with applicable FRF by:

(a) Obtaining an **understanding of methods** used by mgt in determining segment information.

Further,

- (i) Evaluating whether such methods are likely to result in disclosure in accordance with applicable FRF; and
 - (ii) Where appropriate, testing application of such methods; and
- (b) Performing **analytical procedures** or other audit procedures appropriate in circumstances

Note: Auditor is not reqd to perform audit procedures necessary to express opinion on segment information presented on a stand-alone basis.



Understanding of the Methods Used by Mgt

Eg. of matters relevant when obtaining understanding of methods used by mgt in determining segment info and whether such methods likely to result in disclosure as per applicable FRF include:

- o **Sales, transfers and charges** between segments, and elimination of intersegment amounts.
- o **Comparisons** with budgets and other expected results, for example, operating profits as a percentage of sales.
- o **Allocation** of assets and costs among segments.
- o **Consistency with prior periods**, and the adequacy of the disclosures with respect to inconsistencies

SA 505 External Confirmation

- Audit evidence
- obtained as a **direct written response**
- to the auditor from a **third party** (the confirming party),
- in **paper** form, or by **electronic** or **other medium**.

Definition of other Important Terms [RTP May-20]

Positive confirmation request - Request that confirming party respond directly to auditor indicating whether confirming party **agrees or disagrees** with info. in request, or **providing requested info.**

Negative confirmation request - Request that confirming party respond directly to auditor **only if confirming party disagrees** with info. provided in the request.

Non-response - **Failure** of confirming party to **respond, or fully respond**, to positive confirmation request, or a confirmation request **returned undelivered**.

Exception - Response that indicates a **difference between information requested** to be confirmed, or contained in entity's records, **and info provided** by confirming party.

Exception needs to be assessed to the entire population after analysing reason for difference.

External Confirmation Procedures [RTP May-20]

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

- Determining **information** to be confirmed or requested (क्या जानना है)
- Selecting the **appropriate confirming party** (किस्से जानना है)
- Designing the confirmation requests**, including determining that requests are properly addressed and contain return information for responses to be sent directly to auditor (पूछ लो) &
- Sending the requests**, including follow-up requests when applicable, to confirming party (भेजदो)

Determining the Information to be Confirmed or Requested

Performed to confirm or request information regarding **account balances and their elements**. Also be used to confirm **terms of agreements, contracts, or transactions** between entity and other parties, or confirm absence of certain conditions, such as a "side agreement".

Selecting Appropriate Confirming Party

Relevant & reliable audit evidence if confirming party **knowledgeable** about info. to be confirmed.

Designing Confirmation Requests

Design of a confirmation request may **directly affect confirmation response rate**, and reliability and nature of audit evidence obtained from responses.

Factors to consider when designing confirmation requests include:

- **Layout and presentation** of confirmation request.
- **Assertions** being addressed.
- **Prior experience** on audit or similar engagements.
- Specific identified **RoMM**, including fraud risks.
- **Mgt's authorisation or encouragement** to confirming parties to respond to auditor. Confirming parties may only be willing to respond to a confirmation request containing mgt's authorisation.
- **Method of communication** [for eg, paper form, or electronic mode (like e-mail) or other medium].
- **Ability of intended confirming party** to confirm or provide requested info. (for eg, individual invoice amount versus total balance).

Management's Refusal to Allow the Auditor to Send a Confirmation Request [Nov-20]

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

- a. Inquire as to **mgt's reasons** for refusal, and **seek audit evidence** as to their **validity and reasonableness**
- b. Evaluate **implications of management's refusal** on auditor's assessment of relevant **RoMM**, **including risk of fraud**, and on NTE of other audit procedures
- c. Perform **alternative audit procedures** designed to obtain relevant and reliable audit evidence.
 - ✓ If auditor concludes that mgt's refusal is **unreasonable**, or auditor is **unable to obtain relevant and reliable audit evidence** from alternative audit procedures, auditor shall communicate with TCWG as per **SA 260**.
 - ✓ Auditor also shall determine implications for audit and auditor's opinion as per **SA 705**.

Reasonableness of Management's Refusal?

- ✓ Refusal by mgt is a **limitation on the audit evidence** auditor may wish to obtain.
- ✓ Auditor is required to **inquire as to reasons** for the limitation. A **common reason** is **existence of a legal dispute or ongoing negotiation** with confirming party, which may be affected by an untimely confirmation request.
- ✓ Auditor is required to **seek audit evidence** as to validity and reasonableness of the reasons **because of risk** that mgt may be **attempting to deny** auditor **access** to audit evidence that **may reveal fraud or error**.

Alternative Audit Procedures

- For a/c receivable balances - examining specific **subsequent cash receipts**, shipping documentation, and **sales** near the period-end.
- For a/c payable balances - examining **subsequent cash disbursements** or correspondence from 3rd parties, and other records, such as **goods received notes**.

Positive Confirmation Requests (PCR)

- ✓ PCR **asks confirming party to reply in all cases**, either by indicating agreement with given info, or providing information.
- ✓ Response to PCR is expected to **provide reliable audit evidence**.
- ✓ There is **risk** that confirming party may **reply without verifying** if information is correct.
- ✓ Auditor may **reduce this risk** by **not stating amt** (or other info) on confirmation request, and **ask confirming party to fill amount** or furnish other info.
- ✓ On other hand, **use of this type of "blank" confirmation request** may **result in lower response rates** because **additional effort** is required by confirming parties.

Negative Confirmations [July-21]

Negative confirmations **provide less persuasive audit evidence** than positive confirmations. Accordingly, auditor shall not use negative confirmation requests as sole substantive audit procedure to address an assessed ROMM at assertion level **unless all of following are present**:

- Auditor has **assessed RoMM as low** and obtained SAAE regarding operating **effectiveness of controls** relevant to assertion;
- Population** comprises **large no. of small, homogeneous**, account balances, transactions or conditions;
- A very **low exception rate** is expected; and
- Auditor is **not aware of circumstances** or conditions that would cause recipients of negative confirmation requests to **disregard such requests**.

"Believe you can & you are halfway there"

SA 510- "Initial Audit Engagements- Opening Balances"

- Auditor's **responsibilities relating to opening balances** when conducting initial audit engg.
- In addition to F.S. amounts, opening balances **include disclosures** that existed at beginning of period, such as contingencies and commitments.

Initial Audit Engagement

Engagement in which either:

F.S. for prior period → not audited OR were audited by a predecessor auditor [आप नहीं थे]

Objective of Auditor w.r.t Opening Balances - in conducting an Initial Audit Engagement

To obtain SAAE whether:

- Opening balances** contain misstatements that materially affect current period's FS &
- Appropriate a/c policies** reflected in opening balances have been
 - **consistently applied** in current period's FS or
 - **changes are accounted, presented and disclosed** as per applicable FRF.

Audit Procedures regarding Opening Balances [Nov-18]

Auditor shall obtain **SAAE** whether opening balances contain **misstatements** that **materially affect** current period's FS by:

- Determining whether **prior period's closing balances** have been **correctly b/f** to current period or any adjustments have been disclosed as **prior period items** in current year's P&L
- Determining whether opening balances reflect application of **appropriate a/c policies** and
- Performing one or more of following:
 - Where prior year FS were audited, **perusing copies of audited F.S.**
 - Evaluating whether **audit procedures performed in current period** provide evidence relevant to opening balances or
 - Performing **specific audit procedures** to obtain evidence regarding opening balances

If auditor obtains audit evidence that **opening balances contain misstatements** that **could** materially affect current period's FS → auditor shall perform such **additional audit procedures** to determine effect on current period's FS

If auditor **concludes** that such **misstatements exist in current period's FS**, auditor shall **communicate** → mgt and TCWG.

Nature and extent of Audit Procedures

Nature and extent of audit procedures necessary to obtain SAAE regarding opening balances depend on such matters as:

- Whether prior period's FS were **audited** and, if so, whether the predecessor auditor's opinion was **modified**.
- **Nature of ABCD** and **RoMM** in current period's FS.
- **Significance of opening balances** relative to current period's FS.
- **Accounting policies** followed by entity.

If prior period's FS were audited by a predecessor auditor

- Obtain SAAE regarding opening balances → By **perusing copies of audited FS** including other relevant documents relating to prior period FS such as **supporting schedules** to audited FS.
- Current auditor **can rely on closing balances** of prior period FS, **except** when **performing of current audit procedures possibility of misstatements** in opening balances is **indicated**.

Opening current assets & liabilities → audit evidence obtained during current audit procedures

Debtors/Creditors

Collection (payment) of opening a/c receivable (accounts payable) during current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at beginning of the period.

Inventories

Current period's audit procedures on closing inventory balance provide little audit evidence regarding inventory at beginning of period.

Additional audit procedures may be necessary, and one or more of following may provide SAAE:

- **Observing a current physical inventory count & reconciling** to opening inventory quantities.
- Performing audit procedures on **valuation of opening inventory** items.
- Performing audit procedures on **gross profit & cut-off**.

Non-current assets and liabilities

- i. PPE, investments and long-term debt → Examine **a/c records & other info** underlying opening balances.
- ii. In certain cases, obtain some audit evidence regarding opening balances through **confirmation with 3rd parties**. For eg, **long-term debt and investments**



Consistency of Accounting Policies relating to opening balances

Obtain SAAE whether:

- ⇒ a/c policies reflected in opening balances have been **consistently applied** in current period's FS
- ⇒ whether **changes** have been properly **accounted, presented & disclosed** as per applicable FRF

If not → **Qualified/Adverse Opinion** as per SA 705

Audit Conclusions and Reporting

Unable to obtain SAAE → **Qualified or Disclaimer** of opinion as per SA 705.

Concludes opening balances misstatements → materially affects current period's FS & is not properly accounted, presented or disclosed → **Qualified or Adverse opinion** as per SA 705.

Captain SA 510 will return in SA 710

SA 550- "Related Parties"

Definition of Related Party (RP)

A party that is either:

- a. A related party as defined in applicable FRF or
- b. Where applicable FRF establishes minimal or no RP requirements:
 - i. Person or other entity that **has control or significant influence**, directly/indirectly through one or more intermediaries, **over reporting entity** (who controls)
 - ii. Another entity **over which reporting entity has control or significant influence**, directly/indirectly through one or more intermediaries or (whom we control)
 - iii. Another entity under **common control with reporting entity** having:
 - ⇒ Common controlling ownership
 - ⇒ Owners who are close family members or
 - ⇒ Common key mgt (common control)



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

Meaning of control and significant influence in reference to related party

Many FRFs discuss control and significant influence. They generally explain that:

- a. Control is **power to govern financial & operating policies** of entity to obtain benefits from its activities &
- b. Significant influence (which may be gained by share ownership, statute or agreement) is **power to participate in financial & operating policy decisions** of entity, but is not control over those policies.

Existence of following relationships may indicate presence of control or significant influence:

- i) Direct or indirect **equity holdings or other financial interests** in the entity.
- ii) Entity's holdings of **direct or indirect equity or other financial interests** in other entities.
- iii) Being part of **TCWG or key mgt** (i.e., mgt who have authority and responsibility for planning, directing and controlling activities of entity).
- iv) Being a **close family member** of TCWG or key mgt.
- v) Having a **significant business relationship** with TCWG or Key mgt.

Related Parties with Dominant Influence [Apni chalana]

- ⇒ Related parties having ability to exert **control or significant influence**, may exert **dominant influence over the entity or its mgt.**
- ⇒ Consider such behaviour when identifying and assessing **RoMM due to fraud.**

Nature of Related Party Relationships and Transactions [Nov-23]

Many RPTs are in normal course of business. In such circumstances, they carry no higher RoMM of F.S. than similar transactions with unrelated parties.

However, nature of related party relationships and transactions may, in some circumstances, give rise to higher RoMM of FS than transactions with unrelated parties.

Example

- (i) RPs may operate through **extensive & complex range of relationships and structures**, with corresponding increase in complexity of related party transactions.
- (ii) **Information Systems** may be ineffective at identifying or summarising transactions and o/s balances between entity and RPs.
- (iii) RPTs **not conducted under normal market terms & conditions**; For eg, some RPTs may be conducted with no exchange of consideration.

Understanding Entity's Related Party Relationships & Transactions

Auditor shall **inquire mgt** regarding:

- a. **Identity** of entity's **RPs**, including **changes from** prior period;
- b. Nature of **relationships** between entity and these RPs; and
- c. Whether entity entered into **transactions** with these RPs during the period and, if so, **type and purpose** of transactions.

Auditor shall **inquire mgt and others** within entity, & perform **other risk assessment procedures** considered appropriate, to obtain an **understanding of controls**, if any, mgt has established to -

- a. **Identify, account for, and disclose** RP relationships and transactions as per applicable FRF;
- b. **Authorise & approve significant transactions & arrangements with RPs** and
- c. **Authorise & approve significant transactions & arrangements outside normal course of business.**



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

[RTP Nov-21]

During audit, auditor should **maintain alertness** for RP information while **reviewing records and documents**.

Following records that may provide info. about RP relationships and transactions, for eg:

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

Pairing



SA 560, "Subsequent Events"

Subsequent Events?

- ✓ **Events** occurring between date of F.S. and date of A/R AND
- ✓ **Facts** that become known to auditor after date of A/R.

Date of FS: Date of the end of latest period covered by the F.S. [BS Date]

Date of auditor's report: Date the auditor dated report on F.S as per SA 700.

FS affected by events that occur after date of FS. Many FRFs specifically refer to such events. There can be 2 types of events:

- a. Those that provide evidence of conditions that existed at the date of F.S [Adjusting] and
- b. Those that provide evidence of conditions that arose after the date of F.S. [Non-Adjusting]

Examples of events providing evidence of conditions that existed at date of FS

- Declaration of **insolvency of a major debtor** of entity between date of FS and date of A/R providing **evidence on recoverability of money due from debtor** as on date of FS.
- **Settling a legal claim outside the court** at reduced amount between date of FS and date of auditor's report for which provision already made in FS.

Examples of events providing evidence of conditions that arose after the date of FS

- Issue of **new share capital**.
- Planned **merger** of the company.
- **Destruction of substantial inventories** due to **fire** between date of FS and date of A/R.

Audit Procedure Regarding Events Occurring between Date of FS and Date of A/R [July-21]

- Perform audit procedures to obtain SAAE that all events occurring between date of FS and A/R that require adjustment, or disclosure FS have been identified.

Auditor shall consider auditor's risk assessment, which shall include following:

- a. Obtaining an **understanding of any procedures** mgt established to ensure that subsequent events are identified
- b. **Inquiring of management** and TCWG as to whether any subsequent events have occurred which might affect FS
- c. Reading **minutes**, if any, of meetings, of entity's owners, mgt and TCWG, that have been held after date of FS and inquiring about matters discussed at any such meetings for which minutes not available
- d. Reading entity's **latest subsequent interim FS**, if any.

When, as a result of procedures → auditor identifies events that require adjustment, or disclosure in FS, determine whether each such event is appropriately reflected in FS.

Written Representations with respect to subsequent events:
Request mgt and TCWG, to provide a WR as per SA 580 → all events after date of FS requiring adjustment or disclosure as per FRF have been adjusted or disclosed.

Understanding mgt process → Inquiry → Read [M.O.M + Interim] → WR

*Specific inquiries to be made from mgt:

- ✓ Whether new commitments, borrowings or guarantees have been entered into.
- ✓ Whether sales or acquisitions of assets have occurred or are planned.
- ✓ Whether any assets have been appropriated by govt or destroyed, for eg, by fire or flood.
- ✓ Whether any events have occurred that are relevant to recoverability of assets.
- ✓ Whether there have been increases in capital or issuance of debt instruments, such as issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- ✓ Whether there have been any developments regarding contingencies.
- ✓ Whether any unusual accounting adjustments have been made or are contemplated.
- ✓ Whether any events have occurred or are likely to occur that will bring into Question (?) appropriateness of accounting policies used in F.S, for eg, if such events call into question validity of going concern assumption.
- ✓ Whether any events have occurred that relevant to measurement of estimates or provisions made in FS.

Liabilities >> Assets >> Capital >> Contingencies >> A/c estimates/policies/adjustments

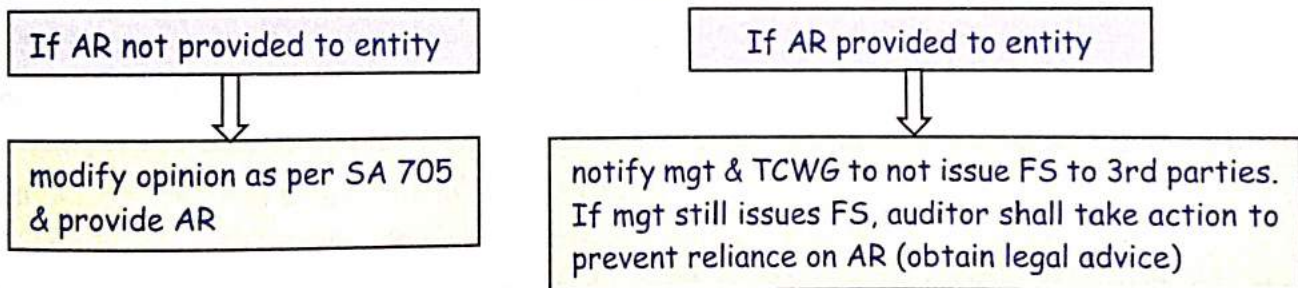
Meaning of "Date the FS are issued"

- Date that A/R and audited FS are made available to 3rd parties.
- Generally depends on regulatory environment of entity.
- In some circumstances, date may be the date that they are filed with a regulatory authority.
- Audited FS can't be issued without A/R, date FS are issued must be
 - ✓ at or later than date of A/R, &
 - ✓ also be at or later than date A/R is provided to the entity.

- Facts that become known to auditor after date of Audit report but before F.S. are issued
- Auditor has **no obligation** to perform any procedure regarding FS after issue of AR.
 - However, if a fact becomes known to auditor that had been known before issue of AR, it may have amended the AR, he shall:
 - **Discuss** matter with mgt & TCWG
 - **Determine** if FS need amendment & if so
 - **Inquire** how mgt intends to address the matter in FS
 - If mgt amends FS, he shall,
 - Carry our audit procedures on amendment
 - **Extend these procedures** to date of new AR &
 - Provide a **new AR** on amended FS dated not earlier than date of approval of amended FS
 - If law or reg. or FRF doesn't prohibit mgt from **restricting amendment** of FS to **subsequent event**, auditor is permitted to restrict audit procedures to that amendment.

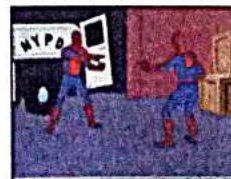
Auditor shall either:

- Amend AR to include an **additional date** that conveys audit procedures restricted to amendment in FS [**Dual Dating**] OR
 - Provide a **new or amended AR** that includes **EOM/OM para** that conveys audit procedures on subsequent events restricted to amendments in FS [**EOM/OM Para**]
- e) If mgt doesn't amend FS when auditor requires:



Facts which become known to auditor after F.S. are issued

- After FS have been issued auditor has **no obligation**.
- However if any fact becomes known to auditor, had it been know at date of A/R, he may have amended the A/R, he shall:
 - **Discuss** with mgt & TCWG
 - **Determine** if FS need amendment & if so,
 - **Inquire** how mgt intends to address the matter
- If mgt amends the FS, auditor shall:
 - Carry out audit procedures necessary in circumstances of amendment



- Review steps taken by mgt that everyone in receipt of previously issued FS with A/R has been informed of the situation
 - If restricted amendment allowed → Dual Dating/SA 706(OM or EOM para)
 - If Not, then Extend audit procures to date of new AR, dated no earlier than date of approval of amended FS
 - Provide a new AR on amended FS
 - In New or amended AR include EOM/OM para referring to note in FS discussing reasons for amendment in FS & AR
- c) If mgt doesn't amend FS & inform users about the situation → auditor shall notify mgt & TCWG that auditor seek to prevent future reliance on A/R.
If despite such notification, mgt & TCWG don't take steps, auditor shall take action to prevent reliance on A/R (obtain legal advice)

SA 570: Going Concern



1. Events/Conditions = E/Cs
2. Going Concern = GC
3. Material Misstatement = MM
4. Material Uncertainty = MU

SA 570 (Revised) on "Going concern" deals with :

- I. Auditor's responsibilities in audit of FS relating to G.C. and
- II. The implications for auditor's report.

Going Concern Basis of Accounting

- FS are prepared on assumption that entity will continue operations for **foreseeable future**.
- General purpose FS are prepared using going concern basis of accounting, unless mgt intends to liquidate entity or cease operations, or has no realistic alternative but to do so.
- When GC basis of accounting is appropriate, assets & liabilities are recorded on basis that entity will be able to **realize its assets & discharge liabilities in normal course of business**.
- Entity is **not a going concern** → FS prepared on **liquidation basis**.

Responsibility for Assessment of Entity's Ability to Continue as a Going Concern [GC]

- a. It is mgt responsibility to assess entity's ability to continue as GC even if FRF doesn't include explicit requirement.
- b. Mgt's assessment of entity's ability to continue as GC involves making **judgment, at particular point in time**, about inherently uncertain future outcomes of events or conditions.
- c. Following factors are relevant to that judgment:
 - **Degree of uncertainty** associated with outcome of an event or condition.
 - **Size and complexity** of entity, nature & condition of business & **degree** to which it is affected by external factors.
 - Any judgment about future is based on info available at the time judgment is made. **Subsequent events** may result in outcomes inconsistent with judgments reasonable at time they were made.

Size & Complexity of entity → Degree [Affected + Uncertainty] → Subsequent events

Auditor's Responsibilities

- Obtain **SAAE** and conclude on, **appropriateness of mgt's use of GC basis** of accounting in preparation of FS
- To **conclude**, based on audit evidence obtained, **whether a material uncertainty (MU) exists about entity's ability to continue as a GC**
- **SA 200** → potential effects of **inherent limitations** on auditor's ability to detect **MM** are greater for **future E/Cs** that may **cause** entity to **cease to continue as GC**
- Auditor **cannot predict** such future events or conditions.
- **Absence of reference** to **MU** about entity's ability to continue as **GC** in A/R **cannot be viewed as a guarantee** as to entity's ability to continue as **GC**

Risk Assessment Procedures and Related Activities

When performing RAP as per SA 315, auditor shall consider whether E/Cs exist that may cast significant doubt on entity's ability to continue as a **GC**

In doing so, determine whether mgt has already performed a preliminary assessment of entity's ability to continue as a **G.C.** &

- a) If assessment performed → **discuss** the assessment **with mgt** & determine whether mgt has **identified E/Cs** that, individually or collectively, cast significant doubt on entity's ability to continue as **GC** and, if so, **mgt's plans** to address them or
- b) If assessment not performed → **discuss with mgt BASIS** for use of **GC** basis of accounting & **inquire** whether **events or conditions** exist that, individually or collectively, may cast significant doubt on entity's ability to continue as **GC**.

Auditor shall **remain ALERT** throughout audit for audit evidence of E/Cs that cast significant doubt over entity's ability to continue as **GC**.

Evaluating mgt assessment of Going Concern [G.C.]

Auditor shall evaluate mgt's assessment of entity's ability to continue as a **GC**. Management's assessment is a key part of auditor's consideration of mgt's use of **GC** basis of accounting.

It is not auditor's responsibility to rectify lack of analysis by mgt.

- In some circumstances, **lack of detailed analysis** by mgt to support its assessment may **not prevent auditor from concluding** whether mgt's use of **GC** basis of accounting is appropriate.
- For eg, when there's **history of profitable operations** & **ready access to financial resources**, mgt may make assessment without detailed analysis.



o In this case, auditor's evaluation of appropriateness of mgt's assessment may be made without performing detailed evaluation if auditor's other procedures sufficient to conclude mgt's use of GC basis of accounting appropriate in circumstances.

In other circumstances, evaluating mgt's assessment of entity's ability to continue as a GC, may include an evaluation of

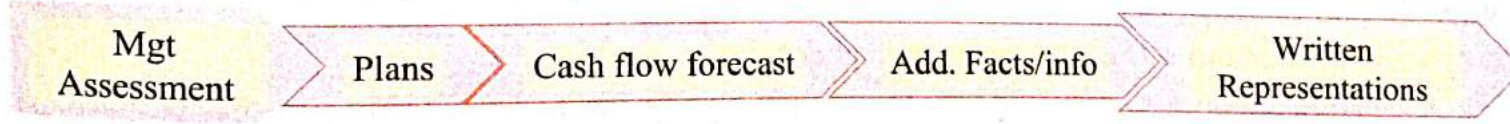
- ✓ process mgt followed to make its assessment,
- ✓ assumptions on which assessment is based &
- ✓ mgt's plans for future action and whether plans are feasible in the circumstances.

In evaluating mgt's assessment of GC, auditor shall cover same period as used by mgt to make its assessment, as required by applicable FRF, or L/R if it specifies longer period.

If mgt's assessment covers less than 12 months from date of FS, request mgt to extend its assessment period to at least 12 months.

Additional Audit Procedures When Events or Conditions Are Identified

- a) Where mgt has not yet performed assessment of entity's ability to continue as going concern, requesting mgt to make its assessment.
- b) Evaluating mgt's plans for future actions, whether outcome of these plans likely to improve situation and whether management's plans are feasible in the circumstances.
- c) Where entity has prepared cash flow forecast, and analysis of forecast is a significant factor in considering future outcome of events or conditions:
 - i. Evaluating reliability of underlying data generated to prepare forecast; and
 - ii. Determining whether there is adequate support for assumptions underlying forecast.
- d) Considering whether any additional facts or info become available since date on which mgt made its assessment.
- e) Requesting written representations from mgt and TCWG, regarding their plans for future actions and feasibility of these plans.



Additional procedures:

- o Analysing and discussing cash flow, profit and other relevant forecasts with mgt.
- o Analysing and discussing entity's latest available interim financial statements.
- o Reading terms of debentures & loan agreements → determining whether breached.
- o Reading minutes of meetings of shareholders, TCWG & committees for reference to financing difficulties.

- o Inquiring of entity's **legal counsel** regarding litigation and claims & reasonableness of mgt's assessments of their outcome & financial implications.
- o Confirming existence, legality and enforceability of **arrangements** to provide or maintain **financial support** with related and 3rd parties and assessing financial ability of such parties to provide additional funds.
- o Evaluating entity's plans to deal with **unfilled customer orders**.
- o Performing audit procedures regarding **subsequent events** to identify those that either mitigate or otherwise affect entity's ability to continue as a going concern.
- o Confirming existence, terms and adequacy of **borrowing facilities**.
- o Obtaining and reviewing reports of **regulatory actions**.
- o Determining adequacy of support for any **planned disposals of assets**.

Auditor's Conclusion

- o Auditor shall evaluate whether **SAAE** obtained & **conclude on appropriateness of mgt's use of GC** basis of accounting in preparation of FS.
- o Based on audit evidence obtained, conclude whether **MU exists** related to E/Cs that, individually or collectively, may cast significant doubt on entity's ability to continue as a GC.
- o A MU exists when **magnitude of impact & likelihood of occurrence** is such that, **appropriate disclosure is necessary**.



Material Uncertainty

Adequacy of Disclosures

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

G.C. is appropriate but MU exists, auditor shall determine whether FS:

- Adequately disclose principal E/Cs** that may cast significant doubt on entity's ability to continue as a GC and **mgt's plans** to deal with these E/Cs and
- Disclose clearly there is **MU** related to E/Cs that may cast significant doubt on entity's ability to continue as a GC & **may be unable to realize its assets and discharge its liabilities in normal course of business**.

E/Cs + Plans + MU + Asset/Liab

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

Auditor shall evaluate whether **FS** provide adequate disclosures about these events or conditions.

Implications for Reporting

Use of Going Concern Basis of Accounting Is Inappropriate

Auditor shall express an **adverse opinion**.

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

Adequate Disclosure of a Material Uncertainty Is Made in F.S. → Express an **unmodified opinion** & report shall include **separate section** under the heading "**Material Uncertainty Related to Going Concern**" to:

- Draw attention** to note in F.S. that discloses the matters; and
- State that these E/Cs indicate that a MU exists that may cast significant doubt on entity's ability to continue as a GC and that **auditor's opinion is not modified** in respect of the matter.

Adequate Disclosure of a Material Uncertainty Is Not Made in F.S.

- Express a **Qualified or Adverse opinion**, as per SA 705 (Revised) &
- In **Basis for Qualified (Adverse) Opinion** section of auditor's report, state that **MU exists** that may cast significant doubt on entity's ability to continue as a GC and **FS don't adequately disclose this matter**.

Management Unwilling to Make or Extend Its Assessment → Consider the implications for A/R. **Qualified or Disclaimer of opinion** may be appropriate, because not possible for auditor to obtain SAAE regarding mgt's use of GC basis of accounting in preparation of FS.

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

Financial

- **Net liability** or net current liability position.
- **Fixed-term borrowings** approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- **Inability to pay creditors on due dates**.
- Indications of withdrawal of financial support by **creditors**.
- Substantial **operating losses** or significant deterioration in value of assets.
- Arrears or **discontinuance of dividends**.
- **Negative operating cash flows** indicated by historical or prospective FS.
- **Adverse key financial ratios**.
- Change from **credit to cash-on-delivery** transactions with suppliers.

Operating

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

Supplies >> Labor + Key mgt >> Loss of Mkt/customer etc >> Competitor >> Mgt intention to liquidate

Other

- Non-compliance with **capital or statutory or regulatory requirements**
- Pending **legal or regulatory proceedings** against entity that may result in claims that entity is unlikely to satisfy.
- **Changes in law or regulation** or government policy expected to adversely affect entity.
- Uninsured or underinsured **catastrophes** when they occur.

Non-compliance CSR → Legal proceedings >> Change in law >> Uninsured Catastrophe



SA 580- "Written Representations"

WR may be defined as a

- ⇒ **written statement** by management provided to the auditor
- ⇒ to **confirm** certain matters or
- ⇒ to **support** other audit evidence.

WR don't include FS, assertions therein, or supporting books and records.

Is WR Enough?

- WR provide **necessary** audit evidence, they **don't provide SAAE** on their own about any of matters with which they deal.
- Fact that mgt has provided reliable WR **doesn't affect nature or extent of other audit evidence** that auditor obtains about fulfilment of mgt's responsibilities, or about specific assertions.

Objectives of Auditor [Jan-21]

(a) To obtain written representations

To obtain WR from mgt & TCWG that they believe that they have fulfilled their responsibility for preparation of FS and for completeness of info provided to auditor.

(b) To support other evidence

To support other audit evidence relevant to FS or specific assertions in FS by means of WR

(c) To respond appropriately

Respond appropriately to WR provided by mgt or if mgt doesn't provide WR requested by auditor

Obtain → Support → Respond

WRs about management's responsibilities

Confirmation of fulfilment of mgt's responsibilities in following areas: -

(I) Preparation of FS

Request mgt to provide a WR that it has fulfilled its responsibility for preparation of FS **as per applicable FRF**, including, where relevant, their **fair presentation**, as per terms of audit engg.

Due to its **responsibility for PPFS and conducting entity's business**, mgt would be expected to have **sufficient knowledge of process** followed by entity in **preparing and presenting FS**.

In some cases, **mgt may** decide to **make inquiries of others** who participate in PPFs and assertions therein, including **individuals** who have **specialized knowledge** relating to matters about which WRs are requested.

Such individuals may include:

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

Qualifying Language allowed?

- **Mgt may include** in WRs qualifying language that WRs are made to **best of its knowledge & belief**.
- **Reasonable to accept such wording** → If auditor satisfied that WRs being **made by those** with appropriate **responsibilities & knowledge** of matters included in WRs.
- To ensure mgt make informed WRs → auditor may **request mgt include in WRs, confirmation** that it has made appropriate inquiries to make requested WRs.

(II) Info provided & completeness of transactions

Request mgt to provide a WR that: -

- It has provided auditor with all relevant info & access agreed in terms of audit engg. and
- All transactions recorded and reflected in FS.

Why Written representations about mgt responsibilities necessary?

Auditor **can't judge solely on other audit evidence** whether mgt has prepared and presented FS and provided info to auditor on the basis of agreed acknowledgement and understanding of its responsibilities.

For eg, auditor can't conclude that mgt has provided auditor all agreed relevant info without asking and receiving confirmation that, such information has been provided.

Reconfirmation from Mgt

Auditor may also ask mgt to reconfirm its acknowledgement and understanding of those responsibilities in WR.

This is particularly appropriate when:

- Terms of audit engagement were prepared in a **previous year**
- Those who signed **terms of audit engg.** on behalf of entity no longer have relevant responsibilities
- There is any indication that **mgt misunderstands** those responsibilities
- **Changes in circumstances** make it appropriate to do so

Previous Year + Signing ppl changed + Misunderstanding + changes in Circumstances



Other SAs require auditor to request WRs. In addition if auditor determines necessary to obtain one or more WRs to support other audit evidence, auditor shall request such other WRs.

Other Written representations
WR in addition to WR on Responsibility of FS
Such WRs may supplement, but do not form part of, written representation relating to mgt's responsibilities regarding preparation of FS.

- They may include representations about the following: -
- ⇒ Whether selection & application of **a/c policies appropriate** and
 - ⇒ Whether following matters recognized, measured, presented or disclosed as per FRF:
 - ✓ **Plans or intentions** that may **affect carrying value or classification of assets & liabilities**
 - ✓ **Liabilities**, both actual and contingent
 - ✓ **Title to, or control over, assets**, the **liens** or **encumbrances** on assets, and assets **pledged** as collateral
 - ✓ Aspects of **laws, regulations and contractual agreements** that may affect the financial statements, including non-compliance.

Written representations about specific assertions

When obtaining evidence or evaluating, judgments and intentions, auditor may consider one or more of the following:

- Entity's **past history** in carrying out its stated intentions.
- Entity's **reasons** for choosing a particular course of action.
- Entity's **ability** to pursue a specific course of action.
- Existence or lack of **any other info** obtained during audit inconsistent with mgt's judgment or intent.

Note:

Auditor may request mgt to provide WRs about specific assertions in FS to support understanding obtained from other audit evidence about mgt's judgment or intent.

For eg, if **intent of mgt** is important to **valuation basis for investments**, it may not be possible to obtain SAAE without a WR about its intentions. Although such WRs provide **necessary audit evidence**, they don't provide SAAE on their own for that assertion.

Date & Period covered by WR

Date

- WRs are **necessary audit evidence**, auditor's opinion can't be expressed, & auditor's **report can't be dated before** the date of WRs.
- Furthermore, because auditor is concerned with events occurring up to date of auditor's report that may require adjustment to or disclosure in FS, WRs are **dated as near as practicable to, but not after, date of auditor's report** on FS



Period

- WRs are for all periods referred in auditor's report because mgt needs to reaffirm that WR it previously made wrt prior periods remain appropriate.
- Situations may arise where current mgt were not present during all periods referred to in A/R. Such persons may assert that they are not in position to provide some or all of WRs because they were not in place during prior period.
- This doesn't diminish such persons' responsibilities for F.S. as a whole. Accordingly, requirement for auditor to request WRs that cover whole of relevant period(s) still applies.

Form of Written Representations

WR is a form of a representation letter addressed to auditor.

If law or regulation requires mgt to make written public statements about responsibilities, and auditor determines that such statements provide some or all of representations required, relevant matters covered by such statements need not be included in representation letter.

Doubt as to Reliability of Written Representations

- a. If WR inconsistent with other audit evidence, auditor shall perform audit procedures to resolve the matter.
- b. If matter remains unresolved, auditor shall reconsider the assessment of competence, integrity, ethical values or diligence _____ of mgt, & determine the effect on reliability of representations (oral or written) and audit evidence in general.
- c. If auditor concludes that WR not reliable,
Take appropriate actions, including determining possible effect on opinion in A/R as per SA 705 i.e. Disclaimer of opinion.

Inconsistency >> Resolve the matter >> If Unresolved >> Reconsider DICE + Disclaim

Requested Written Representations Not Provided [RTP May-18 + MTP Mar-21]

If mgt doesn't provide one or more of requested written representations, auditor shall:

- a. Discuss the matter with mgt
- b. Re-evaluate integrity of mgt & evaluate effect on reliability of representations (oral or written) & audit evidence in general and
- c. Take appropriate actions, including determining possible effect on opinion in A/R as per SA 705 i.e. Disclaimer of Opinion.

Discuss → Re-evaluate integrity → SA 705

SA 260 (Revised) "Communication with Those Charged With Governance"

Role of communication

Effective two-way communication is important in assisting:

- Auditor and TCWG in **understanding matters** related to audit & developing a **constructive working relationship**.
- Auditor in obtaining info. from TCWG **relevant to audit**. For eg, TCWG may assist auditor in understanding entity and its environment, in identifying appropriate sources of audit evidence, and providing info about specific transactions or events and
- TCWG in fulfilling their responsibility to **oversee financial reporting process (FRP)**, thereby reducing ROMM of F.S.

Auditor's Objective

- To **communicate** with TCWG **responsibilities of auditor** and planned **scope** and **timing** of audit.
- To **obtain** from TCWG info relevant to audit.
- To **provide** TCWG with timely observations significant and relevant in overseeing Financial Reporting Process.
- To promote effective **two-way communication** between auditor and TCWG

When All of TCWG are involved in Managing the Entity

In some cases, all of TCWG are involved in managing entity, for eg, small business where single owner manages entity and no one else has governance role. In these cases, matters already communicated need not be communicated again with same person(s) in governance role.

Matters to be communicated

- Auditor's responsibilities in relation to F.S. Audit
 - The auditor is responsible for forming and expressing an **opinion** on F.S.; and
 - The audit of F.S. **does not relieve mgt or TCWG** of their responsibilities
- Planned Scope & Timing of Audit including Significant risks identified by auditor.
- Significant Findings from the Audit : Auditor shall communicate with TCWG:
 - Auditor's views about **significant qualitative aspects** of entity's a/c practices, including a/c policies, a/c estimates and FS disclosures
 - Significant difficulties**, if any, encountered during audit
 - Unless all of TCWG are involved in managing entity:
 - ✓ **Significant matters** discussed or subject to correspondence with mgt &
 - ✓ **Written representations** auditor is requesting and
 - Circumstances that affect **form and content of auditor's report**, if any

- e. **Any other significant matters** that in auditor's professional judgment significant to oversight of financial reporting process.

Auditor Independence

In case of **listed** entities, the auditor shall communicate with TCWG:

- a. Statement that engg team & others in firm have **complied** with relevant ethical requirements regarding independence
- b. All **relationships** and other matters between firm, network firms, and entity that bear on independence
- c. Related **safeguards applied** to
 - ✓ **eliminate** identified **threats** to independence or
 - ✓ **reduce** them to acceptable level.

SA 265 "Communicating Deficiencies in Internal Control to TCWG & Management"

Auditor's Objective

To **communicate** to TCWG and mgt, **deficiencies** in internal control that auditor identified and in **auditor's professional judgment** are of **sufficient importance** to merit their respective attentions.

Deficiency in internal control -

- i) A **control** is designed, implemented or operated in a way it's **unable to Prevent/Detect/Correct**, misstatements in FS on a timely basis or
- ii) A **control necessary** to P/D/C misstatements in FS on a timely basis **is missing**.

Significant deficiency in internal control: **Deficiency or combination of deficiencies** in internal control, in auditor's professional judgment, of **sufficient importance to merit attention of TCWG**.

Note:

Significance of a deficiency(s) in internal control depends **not only** on whether a **misstatement** has **actually occurred**, but **also on likelihood that a misstatement could occur** and **potential magnitude** of misstatement. Significant deficiencies may, therefore, **exist even though** auditor has **not identified misstatements** during audit.

How to decide if Identified Deficiency is Significant or Not?

Eg. of matters that auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:

- **Likelihood of deficiencies** leading to MM in F.S. in future.
- **Interaction of deficiency** with other deficiencies in internal control.
- **Volume of activity** that has occurred or could occur in account balance or class of transactions exposed to deficiency or deficiencies.
- **F.S. amounts exposed to deficiencies.**
- **Susceptibility to loss or fraud** of related asset or liability.
- **Importance of controls** to financial reporting process; for example:
 - ✓ General monitoring controls (such as oversight of management).
 - ✓ Controls over the prevention and detection of fraud.
 - ✓ Controls over the selection and application of significant accounting policies.
 - ✓ Controls over significant transactions with related parties.
 - ✓ Controls over significant transactions o/s entity's normal course of business.
 - ✓ Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).



Likelihood >> Interaction >> Volume of Activity >> FS Amt's expose >> Loss/fraud >> Imp of controls

Requirements

- Determine on basis of audit work performed, identified one or more deficiencies in IC.
- If identified determine, on basis of work performed, whether, individually or in combination, they constitute significant deficiencies.

Communication in writing

- Auditor shall **communicate in writing significant deficiencies in IC** identified during audit to **TCWG** on a timely basis.
- Auditor shall **also communicate to mgt** at an appropriate level of responsibility on a timely basis:
 - a. In writing, **significant deficiencies** in IC that auditor has communicated or intends to communicate to TCWG, unless it would be inappropriate to communicate directly to mgt in circumstances and
 - b. **Other deficiencies** in internal control identified during audit that haven't been communicated to mgt by other parties and that, in auditor's professional judgment, are of sufficient importance to merit mgt's attention.

Written communication to TCWG

Auditor shall include in written communication of significant deficiencies in internal control:

- a. A **description of deficiencies** and an explanation of their **potential effects** and
- b. **Sufficient information** to enable TCWG and mgt to **understand context** of communication.

In particular, auditor shall explain that:

- **Purpose** of audit was to express an **opinion on F.S**
- Audit included consideration of Internal Controls relevant to preparation of F.S. in order to **design audit procedures** that are appropriate in circumstances, but **not for purpose of expressing opinion on effectiveness of IC &**
- Matters reported are **limited to deficiencies** that **auditor identified** during audit and has **concluded** are of **sufficient importance** to merit being reported to TCWG.

How to determine if there are significant deficiencies in Internal Control?

Indicators of significant deficiencies in internal control include, for eg:

- ✓ Evidence of **ineffective entity risk assessment process (RAP)**, such as management's failure to identify a ROMM that auditor would expect entity's risk assessment process to have identified.
- ✓ **Misstatements detected** by auditor's procedures that were not **prevented, or detected and corrected(P/D/C)**, by entity's IC.
- ✓ **Disclosure of material misstatement** due to **error or fraud as prior period items in CY's P&L**.
- ✓ Evidence of **mgt's inability to oversee** the **preparation of F.S.**
- ✓ Evidence of **ineffective response to identified significant risks** (e.g., absence of controls over such a risk).
- ✓ Evidence of **ineffective aspects of control environment**, such as:
 - a) Identification of **mgt fraud**, whether or not material, not prevented by entity's IC.
 - b) Management's **failure** to implement appropriate **remedial action** on **significant deficiencies** previously communicated.
 - c) **Absence of a risk assessment process (RAP)** within entity where such process would ordinarily be expected to have been established.

Learn with Fun ☺

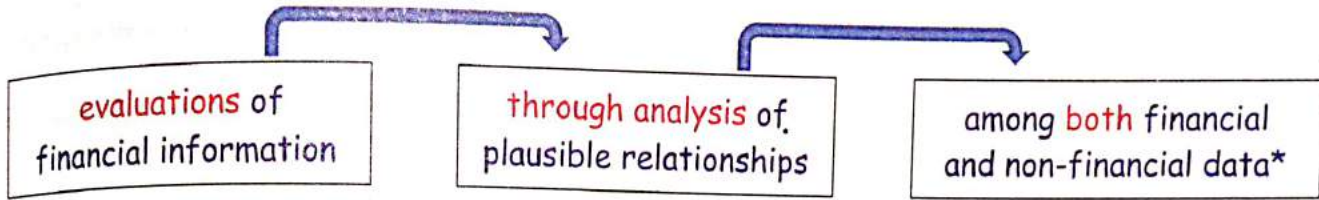
- Ineffective RAP
- Misstatement detected
- Prior period item
- Inability to oversee preparation of F.S.
- Ineffective response
- Ineffective aspects of control environment (fraud/fail/absence)

Q. Why we need Analytics?

Routine checks can't disclose all mistakes or manipulation that may exist in a/cs, certain other procedures also have to be applied like **comparisons, trend and ratio analysis** in addition to reasonable tests. These are collectively known as overall tests.

Q. What are Analytical Procedures?

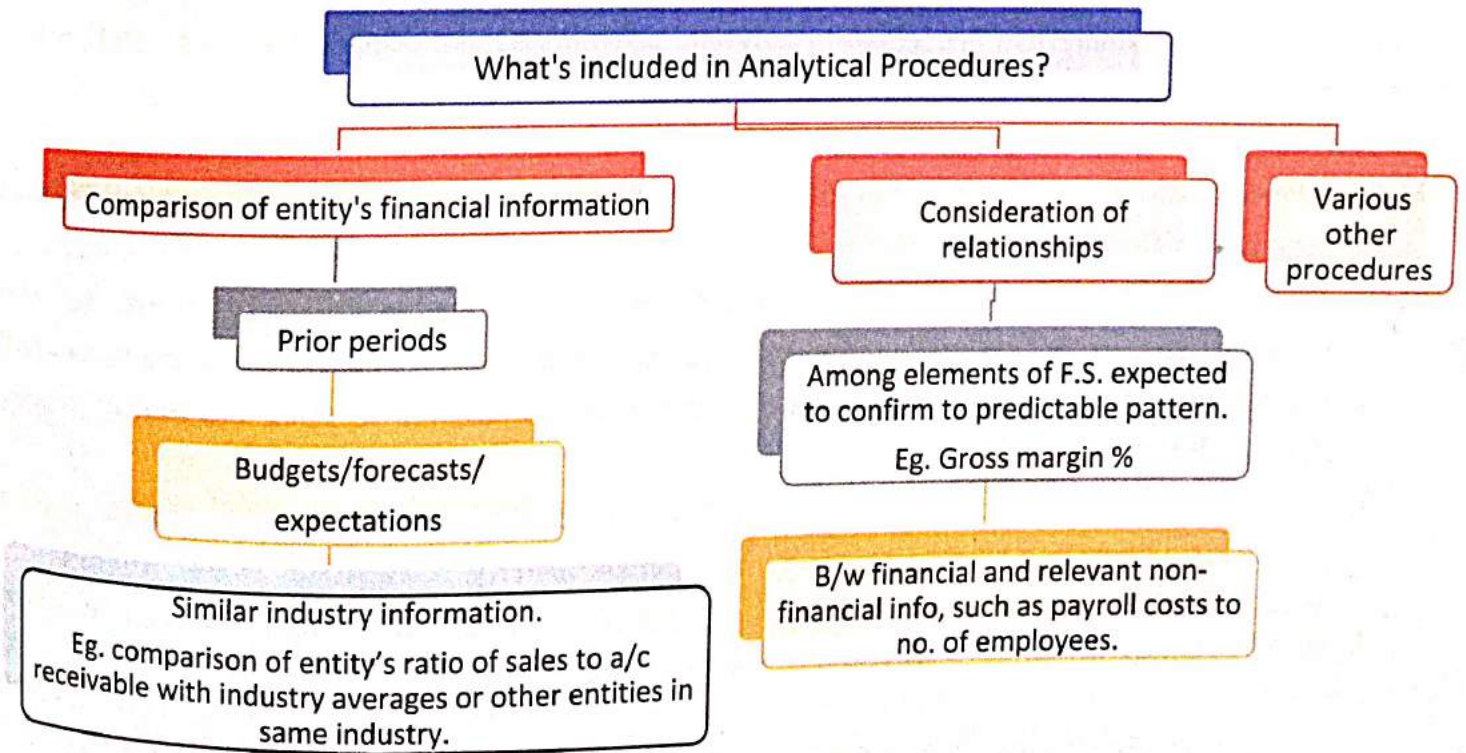
As per SA 520 "Analytical Procedures", term "analytical procedures" means



Analytical procedures also includes such **investigation**

- of identified **fluctuations** or
- relationships that are **inconsistent** with other relevant info. or **differ from expected values** by a significant amount.

* Verifying total wages paid to workers: It can be verified by analysing relationships between wages per worker [financial data i.e. in ₹] & no. of workers [non-financial data]





Q. What are major types of analytical procedures?

Analytical Procedures may be segregated into following major types:

Comparison of client data with:

1. industry data	4. auditor-determined expected results
2. similar prior period data	5. expected results, using non-financial data
3. client-determined expected results	

Objectives of auditor

To obtain relevant and reliable audit evidence when using SAP

To design and perform AnPro near the end of audit that assist auditor when forming an overall conclusion as to whether F.S. are consistent with auditor's understanding of entity.

Purpose of Analytical Procedures

Use comparisons and relationships to assess whether a/c balances or other data appear reasonable.

Auditor while carrying out audit started comparing various items of P&L a/c of the year under audit with previous financial years. What is auditor trying to achieve by carrying out those comparisons?

Purpose of Applying Analytical Procedure: Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Auditor of Flower Ltd. would achieve the following by carrying out comparison stated in the question:

- i) If balances included in Statement of P&L of an entity are compared with previous period, it would be possible to **find out reasons for increase or decrease** in amount of profits of those years.
- ii) By setting up certain **expenses' ratios** on basis of balances included in Statement of P&L, for year under audit, **comparing them with same ratios for previous year**, it is possible to ascertain extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales.
- iii) If **differences are found to be material**, auditor would **ascertain reasons** and assess **whether accounts** have been **manipulated to inflate or suppress profits**.
- iv) It would be possible to **identify existence of unusual** transactions, amounts, ratios and trends **[TAMTR]** that might indicate matters having audit implications.

Ch-11 Analytical Procedures



- Independent verification of correctness of some of items of expenses included in P&L [Dec-21]
- ✓ For instance, **cost of importing goods** which are subjected to **ad-valorem duty** at uniform rate independently from amt of duty paid. Similarly, a qty of sugar sold by sugar mill can be verified independently from amt of excise duty/ GST paid.
 - ✓ Amt of any **income or expenses which has a direct relationship with amt of profits** or that of sales can be verified independently, e.g., **commission paid to manager** calculated on basis of net profits, commission paid to selling agent as % of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.
 - ✓ Analytical procedures may help **identify existence of unusual transactions or events**, and amounts, ratios, and trends that might indicate matters that have audit implications.
 - ✓ Unusual or unexpected relationships that are identified may assist auditor in identifying **RoMM**, especially due to fraud.

Timing of Analytical Procedures

Planning Phase [MTP Nov-21/RTP Nov-20]

Assist auditor in understanding client's business and identifying areas of potential risk by indicating aspects of entity's business of which he was unaware.

» This info will assist auditor in determining NTE of his other audit procedures.

» AnPro. in planning use both financial and non-financial info., such as no. of employees, square ft. of selling space, volume of goods produced and similar info.

Testing Phase

Completion Phase

Notes:

- ☞ Auditor's substantive procedures at assertion level may be **TODs, substantive analytical procedures**, or a **combination** of both.
- ☞ This **decision is based on auditor's judgment** about expected effectiveness and efficiency of available audit procedures to reduce audit risk at assertion level to an acceptably low level.
- ☞ **Inquire mgt** as to availability and reliability of info needed to apply substantive analytical procedures, and results of any such analytical procedures performed by entity.

Factors to be considered for Substantive Audit Procedures (SAP)

- Availability of Data: Availability of **reliable & relevant data** facilitate effective analytical procedures.
- Disaggregation: Degree of disaggregation in data can **directly affect degree of its usefulness** in detecting misstatements.
- Account type: SAP are more useful for certain types of accounts than for others. **Income statement a/cs** tend to be **more predictable** because they reflect accumulated transactions over a period, whereas BS a/cs represent net effect of transactions at a point in time or subject to greater mgt judgment.
- Source: **Some COTs** tend to be **more predictable** because they consist of numerous, similar transactions, (e.g., through routine processes). Whereas transactions recorded by **non-routine and estimation SCOTs** (Significant Classes of Transactions) are often subject to mgt judgment and thus more difficult to predict.
- Predictability: SAP are more appropriate when an a/c balance or relationships between items of data are predictable (e.g., b/w sales and cost of sales or b/w trade receivables and cash receipts). A predictable relationship is one that may reasonably be expected to exist and continue over time.
- Nature of Assertion: SAP may be more effective in providing evidence for some assertions (e.g., **completeness or valuation**) than for others (e.g., rights and obligations). Predictive analytical procedures using data analytics can be used to **address completeness, valuation/measurement and occurrence**.
- Inherent Risk or What could go wrong?: When we are designing audit procedures to address an inherent risk or "what can go wrong", we consider **nature of RoMM** in order to determine if a SAP can be used to obtain audit evidence.

When **inherent risk is higher**, may **design TODs** to address higher inherent risk. When **significant risks** identified, audit evidence obtained solely from **SAP is unlikely to be sufficient**.

Example: When side agreements w.r.t revenue recognition identified as significant or fraud risk, its unlikely that analysis of sales to cash receipts or cost of sales would be appropriate.

Techniques Available as Substantive Analytical Procedures [MTP Apr-22/RTP May-21]

1. Trend analysis

It is comparison of **current data with prior period** balance or with a trend in 2 or more prior periods.

- Auditor evaluates **whether current a/c balance moves in line with established trend** or based on factors that may cause it to change.
- In other words, trend analysis implies **analysing a/c fluctuations** by comparing CY to PY info and, also, to info. derived over several years.

Example:

Auditor may compare salary paid during the year with salary for earlier years. There may be some %age increase in salary expense over the years. However, an unusual increase in such expense may indicate fraudulent payments made to fake employees.

2. Ratio analysis

Ratio analysis is useful for analysing asset and liability a/cs as well as revenue and expense a/cs.

- Individual BS a/c is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., trade receivables balance related to sales).
- Ratios can also be compared over time or to ratios of separate entities within group, or with ratios of other companies in same industry.

Commonly used ratios include: [RTP Nov-21]

- Elements of income or loss as a percentage of sales
- Gross profit turnover
- Accounts receivable turnover
- Inventory turnover
- **Profitability, leverage, and liquidity**

Example:

Auditor can review GP ratio for year under audit. Auditor can further compare such GP ratio with earlier years or other companies in same industry for year under audit.

3. Reasonableness tests

Unlike trend analysis, this analytical procedure doesn't rely on events of prior periods, but upon **non-financial data** for audit period under consideration (e.g., occupancy rates to estimate rental income or intt. rates to estimate intt income or expense).

- These tests **more applicable to income statement** a/cs and certain accrual or prepayment a/cs
- These tests are made by reviewing relationship of certain account balances to other balances for reasonableness of amounts.



Example:

- Interest expense against interest bearing obligations
- Raw Material Consumption to Production (quantity)
- Wastage & Scrap % against production & raw material consumption (quantity)
- Work-in-Progress based on issued of materials & Sales (quantity)
- Sales discounts and commissions against sales volume
- Rental revenues based on occupancy of premises

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

Trend
Analysis

Ratio
Analysis

Reasonableness
Test

Structural
Modelling

Analytical Procedures used as Substantive Tests as per SA 330 [RTP Nov-22]

(i) Determine **SUITABILITY** of particular substantive analytical procedures for given assertions, taking account of assessed RoMM and tests of details, if any, for these assertions

(ii) Evaluate **RELIABILITY of data** from which auditor's expectation of recorded amounts or ratios is developed, taking account of

- *source,*
- *comparability,*
- *nature and relevance of information available, and*
- *controls over preparation*

(iii) Develop an **EXPECTATION of recorded amounts** or ratios and evaluate whether expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause FS to be materially misstated and

(iv) Determine the **amount of any DIFFERENCE** of recorded amounts from expected values that is acceptable without further investigation.



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

- ✓ Application of planned analytical procedures [PaPs] is based on expectation that relationships among data exist & continue in absence of known conditions to contrary.
- ✓ However, suitability of a particular AnPro will depend upon auditor's assessment of its effectiveness in detecting a material misstatement.

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

Example: Payroll Cost

Where entity has known no. of employees at fixed rates of pay, possible to use this data to estimate total payroll costs with high degree of accuracy, providing audit evidence for significant item in F.S. & reducing need to perform TOD on payroll.

3. Different types of analytical procedures provide different levels of assurance.

Example: Rental Income vs Use of Gross Margin to Confirm Revenue

Prediction of total rental income of building divided into apartments, taking rental rates, no. of apts. and vacancy rates into consideration, provide persuasive evidence & eliminate need for further verification.

In contrast, calculation and comparison of gross margin percentages as means of confirming revenue figure may provide less persuasive evidence, but may be useful if used in combination with other audit procedures.

4. Determination of suitability of particular SAP is influenced by nature of assertion & auditor's assessment of RoMM.

Example: If controls over sales order processing are weak, auditor may place more reliance on tests of details rather than on SAP for assertions related to receivables.

5. Particular SAP may be considered suitable when TOD are performed on same assertion.

Example: Trade Receivables

When obtaining audit evidence regarding valuation assertion for a/c receivable balances, auditor may apply AnPro to aging of customers' a/c in addition to performing TOD on subsequent cash receipts to determine collectability of receivables.

RELIABILITY of DATA [RTP Nov-22]

(i) **Source of information available.**

For eg, info may be more reliable when its obtained from independent sources o/s entity;

(ii) **Comparability** of info available.

For eg, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

(iii) **Nature and relevance of information** available.

For eg, whether budgets have been established as results to be expected rather than goals to be achieved; and

(iv) **Controls over preparation of information** that are designed to ensure its completeness, accuracy, and validity.

For eg, controls over preparation, review and maintenance of budgets.

Source of
information

Comparability

Controls over
preparation

Nature & relevance
of info

Evaluation of whether Expectation is Sufficiently Precise → Identify Material Misstatement

[RTP May-22]

Relevant Matters for such evaluation include:

(i) **Accuracy** with which expected results of SAP can be predicted.

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

(ii) **Degree** to which information can be *disaggregated*.

For eg, SAP may be more effective when applied to financial information on individual sections of an operation or to F.S. of components of a diversified entity, than when applied to F.S. of entity as whole.

(iii) **Availability** of information, both financial and non-financial.

For eg, auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as no. of units produced or sold, is available to design SAP. If information is available, auditor may also consider reliability of the information.

Availability of Information → Disaggregate → Prediction

Amount of Difference of Recorded amounts from Expected Values that's ACCEPTABLE

Its influenced by

- > **materiality** and
- > **desired level of assurance**, considering possibility that a misstatement, individually or when aggregated with other misstatements, may cause FS to be materially misstated.

SA 330 requires auditor to obtain **more persuasive audit evidence** higher the auditor's assessment of risk. As assessed risk increases, amount of difference acceptable without investigation decreases to achieve desired level of persuasive evidence.

Investigating Results of Analytical Procedures

If AnPro identify fluctuations or relationships → inconsistent with other relevant info or that differ from expected values by significant amount, auditor shall investigate such differences by:

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

(ii) Performing **other audit procedures** as necessary in the circumstances: Need to perform other audit procedures arise when

- > mgt is unable to provide explanation, or
- > explanation, together with audit evidence obtained isn't considered adequate.

Analytical Procedures that assist when Forming Overall Conclusion

- Conclusions drawn from results of analytical procedures are **intended to corroborate conclusions** formed during audit of individual components or elements of F.S.
- This assists auditor to draw reasonable conclusions to base auditor's opinion.
- Results of such analytical procedures **may identify a previously unrecognized RoMM**. In such circumstances, SA 315 requires auditor to revise auditor's assessment of RoMM and modify further planned audit procedures accordingly.

*"A little progress each day adds up to **BIG RESULTS**"*

SA 700: Forming an Opinion & Reporting on the Financial Statements

- Form & content of Audit Report
- Consistency & comparability

To Form Opinion - Auditor to Obtain Reasonable Assurance

Auditor shall **form opinion** whether FS are prepared, in all material respects, as per applicable FRF. To form that opinion, auditor shall **conclude** as to whether auditor has obtained **reasonable assurance** about whether FS as a whole are free from material misstatement, whether due to fraud or error.

That conclusion shall take into account:

- a. Whether **SAAE** has been obtained
- b. Whether **uncorrected misstatements are material**, individually or in aggregate
- c. The **evaluations**.

Evaluations by the Auditor

Auditor shall evaluate whether FS are prepared as per requirements of applicable FRF. This evaluation shall include **consideration of qualitative aspects** of entity's accounting practices, including indicators of possible bias in management's judgements

Qualitative Aspects of Entity's Accounting Practices

1. Mgt makes a no. of **judgements** about amts and disclosures in FS.
2. SA 260 (Revised) contains a discussion of the **qualitative aspects** of accounting practices.
3. In considering qualitative aspects of entity's accounting practices, auditor may become aware of **possible bias** in mgt's judgements.

Auditor may conclude that cumulative effect of lack of neutrality with uncorrected misstatements causes FS to be materially misstated.

Indicators of a lack of neutrality include following:

- (i) **Selective correction of misstatements** brought to mgt's attention during audit.
Example: Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have effect of decreasing reported earnings.
- (ii) Possible **mgt bias** in making of a/c estimates.

4. SA 540 addresses possible management bias in making accounting estimates.

Indicators of possible mgt bias don't constitute misstatements for purposes of drawing conclusions on reasonableness of individual a/c estimates. They may, however, affect auditor's evaluation of whether F.S. as a whole are free from material misstatement.

Specific Evaluations by Auditor

- a. F.S. adequately **disclose** Significant **a/c policies** selected & applied
- b. **A/C Policies** selected & applied are **consistent with FRF & appropriate**
- c. **a/c estimates** made by mgt are reasonable
- d. F.S. provide adequate **disclosures**

(e) Info presented (relevant, reliable, comparable & understandable)

(e) Terminology used in F.S. is appropriate

If F.S. are as per Fair Presentation Framework,

- a) Overall Presentation, Structure & Content of F.S.
- b) Whether FS including notes → achieve fair presentation

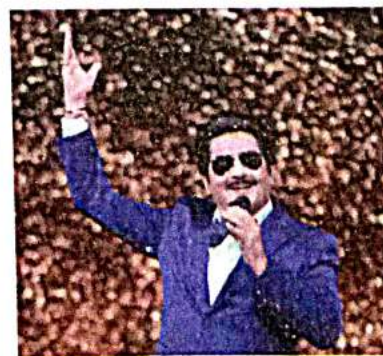
Forms of Opinion

Unmodified opinion
F.S. in all material respects prepared as per FRF

Modified Opinion
F.S. not free from MM. (whether evidence obtained or not) [SA 705]

Elements of Audit Report

- Title [Independent Auditor's Report]
- Addressee [To members of Co.]
- Auditor's Opinion
 - ✓ Identify **entity** whose F.S. have been audited
 - ✓ State that **F.S.** have been audited
 - ✓ Identify **title** of each statement comprising the F.S.
 - ✓ Refer to the **notes**, including summary of significant accounting policies; and
 - ✓ Specify the **date** of, or period covered by, each F.S.



Unmodified Opinion:

When expressing unmodified opinion on FS, auditor's opinion shall, unless required by L/R, use one of following phrases:

- (a) In our opinion, **FS present fairly**, in all material respects, in accordance with [applicable FRF]; or
- (b) In our opinion, accompanying FS give true & fair view of [...] in accordance with [applicable FRF].

Ch-12 Audit Report [SA 700 Series]

Phrases "present fairly, in all material respects," and "give a true & fair view" treated equivalent.

When auditor expresses an unmodified opinion, **inappropriate** to use **phrases** such as "with the foregoing explanation" or "subject to" in relation to opinion, as these suggest **conditional opinion** or **weakening or modification of opinion**.

- Basis for Opinion
 - States that audit was conducted in accordance with **SA**
 - Refer to the **section** of A/R that describes auditor's responsibilities under SAs
 - Includes a **statement** that auditor is independent of entity
 - States whether auditor believes that audit evidence is **SAAE**
- Going Concern [SA 570]

SA 701: Key Audit Matters

For Audit of **Listed Entities** → Communicate KAM
May decide to communicate KAM for **other entities** that maybe of **significant public interest** like financial institutions such as Banks, Insurance Cos, & pension funds

Matters → Auditor's Professional Judgment → MOST SIGNIFICANCE in Audit of F.S.

But from where are they selected? From matters communicated with TCWG

Purpose of KAM?

- Enhance communicative value of A/R by providing transparency about audit performed
- Provide add. Info to assist users to understand matters → MOST Significance in auditor's Professional judgment
- Also understand entity & areas of significant mgt judgment.

Determining KAM

Determine from matters communicated with TCWG, matters that required significant auditor attention in performing audit. In making this determination, auditor shall take into account following:

- Areas of higher assessed **ROMM** or Significant Risk as per SA 315
- Significant Auditor **Judgment** relating to areas in F.S. involving significant mgt judgment
- Effect on Audit of Significant events or **Transactions** that occurred during the period

Auditor shall determine which of the above matters determined, were of **most significance in audit** of FS of current period and therefore are key audit matters.

Auditor shall describe each KAM, using an appropriate subheading, in a **separate section** of A/R under heading "**Key Audit Matters**".

The introductory language in this section of A/R shall state that:

- KAM are those matters that, in auditor's **PJ**, were of **most significance** in audit of FS [of current period]; and
- These matters were **addressed in context of audit of FS** as a whole, and in forming auditor's opinion thereon, and auditor **does not provide a separate opinion** on these matters.

Communicating KAM not a Substitute for:-

- ✓ **Disclosures** in F.S.
- ✓ **Modified** opinion as per SA 705
- ✓ **Reporting** as per SA 570 → Material Uncertainty.....
- ✓ **Separate** Opinion on Individual matters



What to do if no KAM to communicate?

Key Audit Matters

[Except for the matter described in Basis for Qualified (Adverse) Opinion section or MURG section,] We have determined that there are no [other] KAM to communicate in our report.

Note: Unless required by L/R, when auditor disclaims an opinion on FS, A/R shall not include a KAM section as per SA 701

- Other Information: Where applicable, report as per SA 720 (Revised)
- Responsibilities for the Financial Statements [Read from icai sm]
- Auditor's Responsibilities for the Audit of the Financial Statements [Read from icai sm]
- Location of description of auditor's responsibilities for audit of FS

a) Within body of Audit Report

b) Within an appendix to auditor's report in that case auditor shall include reference to location of appendix

c) By specific reference within auditor's report to location of such description on website of appropriate authority, where law, regulation or auditing stds permit.

- Signature of Auditor: Audit report shall be signed by Auditor in **personal name** & audit **firm**.
Mention **membership no.** + **Registration no.** of firm + **UDIN**
- Place of Signature: Location i.e. city where its signed

- Date of Auditor's Report: Not earlier than date auditor obtained SAAE/ FS prepared/ Mgt asserted they have taken responsibility of FS

SA 705: MODIFICATIONS to the OPINION in INDEPENDENT Auditor's Report

Nature of matter →	Material but not pervasive	Material & Pervasive
SAAE	Qualified	Adverse
SAAE	Qualified	Disclaimer

Definition of Pervasive: Used in context of misstatements, describe effects/possible effects on F.S. of Misstatements undetected due to inability to obtain S.A.A.E

Pervasive effects on the financial statements are those that, in the auditor's judgement:

- Are not confined to specific elements, accounts or items of FS
- If so confined, represent or could represent a substantial proportion of FS
- In relation to disclosures, are fundamental to users' understanding of FS

What if Mgt imposed limitation → ~~SAAE~~ → What will Auditor do? [V. Imp]

- If likely to result in Q/D opinion → request mgt to remove limitation
- If mgt refuses → communicate TCWG & determine whether Alt. audit procedures possible
- If still can't obtain SAAE:-
 - ✓ Misstatement is material but not pervasive → Qualified opinion
 - ✓ Misstatement is material & pervasive
 - Withdraw from engg
 - Not practicable to withdraw → Disclaim opinion
- Before withdrawal communicate to TCWG matters giving rise to modification

Form and Content of the Auditor's Report When the Opinion is Modified

Auditor's Opinion

When auditor modifies audit opinion, auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for Opinion section.

Qualified Opinion: When the auditor expresses (Q) opinion due to MM in FS, auditor shall state that, in auditor's opinion, **except for effects** of matter(s) **described in Basis for Qualified Opinion section**:

- When reporting as per **fair presentation framework**, accompanying F.S. **present fairly**, in all **material respects** (or give a true and fair view of) [...] in accordance with [applicable FRF] or
- When reporting as per **compliance framework**, accompanying F.S. have been **prepared**, in all **material respects**, in accordance with [applicable FRF].



When modification arises from inability to obtain SAAE, auditor shall use corresponding phrase "except for possible effects of matter(s) ..." for modified opinion.

Adverse(A) Opinion: **Obtained SAAE**, concludes misstatements, individually or in the aggregate, **both material and pervasive** to financial statements.

Spl. Considerations: When auditor expresses an (A) opinion, auditor shall state that, in auditor's opinion, **because of significance of matter(s)** described in Basis for (A) Opinion section:

1. When reporting as per a **fair presentation framework**, accompanying F.S. **do not present fairly** (or give a true and fair view of) [...] in accordance with [applicable FRF] or
2. When reporting as per **compliance framework**, accompanying F.S. have **not been prepared**, in **all material respects**, in accordance with [applicable FRF].

Disclaimer of Opinion

When auditor disclaims an opinion due to inability to obtain SAAE, auditor shall:

- a. State that **auditor does not express an opinion** on accompanying FS
- b. State that, **because of significance of matter(s)** described in Basis for Disclaimer of Opinion section, auditor has not been able to obtain SAAE to provide a basis for audit opinion on FS
- c. **Amend the statement required by SA 700**, which indicates that FS have been audited, to state that auditor was engaged to audit FS.

Basis for Opinion

When auditor modifies opinion on FS, auditor shall, in addition to specific elements required by SA 700 (Revised):

- **Amend the heading "Basis for Opinion"** required by SA 700 (Revised) to **"Basis for Qualified Opinion," "Basis for Adverse Opinion,"** or **"Basis for Disclaimer of Opinion,"** as appropriate and
- Within this section, **include a description of the matter** giving rise to modification.

S No.	MM Relates to:	What to include in Basis for Opinion Section
1	specific amounts in FS (including quantitative disclosures in notes to FS)	✓ Description & quantification of financial effects of misstatement , unless impracticable ✓ If not practicable to quantify the financial effects, auditor shall so state in this section.
2	narrative disclosures	explanation of how the disclosures are misstated
3	non-disclosure of info.	Auditor shall: ✓ Discuss non-disclosure with TCWG ✓ Describe in Basis for Opinion section nature of the omitted information and

		✓ Unless prohibited by L/R, include omitted disclosures, provided it is practicable and auditor has obtained SAAE about omitted info.
4	Inability to obtain SAAE	Reasons for that inability

When auditor disclaims opinion on FS, A/R shall not include following elements required by SA 700:

- Reference to **section of A/R** where auditor's **responsibilities are described**; and
- Statement** about **whether audit evidence obtained is sufficient and appropriate** to provide a basis for auditor's opinion.

Note: Even if auditor expressed A/D opinion on FS, auditor shall describe in Basis for Opinion section reasons for any other matters of which auditor is aware that would have required a modification to opinion, and effects thereof.

Description of Auditor's Responsibilities for Audit of FS → When Auditor Disclaims an Opinion on FS

When auditor disclaims an opinion on FS due to an inability to obtain SAAE, amend the description of auditor's responsibilities required by SA 700 to include only the following:

- Statement that auditor's responsibility is to **conduct audit** of entity's FS **as per Standards on Auditing** and to **issue an A/R**
- Statement that, however, **because of the matter(s)** described in Basis for Disclaimer of Opinion section, auditor was **unable to obtain SAAE** to provide a basis for an audit opinion on FS and
- Statement about **auditor independence and other ethical responsibilities** required by SA 700 (Revised).

SA → SAAE → Independence & ethics

Communication with TCWG

When auditor expects to modify opinion, auditor shall **communicate** with TCWG

- ✓ **circumstances** that led to expected modification &
- ✓ **wording** of modification.



SA 706: Emphasis of Matter Paragraph & Other Matter Paragraph in the Independent Auditor's Report

Emphasis of matter para:-

- It is a para included in A/R
- that refers to a **matter appropriately presented or disclosed in FS**
- that, in auditor's judgement,
- is of such importance that it is **fundamental to users' understanding of FS**

EOM Para in the Auditor's Report

If auditor considers necessary to **draw users' attention** to a matter presented or disclosed in FS that, in auditor's judgement, is of such importance that its fundamental to users' understanding of FS, auditor shall include an EOM para in A/R provided:

- a. Auditor would not be required to modify opinion as per SA 705 as a result of the matter; and
- b. When SA 701 applies, matter hasn't been determined to be a KAM to be communicated in A/R.

When the auditor includes an EOM para in auditor's report, auditor shall:

- a. Include the paragraph within a **separate section** of A/R with appropriate heading that includes the term "Emphasis of Matter"
- b. Include in para **clear reference** to matter being emphasized and where relevant disclosures that fully describe the matter can be found in FS. Para shall refer only to info presented or disclosed in FS and
- c. Indicate that auditor's **opinion is not modified** in respect of matter emphasized.

Some eg of circumstances where auditor may consider it necessary to include an EOM para

- An uncertainty relating to future outcome of exceptional **litigation** or regulatory action.
- A **significant subsequent event** that occurs between the date of FS and date of A/R.
- **Early application** (where permitted) of a new a/c std that has a material effect on F.S.
- Major **catastrophe** that had or continues to have, significant effect on entity's financial position.

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EOM paragraph is not a substitute for:

- a. **Modified opinion** as per SA 705 when required by circumstances of a specific audit engg.
- b. **Disclosures in FS** that applicable FRF requires mgt to make, or otherwise necessary to achieve fair presentation or

- c. Reporting as per **SA 570** when a material uncertainty exists relating to E/Cs that may cast significant doubt on an entity's ability to continue as a GC. [माँ मुझे याद आ रहा है]

Other Matter Paragraphs (OM Para)

To communicate a matter **other than those presented or disclosed in F.S.** that, in auditor's judgement, is relevant to **users' understanding of**

- ✓ audit,
- ✓ auditor's responsibilities or
- ✓ auditor's report, auditor shall include an OM para in A/R, provided:
 - a. **Not prohibited** by law or regulation and
 - b. When SA 701 applies, matter **not determined to be a KAM**

When auditor decides to include EOM/OM para → Communicate with TCWG

SA 710 Comparative Information- Corresponding figures & Comparative F.S.

Comparative Information:

- Amounts and disclosures included in F.S.
- in respect of one or more prior periods in accordance with the applicable FRF.

Audit Procedures

Basic Procedures:

Auditor shall evaluate whether:

- a. **Comparative info. agrees** with amounts and other disclosures presented in **prior period &**
- b. **A/c policies** reflected in comparative info are
 - ✓ **consistent** with current period or,
 - ✓ if there have been **changes** in a/c policies, whether changes have been properly **accounted, presented and disclosed.**

Material Misstatement:

- If auditor becomes aware of **possible material misstatement** in comparative info while performing current period audit, **perform additional audit procedures** to obtain SAAE to determine whether material misstatement exists.
- If auditor audited prior period's FS, also follow requirements of SA 560.

Written Representations:

- ✓ As per SA 580, auditor shall request WR **for all periods** referred to in auditor's opinion.
- ✓ Auditor shall also obtain a **specific WR** regarding any **prior period item** that is separately disclosed in current year's statement of P&L.

Basic Procedures → M.M. + 560 → 580

Corresponding Figures

Comparative info. where amts & other disclosures for prior period are included as **integral part of current period FS** and **intended to be read only** in relation to current period figures.

Level of detail presented in corresponding amts and disclosures is **dictated primarily by its relevance to current period figures.**

Reporting [May-22]

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

1. If A/R on prior period included a **modified opinion** and **matter** which gave rise to modification is **unresolved**, auditor shall modify auditor's opinion on the current period's FS.

In Basis for Modification para in A/R, auditor shall either:

- Refer to both** current period and corresponding fig. in description of matter giving rise to modification when **effects or possible effects** of matter **on current period's fig. are material** or
- In **other cases**, explain that audit opinion been modified because of **effects or possible effects** of unresolved matter **on comparability of current period's fig. and corresponding figures.**

2. If auditor obtains audit evidence that **MM exists in prior period FS on which unmodified opinion been previously issued**, verify whether misstatement been **resolved** &, if not, express **Q/A opinion** in A/R on current period FS.

3. Prior Period FS Not Audited- If prior period FS **not audited**, state in **OM para** that corresponding fig. are unaudited. Such statement doesn't relieve auditor to obtain SAAE that opening balances don't contain misstatements that materially affect current period's FS.

Summary:

[2 cases → prior period FS audited but MM there (detected/ undetected)
Last case → Prior Period FS → not audited]

Comparative Financial Statements

Comparative info where amounts and other disclosures for prior period are **included for comparison with FS of current period** but, if audited, are referred to in auditor's opinion.

Level of info included in **comparative FS is comparable** with that of current period.

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Auditor's opinion- to refer each period:

When comparative F.S. are presented, auditor's opinion shall refer to each period for which FS are presented and on which an audit opinion is expressed.

Different opinion on Comparative FS

When reporting on Prior Period FS in connection with current period's audit, if auditor's opinion differs from opinion auditor previously expressed, disclose substantive reasons for different opinion in OM para as per SA 706.

Material Misstatement found in Prior Period FS [Earlier unmodified opinion issued]

- ✓ If auditor concludes that a MM exists that affects prior period FS on which predecessor auditor had previously reported without modification, auditor shall communicate to mgt and TCWG & request that predecessor auditor be informed.
- ✓ If prior period F.S. are amended, and predecessor auditor agrees to issue new auditor's report on amended F.S. of prior period, auditor shall report only on current period.

Prior Period Financial Statements Audited by a Predecessor Auditor [Common for both]

If FS of prior period audited by predecessor auditor, in addition to expressing opinion on current period's FS, auditor shall state in OM para:

- a. FS of prior period were audited by a predecessor auditor
- b. Type of opinion expressed by predecessor auditor and if it was modified, reasons therefor &
- c. Date of that report, unless predecessor auditor's report on prior period's FS is revised with FS

Prior Period F.S. Not Audited [Same as Corresponding fig.]

Audit of Branch Office Accounts

- Sec 128(1) → Every Co. shall keep at Regd office books of a/c & FS that give true & fair view & as per accrual basis + double entry system of accounting
- If kept at any other place inform ROC within 7 days
- If Co. has branch office, it can keep books of Branch at that office & proper summarised returns sent to Regd office periodically
- Sec 143(8) → Powers & duties of Co. Auditor in relation to branch audit & branch auditor
- Branch a/c can be audited by Co. auditor or any other qualified person
- If Branch is situated o/s India then Audit shall be done by Co. Auditor or by a person duly qualified to be appointed as auditor as per the laws of that country
- Branch auditor (if different) shall share his report with Co. Auditor

SA 600, Using the Work of Other Auditor shall apply in such case:

- Right of principal auditor to visit component & examine books & records, if necessary
- Obtain SAAE that other auditor's work adequate for him
- Ordinary procedures: Advise other auditor of use of his work & Coordinate at planning stage
 - ✓ Inform about **Areas requiring spl considerations**
 - ✓ **Procedures** for identifying inter-component transactions that require disclosure
 - ✓ Advise about significant **A/c, auditing & reporting requirements**
 - ✓ **Time-table** for audit completion
 - ✓ **Obtain representation** as to compliance with them
- Might **discuss audit procedures applied** or obtain written summary of other auditor's procedures in form of **Questionnaire/checklist**
- **NTE of procedures** will depend on **circumstances** of engagement & **knowledge about competence** of other auditor. Knowledge can be enhanced through review of his previous audit work.



Advantages:

- i. **Sharing** of expertise.
- ii. **Better quality** of performance.
- iii. **Improved service** to the client.
- iv. **Lower workload**.
- v. **Lower staff development costs**.
- vi. **Lower costs to carry out the work**.
- vii. Advantage of mutual consultation.
- viii. In respect of MNCs, work can be spread using the expertise of local firms which are in a better position to deal with detailed work and local laws and regulations.
- ix. Sense of healthy competition towards a better performance.

Disadvantages:

- i. The **fees** being shared.
 - ii. **Psychological problem** where firms of different standing are associated in the joint audit.
 - iii. General **superiority complexes** of some auditors.
 - iv. **Problems of co-ordination** of the work.
 - v. **Areas of work of common concern** being neglected.
 - vi. **Uncertainty** about **liability** for the work done.
- **Audit Planning:** EP & key engg. team members from each joint auditors involved in Audit Planning.
 - **Audit Strategy:** Jointly establish overall audit strategy which sets scope, timing & direction of audit, and also guides development of audit plan.
 - Before commencement of audit, discuss and develop a joint audit plan.
- In developing the joint audit plan, joint auditors should:
- a. identify **division** of audit areas and **common** audit areas
 - b. ascertain the **reporting objectives** of engagement
 - c. consider & communicate among all joint auditors factors **significant in directing engg. team's efforts**
 - d. consider results of **preliminary engagement activities**, or **similar engg. performed earlier**.
 - e. ascertain **NTE of resources** necessary to accomplish the engg.
- **RoMM:** Each of joint auditors should consider & assess RoMM & communicate to other joint auditors.
 - Joint auditors should discuss & document NTE of audit procedures for:
 - (I) common and (II) specific allotted areas of audit to be performed.
 - Obtain **common engagement letter** and common **mgt representation letter**.
 - **Work allocation document signed by all joint auditors and communicated to TCWG.**



Responsibility of Joint Auditors

For audit work divided among joint auditors, each joint auditor shall be **responsible only for work allocated** to such joint auditor including proper execution of audit procedures.

On other hand, all joint auditors shall be jointly and severally responsible for:

- i) Audit work which **isn't divided** among joint auditors and carried out by all joint auditors
- ii) **Decisions** taken by all joint auditors under audit planning in respect of common audit areas
- iii) **Matters** brought to notice of joint auditors **by any one of them & agreement among joint auditors** on such matters
- iv) Examining that **FS** of entity comply with requirements of relevant statutes
- v) Presentation & disclosure of **FS** as required by the applicable FRF
- vi) Ensuring that **A/R** complies with requirements of relevant statutes, applicable SA and other relevant pronouncements issued by ICAI

Not divided >> decisions by all >> agreement among all >> FS & A/R

Matters relevant for Others: If joint auditor comes across matters relevant to areas of responsibility of other joint auditors and deserve their attention, or require disclosure or discussion with, or application of judgment by other joint auditors, **communicate** the same to all other joint auditors **in writing prior to completion of audit**.

Reporting

- ✓ Joint auditors are required to issue **common audit report**.
- ✓ However, where joint auditors **disagree**, express their opinion in a **separate audit report**.
- ✓ In such circumstances, audit report(s) issued by joint auditor(s) shall make a **reference to each other's audit report(s)**.

Applicability:

To every Co. including foreign Co. **except:**

- Banking Co.
- Insurance Co.
- Sec 8 Co. (NGO)
- One Person Co. (OPC) & Small Co.
- Pvt Ltd Co. (not holding/subsdy of Public Co.)



BaSSI Pvt Ltd

Paid up Share Cap + Reserves & Surplus \leq 1 Cr (B.S. Date) & Borrowings (Bank or FI) \leq 1 Cr (Any time during year) &

Revenue (including revenue from discontinued operations) \leq 10 Cr as per F/S

*CARO not applicable to Consolidated financial statements except clause (xxi)

Eg 1: 'Educating Child' is a Ltd Co. regd u/s 8 of Companies Act, 2013.

In given case, 'Educating Child' is licensed to operate under Sec 8 of Companies Act, 2013.

Therefore, CARO, 2020 shall not be applicable to 'Educating Child' accordingly.

Eg 2: Ashu Pvt. Ltd. has fully paid capital and reserves of ₹50 lakh. During the year, Co. had borrowed ₹70 lakh each from a bank and a financial institution independently. It has turnover of ₹900 lakh.

In given case of Ashu Pvt. Ltd, has paid capital and reserves of ₹50 lakh i.e. less than 1 Cr, turnover of ₹9 crore i.e. less than ₹10 crore. However, it has maximum outstanding borrowings of ₹1.40 crore (₹70 lakh + ₹70 lakh) collectively from bank and financial institution. Therefore, it fails to fulfill condition relating to borrowings. Thus, CARO, 2020 shall be applicable to Ashu Pvt. Ltd. accordingly.

Para 3: Clauses (i) to (xxi)

(i) (Proper records of PPE/Intangibles + Physical verification + Title deeds + Revaluation + Benami)

(a) (A) whether Co. is maintaining **proper records** showing full particulars, including quantitative details and situation of **Property, Plant and Equipment**

(B) whether company is maintaining proper records showing full particulars of **intangible assets**

(b) whether these PPE have been **physically verified** by mgt at reasonable intervals; whether any **material discrepancies** were noticed on such verification and if so, whether same have been **properly dealt in books of a/c**

(c) whether **title deeds** of all immovable properties (other than properties where Co. is lessee & lease agreements duly executed in favour of lessee) disclosed in F.S. are held in name of Co, if not, provide details in format below:-

Description of property	Gross carrying value	Held in name of	Whether promoter, director or their relative or employee	Period held- indicate range, where appropriate	Reason for not being held in name of Co.*
-------------------------	----------------------	-----------------	----------------------------------------------------------	------------------------------------------------	-------------------------------------------

- | | |
|--|----------------------|
| | Indicate any dispute |
|--|----------------------|
- (d) whether Co. has **revalued** its PPE (including Right of Use assets) or intangible assets or both during year and, if so, whether revaluation by **Registered Valuer**; specify amt of change, if change is **10% or more** in **aggregate** of **net carrying value** of **each class** of PPE or intangible assets
- (e) whether any **proceedings** initiated or pending against Co. for **holding any benami property** under Benami Transactions (Prohibition) Act, 1988 and rules made thereunder, if so, whether Co. has appropriately disclosed details in its FS

(ii) [Inventory → Physical verification + Working capital loans]

- (a) whether **physical verification** of inventory conducted at **reasonable intervals** by mgt and whether, in opinion of auditor, **coverage & procedure** of verification by mgt appropriate; whether any **discrepancies of 10% or more** in aggregate for each class of inventory noticed and if so, whether they have been properly dealt with in books of a/c
- (b) whether during any point of time of year, Co. been **sanctioned working capital limits in excess of 5 Cr.** in aggregate, from banks or financial institutions on basis of security of current assets; whether **quarterly returns or statements** filed by Co. with such banks or financial institutions in **agreement with books of a/c of Co.** if not, give details

Co. has dispensed with practice of taking inventory of their inventories at year-end as in their opinion exercise is redundant, time consuming and intrusion to normal functioning of operations.

Explain reporting requirement under CARO, 2020.

Reporting for Physical Verification of Inventory:

Clause (ii) of Para 3 of CARO, 2020, requires auditor to report

[Reporting requirement discussed above]

In given case, above requirement of physical verification of inventory by mgt hasn't taken place and therefore auditor should point out the same under CARO, 2020.

He may consider impact on F.S. and report accordingly

(iii) Loans, Investments, Guarantee & Securities (LIGS)

whether during year Co. made investments in, provided any guarantee/security or granted any loans/advances in nature of loans, secured/unsecured, to Cos, firms, LLPs or any other parties, if so, -

- a) whether during year Co. has provided **loans or provided advances in nature of loans**, or stood **guarantee, or provided security to any other entity [not applicable to companies whose principal business is to give loans]**, if so, indicate-

(A) aggregate amt during year, and balance o/s at BS date w.r.t. such loans or advances and guarantees or security to **subsidiaries, joint ventures and associates**;

(B) Agg. amt during year, and balance outstanding at BS date w.r.t such LAGS to **parties other than subsidiaries, joint ventures and associates**;

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- b) whether **investments made, guarantees provided, security given** & T&Cs of grant of all loans and advances in nature of loans and guarantees provided are not prejudicial to the company's interest
- c) in respect of loans and advances in nature of loans, whether **schedule of repayment** of principal and payment of interest has been stipulated and whether repayments or receipts are regular
- d) if amount is overdue, state total **amount overdue for more than 90 days**, and whether reasonable steps have been taken by company for recovery of principal and interest
- e) whether any loan or advance in nature of loan granted which has **fallen due during year**, has been **renewed or extended or fresh loans** granted to settle existing loans given to same parties, if so, specify aggregate amt of such dues renewed or extended or settled by fresh loans & %age of agg. to total loans or advances in nature of loans granted during year **[not applicable to companies whose principal business is to give loans]**
- f) whether Co. granted any loans/advances in nature of loans **repayable on demand or without specifying any terms or period of repayment**, if so, specify agg. amt, %age to total loans granted, agg. amt of loans granted to Promoters, related parties defined u/s 2(76) of Cos Act, 2013

(iv) Sec 185 & 186

in respect of loans, investments, guarantees, and security (LIGS), whether provisions of **sections 185 and 186** of the Companies Act have been complied with, if not, provide the details thereof

(v) Deposits

in respect of deposits accepted by Co. or amounts deemed to be deposits, whether

- **directives issued by RBI** and
- provisions of **Sec 73 to 76** or any other relevant provisions of Cos. Act and rules made thereunder, where applicable, have been complied with,

if not,

- **nature of such contraventions** be stated;
- if an **order** has been passed by Company Law Board or NCLT or RBI or any court or any other tribunal, whether the same has been **complied with or not**

(vi) Cost records

whether maintenance of cost records has been **specified by CG** under section 148(1) of Companies Act and whether such accounts and records have been **so made and maintained**

(vii) Statutory dues

(a) whether Co. is

- ✓ regular in depositing **undisputed statutory dues** including GST, PF, ESI, income-tax, sales-tax, service tax, customs duty, excise duty, VAT, cess & any other stat dues to appropriate authorities and

- ✓ if not, extent of **arrears** of o/s statutory dues **as on last day of FY** concerned for a period of **more than 6 months** from date they became payable, shall be indicated

(b) where statutory dues referred to in sub-clause (a) have not been deposited on account of any **dispute**, then

- ✓ **amounts involved** and
- ✓ **forum** where dispute is pending shall be mentioned

(a mere representation to the concerned Department shall not be treated as a dispute)

(viii) Income Disclosure

whether any **transactions not recorded** in books of a/c have been **surrendered or disclosed as income during year in the tax assessments** under Income Tax Act, 1961, if so, whether previously unrecorded income has been properly recorded in the books of a/c during the year

(ix) Repayment of loans

a) whether Co. has **defaulted in repayment of loans** or other borrowings or in payment of interest to any lender, if **yes, period and amount of default** to be reported as per format below:-

Nature of borrowing, including debt securities	Name of lender	Amt not paid on due date	Whether principal or interest	No. of days delay or unpaid	Remarks, if any
------------------------------------------------	----------------	--------------------------	-------------------------------	-----------------------------	-----------------

*lender wise details in case of default to Bank, financial institutions & Govt

- b) whether Co. is a **declared wilful defaulter** by any bank or financial institution or other lender
- c) whether term loans were **applied for purpose** for which loans were obtained; if not, amount of loan so diverted and purpose for which it is used may be reported
- d) whether funds raised on **short term basis have been utilised for long term purposes**, if yes, nature and amount to be indicated
- e) whether Co. has taken any funds from any entity or person on account of or to **meet obligations of its subsidiaries, associates or joint ventures**, if so, details thereof with nature of such transactions and amt in each case
- f) whether Co. has raised loans during the year on **pledge of securities held in its subsidiaries, joint ventures or associate companies**, if so, give details thereof and also report if Co. has defaulted in repayment of such loans raised

(x) (a) IPO/ FPO Reporting

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

(x) (b) Preferential Allotment/Private placement

whether Co. has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during year and if so, whether the requirements of Sec 42 and Sec 62 of the Companies Act, 2013 have been complied with and funds raised have been used for purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of non-compliance

(xi) Fraud

- a) whether any fraud by the company or any fraud on the company has been noticed or reported during the year, if yes, nature and amount involved is to be indicated
- b) whether any report under Sec 143(12) of Companies Act has been filed by the auditors in Form ADT-4 as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the CG
- c) whether auditor has considered whistle-blower complaints, if any, received during the year by Co.

(xii) Nidhi Company

- a) whether Nidhi Co. complied with Net Owned Funds to Deposits in ratio of 1:20 to meet out liability
- b) whether Nidhi Co. is maintaining 10% unencumbered term deposits to meet out the liability
- c) whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof

(xiii) Related Parties

whether all transactions with related parties are in compliance with Sec 177 and 188 of Companies Act where applicable and details have been disclosed in F.S. as reqd. by applicable a/c standards

(xiv) Internal Audit

- a) whether the Co. has internal audit system commensurate with size and nature of its business
- b) whether reports of Internal Auditors for period under audit were considered by statutory auditor

(xv) Non cash transactions

whether the Co. has entered into any non-cash transactions with directors or persons connected with him and if so, whether provisions of Sec 192 of Companies Act have been complied with

(xvi) RBI

- a) whether Co. is required to be regd. under Sec 45-IA of RBI Act, 1934 (2 of 1934) and if so, whether registration has been obtained
- b) whether Co. has conducted any Non-Banking Financial or Housing Finance activities without a valid Certificate of Registration (CoR) from RBI as per RBI Act, 1934

- c) whether company is a **Core Investment Company (CIC)** as defined in regulations made by RBI, if so, whether it continues to fulfil criteria of a CIC, and in case Co. is exempted or unregistered CIC, whether it continues to fulfil such criteria
- d) whether Group has **more than 1 CIC** as part of Group, if yes, **indicate no. of CICs** part of Group

(xvii) Cash Losses

whether Co. has **incurred cash losses** in financial year and in immediately preceding financial year, if so, state the amount of cash losses [Cash loss even in any 1 year has to be disclosed]

(xviii) Resignation by Statutory Auditors

whether there has been any resignation of statutory auditors during year, if so, whether auditor has taken into **consideration the issues, objections or concerns** raised by the outgoing auditors

(xix) Going Concern

on basis of:

- **financial ratios,**
- ageing and expected dates of realisation of **financial assets** and
- payment of financial **liabilities,**
- **other information** accompanying the F.S,
- auditor's knowledge of Board of Directors and management **plans,**

whether auditor is of the opinion that **no material uncertainty exists** as on **date of audit report** that Co. is **capable of meeting its liabilities existing at date of B.S.** as and when they fall due within a **period of 1 year** from B.S. Date;

(xx) CSR Reporting

- a) whether, in respect of **other than ongoing projects,** Co. has **transferred unspent amount** to a Fund specified in Schedule VII to the Companies Act within a **period of 6 months** of the expiry of FY in compliance with second proviso to Sec 135(5) of the said Act
- b) whether any **amount remaining unspent** under Sec 135(5) of the said Act **ongoing project,** has been **transferred to special a/c** in compliance with Sec 135(6) of the said Act

(xxi) Qualifications in CFS

whether there have been any qualifications or adverse remarks by respective auditors in the CARO reports of companies included in the consolidated financial statements, if yes, indicate details of companies and paragraph numbers of CARO report containing qualifications or adverse remarks.

Sec 143(1) Duty to enquire on Certain Matters

- a) Loans & **advances** made on security have been properly secured & whether terms prejudicial to interest of Co. or its members
- b) Transactions merely represented by **book** entries prejudicial to intt of Co.
- c) Where **Co.** not being Investment/ Banking Co. whether its assets consisting of shares, debentures & other securities sold at price < purchase price
- d) Whether Loans & Advances shown as **Deposits**
- e) Whether personal **expenses** charged to Revenue a/c
- f) Where shares of Co. have been allotted **For cash**, whether cash received & if no cash recd, position as per books & balance sheet, correct, regular & non misleading

Notes:

- Auditor not reqd to report on above matters unless spl. comments to make
- Auditor should report only when ans. to any of matters is in adverse

Sec 143(3) Duty to Report

Auditor's report shall state:

- a. whether he has **sought and obtained all the information and explanations** which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
- b. whether, in his opinion, **proper books of account** as reqd by law have been kept by the Co. so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- c. whether the report on accounts of **branch office** of the Co. audited u/s 143(8) by a person other than the company's auditors has been sent to him and the manner he has dealt with it in preparing report;
- d. whether the company's **balance sheet and profit and loss account** dealt with in the report are in agreement with the books of account and returns;
- e. whether, in his opinion, the financial statements **comply with the accounting standards**;
- f. the **observations or comments** of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
- g. whether any **director is disqualified** from being appointed as a director u/s 164(2)
- h. any **qualification, reservation or adverse remark** relating to the maintenance of accounts and other matters connected therewith;
- i. whether the company has **adequate internal financial controls** with reference to financial statements in place and the operating effectiveness of such controls

Ch-13 CARO 2020 & Company Audit

IFC Reporting NA to Pvt Co. which is a:



- > OPC
- > Small Co.
- > Pvt Co. with
 - ✓ T/o < ₹50 Cr (last audited FS) &
 - ✓ Borrowings from Banks/FI (during FY) < 25 Cr

j. such **other matters** as may be prescribed.

Rule 11 of Cos. (Audit and Auditors) Rules, 2014 other matters to be included in auditor's report namely:-

- a. whether Co. has **disclosed impact of pending litigations on its financial position** in its financial statement
- b. whether Co. has made **provision**, as required under any law or accounting standards, for **material foreseeable losses**, if any, on long term contracts including derivative contracts
- c. whether there been **delay in transferring amt. to Investor Education & Protection Fund** by Co.
- d. i) Whether **mgt has represented** to best of knowledge & belief, **other than disclosed in notes, no funds advanced, loaned or invested by Co. in any person or entity including foreign entity with understanding that Intermediary will lend or invest in another entity or provide guarantee or security on behalf of Co. (Ultimate Beneficiary)**
ii) Whether **mgt has represented** to best of knowledge & belief, **other than disclosed in notes, no funds received by Co. from any person or entity including foreign entity (Funding Parties) with understanding that Co. will lend or invest in another entity (Ultimate Beneficiary) or provide guarantee or security on behalf of Funding Party**
iii) Auditor has found **no material misstatement in above representations**
- e. Whether **Dividend** declared & paid as per Sec 123
- f. Co. **used a/c software** to maintain books of a/c **having audit trail** & same operated throughout year & audit trail hasn't been tampered & preserved by Co. for retention.

While reporting, where any of matters required to be included in A/R is answered in **negative** or with a **qualification**, report shall **state reasons**. Further, every auditor shall **comply with auditing standards** as required under Sec 143(9).

Note: Auditors of public cos. Required to report remuneration to directors within limits u/s 197 under the Section Report on Other Legal and Regulatory Requirements.

Report on Frauds [Sec 143(12) read with Rule 13 of CAAR, 2014]

- If auditor has reason to believe offence of fraud involving amount of 1 Cr or above committed in Co. by its officers or employees
 - Auditor shall report to CG within such time & manner as prescribed
- If fraud < 1 Cr → report to AC or Board in such time & manner prescribed.

Types of Banks [MTP Mar-21]

1. Commercial banks → Provide no. of products & services to public & other segments of economy. Two main functions:- (a) accepting deposits and (b) granting advances.

2. Regional Rural Banks known as RRBs → set up in rural areas in different states to cater to basic banking & financial needs of rural communities.

Examples:- Punjab Gramin Bank , Tripura Gramin Bank , Allahabad UP Gramin Bank , Andhra Pradesh Grameen Vikas Bank, etc

3. Co-operative Banks (like Commercial Banks only) but set up on basis of Cooperative Principles and **regd under Cooperative Societies Act** of respective state or Multistate Cooperative Societies Act & usually **cater to needs of agricultural & rural sectors**.

Eg:- Gujarat State Co-operative Bank Ltd. , Chhatisgarh Rajya Sahakari Bank Maryadit , etc.

4. Payments Banks are a **new type of banks** recently introduced by RBI. **Allowed to accept restricted deposits** but can't issue loans & credit cards. However , customers can open Current & Savings a/cs & avail ATM facility cum Debit cards , Internet & Mobile banking.

Eg:- Airtel Payments Bank , India Post Payments Bank, Paytm Payments Bank , etc.

5. Development Banks → provide funds for **infrastructural facilities** for economic growth of country.

Eg:- Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI) , etc

6. Small Finance Banks → make available **basic banking facilities** to unserved & unorganised sectors like small marginal farmers, small & micro business units, etc.

Eg:- Equitas Small Finance Bank , AU Small Finance Bank , etc.

Reserve Bank of India: Regulating Body

RBI is responsible for :-

- **Development and supervision of constituents** of Indian financial system (comprising banks & non-banking financial institutions)
- Determining with **CG, monetary & credit policies**.
- **Regulating activities** of commercial & other banks

Important functions of RBI are :-

- Issuance of **currency**
- Regulation of **currency** issue
- **acting as banker** to **central and state govts** and
- **acting as banker** to **commercial and other types of banks**.

- **Regulating activities** of commercial and other banks.

Note: No bank can commence banking business or open new branches without RBI license. RBI also has power to inspect any bank.

Regulatory Framework

- ✓ Banking Regulation Act, 1949.
- ✓ SBI Act, 1955.
- ✓ SBI (Subsidiary Banks) Act 1959.
- ✓ Companies Act, 2013.
- ✓ Information Technology Act, 2000.
- ✓ Prevention of Money Laundering Act, 2002.
- ✓ Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.
- ✓ Regional Rural Banks Act, 1976.
- ✓ Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

Peculiarities involved:

- ✓ Huge volumes and complexity of transactions
- ✓ Extensive use of technology
- ✓ Large range of products and services offered
- ✓ Wide geographical spread of banks' network
- ✓ Strict vigilance by the banking regulator etc.

Bank Audit Approach

1. Drawing audit plan based on:

- ✓ Nature & level of operations
- ✓ Nature of adverse features
- ✓ Level of compliance
- ✓ Audit risk based on inadequacy in/breach of internal controls

2. Control environment at Bank → controls to mitigate the risk
(Read nature of Ques table from ICAI SM)

3. Engg team discussions: Done at planning stage of audit [RTP Nov-21/July-21/Nov-19]
Engagement team discussion ordinarily includes a discussion of following matters:

- Errors** that may be more likely to occur
- Errors** which have been identified in prior years



Ch-14 Audit of Banks

- c. Method by which **fraud** might be perpetrated by bank personnel or others within particular account balances and/or disclosures
- d. **Audit responses** to Engagement Risk, Pervasive Risks, and Specific Risks
- e. Need to **maintain professional skepticism** throughout the audit engagement
- f. **Need to alert for information or other conditions** that indicates that a material misstatement may have occurred (e.g., bank's application of a/c policies in given facts and circumstances).

Errors/Frauds → Audit Response → Professional Skepticism → Alert!!

Advantages of such a discussion :-

- ✓ Specific emphasis should be provided to susceptibility of bank's FS to **material misstatement due to fraud**, that enables engg team to consider appropriate response to fraud risks, including those related to engg. risk, pervasive risks and specific risks.
- ✓ EP will **delegate work to experienced ET members** and determine procedures to be followed when fraud identified.
- ✓ EP may **involve specialists** to address issues relating to fraud.

Appointment of Auditor

- ✓ Banking Co. → AGM by Shareholders + RBI Approval
- ✓ Nationalised bank → BOD
- ✓ RRB → Bank approval of CG

Remuneration of Auditor

- a. Banking company → Section 142 Cos Act, 2013 (i.e., by company in GM or in such manner as Co. in GM may determine).
- b. Nationalised banks and SBI → RBI in consultation with CG

Auditor's Report [MTP Oct-18]

In the case of **nationalised bank** → report to CG → state following:

- a. whether, in his opinion, **FS present a true and fair view** of affairs of bank and in case he had called for any **explanation or information**, whether it has been given & whether it is satisfactory
- b. whether or not **transactions of bank**, which come to his notice, been within powers of that bank
- c. whether or not **returns received from offices & bank branches** been found adequate for audit
- d. **any other matter** which he considers should be brought to notice of CG.

Report of auditors of SBI also made to CG and almost identical to report of nationalised bank.

Long Form Audit Report (LFAR)

- **Terms of appointment** of auditors of public sector, pvt sector and foreign banks (also their branches), require auditors to furnish LFAR.
- Matters to deal with in LFAR have been **specified by RBI**.
- LFAR to be **submitted before 30th June every year**.
- To ensure timely submission of LFAR, **proper planning** for completion of LFAR is required.
- While format of LFAR doesn't require **executive summary**, members may consider providing it to bring out key observations from whole document.

Reporting of FRAUD to RBI [MTP Aug-18]

1. RBI issued **Circular** for implementation of **recommendations of Committee on Legal Aspects of Bank Frauds** applicable to all scheduled commercial banks (excluding RRBs).

Regarding liability of accounting & auditing profession, circular provided as under:

"If an accounting professional, in course of internal or external audit or institutional audit finds

- ✓ anything **susceptible** to be fraud or
- ✓ **fraudulent activity** or act of excess power or
- ✓ **smell any foul play** in any transaction,

he should **refer the matter to regulator**.

Any deliberate failure of audit should render himself liable for action".



As per above requirement, member shall **report the kind of matters stated in circular to RBI**.

2. Auditor should consider **SA 250**, "Consideration of Laws and Regulations in an Audit of F.S". Std explains that **duty of confidentiality is over-ridden by statute, law or courts**.

3. **SA 240**, "Auditor's Responsibilities Relating to Fraud in an Audit of F.S." states that auditor conducting an audit in accordance with SAs is responsible for **obtaining reasonable assurance that F.S. taken as a whole are free from MM, whether caused by fraud or error**.

Note: Auditor isn't expected to look into each and every transaction but evaluate system as a whole.

Therefore, if auditor while performing normal duties comes across any instance → report matter to **RBI in addition to Chairman/MD/CEO of concerned bank**.



Types of Bank Audit Reports to be issued (generally) [RTP May-21]

Statutory Central Auditors furnish following reports in addition to main audit report:

- a. Report on adequacy and operating effectiveness of **ICFR** in case of banks regd as companies as per Sec 143(3)(i) of Companies Act, 2013 → given as Annexure to main audit report as per Guidance Note on Audit of ICFR issued by ICAI.
- b. Long Form Audit Report. (**LFAR**)
- c. Report on compliance with **SLR** requirements.
- d. Report on whether **treasury operations** of bank have been conducted as per RBI instructions.
- e. Report on whether **income recognition, asset classification & provisioning** as per RBI guidelines.
- f. Report on whether any **serious irregularity** noticed in bank working requiring immediate attention.
- g. Report on status of compliance by bank w.r.t implementation of **recommendations of Ghosh Committee** relating to frauds and malpractices and **Jilani Committee** on internal control and inspection/credit system.

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Read the topic: Conducting an Audit from ICAI SM

Understanding Risk Management Process [May-19]

Mgt develops controls and uses performance indicators to manage key business & financial risks.

An effective risk management system in a bank generally requires following:

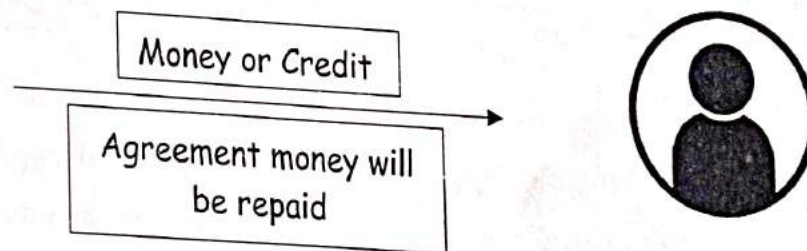
- a. Oversight and involvement in control process by TCWG: TCWG (BOD/MD) should **approve written risk mgt policies**.
- b. Identification, measurement and monitoring of risks: Risks that could significantly impact achievement of bank's goals should be identified, measured and monitored **against pre-approved limits and criteria**.
- c. Control activities: Bank should have appropriate controls to mitigate its risks including effective **SODs** (particularly between front and back offices), verification and **approval of transactions**, setting up **limits**, reporting and approval of **exceptions, physical security** and **contingency planning**.
- d. Monitoring activities: Risk mgt models, methods and assumptions used to measure and mitigate risk should be regularly assessed and updated. May be conducted by **independent risk mgt unit**.
- e. Reliable information systems: Banks require reliable info. systems that provide **adequate financial, operational and compliance info.** on timely & consistent basis.

Reliance on / review of other reports: Auditor should consider adverse comments, if any, on advances appearing in the following-

- o Previous year's audit reports.
- o Concurrent / Internal audit report.
- o Any other internal reports specially related to particular accounts.
- o Latest internal inspection reports of bank officials.
- o Reserve Bank's latest inspection report.
- o Report on verification of security.
- o Manager's charge-handing-over report when incumbent is changed.

Above reports should be reviewed in detail. SCAs must review Annual Financial Inspection report of RBI relating to the bank and ensure that variations in provisions, etc. reported by RBI have been properly considered by bank mgt.

Advances (Most Important)



- Asset for the bank

Types of Advances: - Funded Loans & Non-Funded Loans [MTP Apr-21]

1. Funded loans → Loans where there is actual transfer of funds from bank to borrower.

Example → Term loans, Cash credits, Overdrafts, Demand Loans, Bills Discounted & Purchased, Participation on Risk Sharing basis, Interest-bearing Staff Loans.

2. Non-funded facilities → do not involve such transfer.

Examples: Letters of credit, Bank guarantees, etc.

Classification of Advances

I. Sector Wise

- ✓ RBI issues guidelines for lending to Priority Sector which banks are required to follow.
- ✓ Covering rate of interest, service charges, receipt, sanction, rejection, disbursement Register, issue of Loan Application Acknowledgement
- ✓ RBI also issues targets for banks for lending to Priority Sector.

Example of Priority Sectors are Agriculture , MSME , Education , Housing , etc.

II. Security Wise

Banks ask Security/Collateral while lending to assure that Borrower will return money to bank in prescribed time else Banks have legal authority to sell collateral to recover its money.

Nature of Security [May-18]

A. Primary security refers to security offered by borrower for bank finance or the one against which credit been extended by bank. This security is **principal security for an advance**.

B. Collateral security is an **additional security**. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of common types of securities accepted by banks are following:

Personal Security of Guarantor	Stock Exchange Securities and Other Instruments
Third Party Guarantees	Immovable Property
Goods/Stocks/Debtors/Trade Receivables	Plantations (For Agricultural Advances)
Gold Ornaments and Bullion	Banker's General Lien
Life Insurance Policies	

Mode of Creation of Security [RTP Nov-20]

Depending on **nature of item** concerned, creation of security may take form of a mortgage, pledge, hypothecation, assignment, set-off or lien.

(i) Mortgage: Mortgage are of several kinds but most important are Registered Mortgage & Equitable Mortgage. (Immovable properties)

- ✓ Regd Mortgage can be affected by a **registered instrument** called '**Mortgage Deed**' signed by **mortgagor**. It registers property to mortgagee as a security.
- ✓ Equitable mortgage, on other hand, is effected by a **mere delivery of title deeds** or other documents of title with intent to create security thereof.

(ii) Pledge: It involves **bailment or delivery of goods** by borrower to lending bank with intention of creating a charge on security. **Legal ownership** of goods **remains with pledger** while lending banker gets certain defined interests in goods. Pledge of goods constitutes a **specific (or fixed) charge**.

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

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- ✓ Neither ownership nor possession is trfd to bank. However, borrower holds physical possession of goods as agent/trustee of bank.
 - ✓ Borrower periodically submits statements regarding qty & value of hypothecated assets (stocks, debtors, etc.) to lending banker on basis of which drawing power of borrower is fixed.
- (iv) Assignment: Assignment represents a transfer of 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 secured debt) such as book debts & life insurance policies are accepted by banks as security by way of assignment.
 - ✓ An assignment gives assignee absolute right over the moneys/debts assigned to him.
- (v) Set-off: Its a statutory right of creditor to adjust, wholly or partly, debit balance in debtor's account against any credit balance lying in another account of debtor.
- ✓ Right of set-off enables a bank to combine two a/cs (deposit & loan a/c) of same person provided both are in same name and right.
 - ✓ For purpose of set-off, all branches treated as single entity.
 - ✓ Right of set-off can be exercised for time-barred debts also.
- (vi) Lien: Lien is creation of legal charge with consent of owner, giving lender legal right to seize and dispose / liquidate the asset under lien. [Exercised on Hypothecated/Pledged/Mortgaged property]

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Prudential norms on Income Recognition, Asset Classification & Provisioning pertaining to Advances:

Classification of Advances as per RBI Prudential Norms		NPA Loans
Standard Loans		Sub Std (NPAs upto 12 months)
Standard Regular	SMA- Spl Mention Accounts	Doubtful (D1 → Doubtful upto 1 year D2 → Doubtful 1-3 Years D3 → Doubtful > 3 years)
	SMA 0 (Accounts showing stress signals)	
SMA 1 (Overdue between 30-60 days)	Loss Assets	
	SMA 2 (Overdue between 61-90 days)	

Ch-14 Audit of Banks



Non-performing Assets: An asset becomes NPA when it **ceases to generate income** for Bank.

NPA is a loan or an advance where -:

- Term Loan → Interest &/or principal installment → **overdue > 90 days**
- Overdraft/Cash Credit → A/c remains **'out of order'**
- Bills purchased and discounted → Bill remains **overdue > 90 days.**

Overdue: Any amt → 'overdue' → if it is **not paid on due date** fixed by bank.

Out of Order [July-21]

A/c treated as 'out of order' if:-

- **o/s balance** remains **> sanctioned limit/drawing power** or
- Where **o/s balance < sanctioned limit/drawing power**, but **no credits** continuously for **90 days** as on BS Date or
- **credits are there** but **not enough** to cover interest debited during same period.

Example: A Ltd. been sanctioned Cash Credit Facility by ADB Bank for ₹50L but as per Stock Statements furnished for last quarter, Bank has calculated Drawing Power to be ₹42 L.

Account would be termed as OUT OF ORDER if :-

- **o/s balance** remains continuously **> ₹50 lacs/42 lacs** or
- **o/s balance in a/c < ₹42 lacs** but **no credits** or any payments deposited into this a/c continuously for 90 days as on BS date or
- **credits there** upto say ₹2 lakhs but **not enough** to cover interest debited during same period which is around ₹5 lakhs.

Provisioning Requirement [MTP Oct-21]

Categories of NPA	Provision Required
Sub std assets (NPAs upto 12 months)	15%
Doubtful Assets (Sub std for period of 12 Months)	
<u>Sub Categories</u>	<u>Secured/Unsecured</u>
Doubtful upto 1 year	25%/100%
Doubtful 1-3 years	40%/100%
Doubtful > 3 years	100%/100%
Loss Assets: Loss identified by bank/internal/external auditors or RBI but amt not w/off wholly.	100%

Note :-

1. NPA Classification → based on record of recovery. Availability of security or Net Worth of borrower/guarantor not considered for treating an advance as NPA or otherwise.

2. Asset classification would be borrower-wise and not facility-wise.

All facilities including investments in securities would be termed as NPA.

For eg :- Mr. Raman availed 2 Loan facilities - Car Loan as well as Housing Loan from XYZ Bank. He is regular in depositing Housing loan EMI but not deposited last 4 EMI's (overdue > 90 days) of Car Loan due to paucity of funds. Hence, not only Car loan but Housing Loan treated as NPA because NPA classification is Borrower wise (Mr. Raman) and not Facility wise (Car & Housing Loan individually).

Accounts regularized near B.S. Date: Asset classification of borrower a/cs where a solitary or a few credits recorded before B/S Date should be handled with care and without scope for subjectivity.

Where **a/c indicates inherent weakness** on basis of available data → deemed as NPA.

Auditor should **check sample transactions immediately before & after** closing of FY to **get knowledge of objective behind the transactions** if they have any relation to each other or if any/some transactions are **being reversed** during **first few days after closing** which **might show an arrangement** to prevent Borrower account(s) from slipping into NPA category.

Government Guaranteed advances

- CG guaranteed Advances, where guarantee is **not invoked/ repudiated** would be classified as **Standard Assets**, but regarded as **NPA for Income Recognition purpose**.
- For State Government → **no such exception** → advance treated as NPA if overdue > 90 days for both Provisioning and Income recognition purposes.

Advances under Consortium [MTP Nov-21/Jan-21]

- Advancing loans to borrower by **2 or more Banks** jointly by forming a **Consortium**.
- Joint appraisal, control and monitoring** allow exchange of valuable info among Banks.
- Usually, Bank with higher share **lead** the consortium.
- Consortium advances **classification** should be **based on record of recovery of respective individual member banks & other aspects** having impact on recoverability of advances.
- Where **remittances by borrower pooled with 1 bank** and/or
 - ✓ bank **receiving remittances is not parting with share of other member banks**,
 - ✓ a/c **treated as not serviced** in books of **other member banks** and hence, **NPA**.
- Participating Banks
 - ✓ **need to arrange to get their share of recovery** transferred from lead bank or
 - ✓ **get express consent** from lead bank for transfer of their share of recovery, to ensure proper asset classification in their respective books.

Drawing Power Allocation in case of Consortium Cash Credit A/c:

- ✓ **Lead Bank** responsible for **computing DP** of borrower & **allocate** the same to member banks.
- ✓ In **special circumstances**, at request of Borrower, Lead Bank **may allot a higher or lower share** of drawing power to member bank, as against their share of advances.

Accounts where there is erosion in value of security / frauds committed by borrowers

Erosion means **gradual destruction or diminution of something** not prudent to follow stages of asset classification.

Straight-away classified as doubtful or loss asset as appropriate as follows :-

- i) Erosion in value of security → significant when realisable **value of security < 50 % of value assessed by bank** or accepted by RBI at time of last inspection.
Straight-away classified under **doubtful category** and provisioning should be made.
- ii) **Realisable value** of security, as assessed by bank/ approved valuers/ RBI < **10 % of o/s in borrower a/cs**, existence of security ignored & asset straight-away classified as **loss asset**. Either w/off or fully provided for by the bank.

Advances Against Term Deposits, NSCs, KVPs/ IVPs, etc.

Advances against Term Deposits, NSCs eligible for surrender, KVP/IVP and life policies need **not be treated as NPAs**, provided **adequate margin** is available in the accounts.

Agricultural Advances Affected by Natural Calamities

- **Master Circular** issued by RBI discusses classification and income recognition issues due to impairment caused by natural calamities.
- Banks may decide their **own relief measures**, like conversion of short-term production loan into a term loan or re-schedulement of repayment period and sanctioning of fresh short-term loan, subject to RBI's guidelines.
- Hence, **NPA classification** would be governed by such **rescheduled terms**.

Advances to Staff [MTP Mar-23]

- Interest-bearing staff **advances as a banker** included as **part of advances portfolio** of bank.
- In case of **housing loan or similar advances** granted to staff members where **interest payable after recovery of principal**, interest not considered as overdue from 1st quarter onwards.
- Classified as **NPA only when default in repayment** of installment of principal or intt on due dates.
- Staff advances by bank **as employer** and **not as banker** to be included under **sub-head 'Others' under schedule of Other Assets**.

Agricultural Advances

Agricultural Advances are of 2 types:

- 1) Agricultural Advances for "long duration" crops with Crop Season > 1 year and
- 2) Agricultural Advances for "short duration" crops.

Crop season for each crop, means **period up to harvesting of crops raised**, determined by **State Level Bankers' Committee** in each State.

Following NPA norms apply to agricultural advances (including Crop Term Loans):

- Loan for SDCs: NPA if instalment of principal or intt **overdue for 2 crop seasons**
- Loan for LDCs → NPA if instalment of principal or intt. **overdue for 1 crop season**

Computation of Drawing Power (DP)

1. Meaning: DP is Important concept for Cash Credit (CC) facility availed from banks & financial institutions. Its **limit** up to which a firm or Co. can **withdraw** from **working capital limit** sanctioned.

2. Different from Sanctioned Limit: **Sanctioned limit** is **total exposure** that bank can take on a particular client whereas **DP** is calculated based on **primary security less margin** as on particular date.

3. Considerations: - All **a/c to be kept within both DP & sanctioned limit at all times.**

A/cs with

- **exposure > sanctioned limit or drawing power** or
- against **unapproved securities** or
- otherwise **irregular** → brought to notice of mgt/HO regularly.

4. Bank's Duties:

- Ensure drawings in working capital a/c covered by **adequacy of current assets.**
- DP reqd to be arrived at **based on current stock statement.**
- However, considering difficulties of large borrowers, **stock statements** relied upon by banks for determining DP should **not older than 3 months.**
- If DP calculated from stock statement **older than 3 months** → **deemed as irregular.**

5. Auditor's Concern:-

- **Stock statements, quarterly returns and other statements** submitted by borrower to bank should be scrutinized in detail.
- **Audited Annual Report** submitted by borrower should be scrutinized properly.
- **Monthly stock statement** of the month for which audited a/cs are prepared and submitted should be compared and reasons for deviations, if any, should be ascertained.

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6. Computation of DP:-

- ✓ DP is calculated as per **extant guidelines** formulated by **BOD** of respective bank & **agreed** upon by concerned **statutory auditors**.
- ✓ **Spl consideration** to reporting of **sundry crs** for purposes of calculating drawing power.

7. Stock Audit: -

- ✓ Carried out by bank for a/cs with **funded exposure > 5 crores**.
- ✓ Auditors can also advise for stock audit in **other cases** if **situation warrants** the same.
- ✓ Branches should obtain **stock audit reports** from **lead bank** where **Bank is not leader** of **consortium** of working capital.
- ✓ **Report submitted by stock auditors** should be **reviewed** during audit and **spl focus** to comments made by stock auditors on **valuation of security** and **calculation of DP**.

Calculation of D.P. Formula: [RTP Nov-23]

Particulars	Amount (₹)	DP Amount (₹)
(A) Stocks		
At realizable value	xxx	
(-) Sundry creditors	(xxx)	
Paid for stocks	xxx	
(-) Margin (%)	(xxx)	xxx
(B) Debtors:		
Total debtors	xxx	
(-) Ineligible Debtors	(xxx)	
Eligible debtors	xxx	
(-) Margin (%)	(xxx)	xxx
Total Drawing Power		xxx*

*Make sure its restricted to sanctioned limit

Audit of Advances

Advances generally constitute major part of assets of bank. There are large no. of borrowers to whom variety of advances are granted. Audit of advances requires major attention from the auditors.

Substantive Procedures

- Examine all large advances while other advances may be examined on sampling basis.
- Accounts identified to be problem accounts, to be examined in detail unless amount is insignificant.
- Extent of sample checking depend on auditor's assessment of internal controls.

What's a 'large advance'?

Determine in context of volume of operations of branch e.g. an advance may be considered to be a large advance if the year-end balance is in excess of ` 10 crore or 10% of the aggregate year-end advances of the branch, whichever is less.

About what is Evidence is required? [RTP Nov-19/May-21]

Auditor is primarily concerned with obtaining evidence about following:

- a. Amounts included in BS in respect of advances are outstanding at BS Date.
- b. Advances represent amount due to the bank.
- c. Amounts due to bank are appropriately supported by loan documents & other docs applicable to nature of advances.
- d. There are no unrecorded advances.
- e. Stated basis of valuation of advances is appropriate & properly applied & recoverability of advances recognized in their valuation.
- f. Appropriate provisions have been made as per RBI norms, Accounting Standards and GAAP.
- g. Advances are disclosed, classified & described as per recognised a/c policies & practices & relevant statutory & regulatory requirements.

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How to get SAAE about Advances?

Auditor can obtain SAAE about advances by study and evaluation of internal controls relating to advances, and by:

- ✓ examining **validity of the recorded amounts**
- ✓ examining **loan documentation**
- ✓ reviewing **operation of accounts**
- ✓ examining existence, enforceability, and valuation of the **security**
- ✓ checking compliance with RBI norms including **classification and provisioning** and
- ✓ carrying out appropriate **analytical procedures**.

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Evaluation of Internal Controls over Advances [RTP May-19/Nov-22]

Auditor should examine efficacy of various internal controls over advances to determine NTE of his substantive procedures.

In general, internal controls over advances should include, inter alia, the following:

- **Check Creditworthiness:** Bank advance only after satisfying itself as to credit worthiness of borrower & **obtaining sanction** from appropriate **authorities** of bank.
- **Documentation:** All necessary documents (e.g., **agreements**, demand promissory notes, **letters of hypothecation**, etc.) should be executed by parties before advances made.
- **Compliance:** With the **terms of sanction** and **end use of funds** should be ensured.
- **Securities**
 - ✓ **Margin:** Sufficient margin as specified in sanction letter should be kept against securities taken to **cover for any decline in value**.
 - ✓ **Ownership of Securities:** If securities taken are in **nature of shares, debentures**, etc., **ownership** of the same should be **trfd in name of bank** and effective control of such securities be retained as a part of documentation.
 - ✓ **Registration in Banks Name:** All securities requiring registration should be regd in name of bank or **otherwise accompanied by documents** sufficient to **give title to bank**.
 - ✓ **Goods:** In case of goods in possession of bank, **contents** of packages should be **test checked** at time of receipt. **Godowns frequently inspected** by responsible officers of branch, in addition to inspectors of bank.
- **Drawing Power**

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- ✓ **DP Register updated every month** to record value of securities hypothecated. These entries should be checked by an officer.
- ✓ The **a/cs should be kept within both DP and sanctioned limit**.
- ✓ All the **a/cs > sanctioned limit or drawing power** or are otherwise irregular should be brought to notice of controlling authority regularly.
- **Operation of each advance a/c should be reviewed at least once a year** and at more frequent intervals in the case of large advances.

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Income

Audit Approach and Procedures

Auditor's Concern: Recorded income arose from transactions during **relevant period & pertained to bank** + there is **no unrecorded income** and income recorded at **appropriate amt.**

RBI's Directions: RBI has advised that in respect of

- **any income which > 1% of total income** of bank if income is reckoned on a gross basis or
- **1% of PBT** if income is reckoned net of costs, should be considered on **accrual** as per AS 9.

Materiality: If any **income not considered material** as per above norms, **may be recognised when received** and auditors **not qualify report** in such situation.

Revenue Certainty: Banks **recognise income** (such as interest, fees and commission) on **accrual basis**, i.e., as it's earned. **Essential condition** for accrual of income that it **shouldn't be unreasonable to expect its ultimate collection**. In modern day banking, entries for **interest income** on advances are **automatically generated** through a batch process in **CBS system**.

Revenue Uncertainty:

- In view of **significant uncertainty** regarding **ultimate collection of income** arising in respect of **NPAs**, guidelines require banks **not recognize income until actually realised**.

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- When credit facility classified as NPA for 1st time, interest accrued and credited to income a/c in corresponding PY which has not been realized should be reversed or provided for.
- Apply to Government guaranteed a/c also.

Advances against Securities: Interest on advances against Term Deposits, National Savings Certificates (NSCs), Indira Vikas Patras (IVPs), Kisan Vikas Patras (KVPs) and Life policies may be taken to income account on due date, provided adequate margin available in a/cs.

Bills Purchased: For bills purchased o/s at close of year, discount received thereon should be properly apportioned between 2 years.

- [Unexpired discount/ rebate on bills discounted i.e., part of receipt of discount charges on bills purchased relate to period after year-end, should be recorded as "Other Liabilities".]
- Interest (discount) component paid by Bank/Branch on rediscount of bills from other financial institutions, is not to be netted off from discount earned on bills discounted.

Bills for Collection:

Auditor should examine procedure for crediting the party on whose behalf bill has been collected.

- Procedure is usually such that customer's a/c is credited only after bill has been collected from drawee either by bank itself or through its agents, etc.
- Commission of branch due only when bill collected.

Renegotiations: Fees and commissions earned by banks because of re-negotiations or rescheduling of o/s debts should be recognized on an accrual basis over the period covered by re-negotiated or rescheduled extension of credit.

- Test check interest earned by the banks for sample selected.
- Test check fees and commissions earned by the banks made for commission on bills for collection, letters of credit & bank guarantees.

Reversal of Income [RTP May-20]

- If any advance becomes NPA at close of year, entire intt accrued & credited to income a/c in past periods → reversed or provided for if same isn't realised.
- Apply to Government guaranteed accounts also.
- For NPAs, fees, commission and similar income accrued should cease to accrue in current period should be reversed or provided for w.r.t past periods, if uncollected.
- In case of banks having wrongly recognised income in past should reverse intt recognised as income during current year or make a provision if recognized as income in previous year(s).
- Auditor should enquire if there are large debits in Intt Income a/c not been explained.

- Enquire whether there are any communications from borrowers pointing out differences in intt charge and whether appropriate action been taken in this regard.

Leased assets: Component of finance income (as defined in AS 19 - Leases) on leased asset which was accrued and credited to income account before asset became NPA and remaining unrealised, should be reversed or provided for in current accounting period.

On Take-out finance: Takeout loan is a method of financing whereby a loan that is procured later is used to replace initial loan. More specifically, a takeout loan, or takeout financing, is long-term financing that lender promises to provide at a particular date or when particular criteria for completion of project are met. Takeout loans are commonly used in property development.

In such case, if based on record of recovery, account is classified as NPA, it should not recognize income unless realised from borrower/taking-over institution (if the arrangement so provides).

On Partial Recoveries in NPAs

- In absence of agreement between bank & borrower for appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise right of appropriation of recoveries in a uniform and consistent manner.
- Appropriate policy to be followed is to recognise income as per AS 9 when certainty to realisation & accordingly amount reversed/derecognised or not recognised in past should be accounted. Interest partly/fully realised in NPAs can be taken to income.
- However, ensure that credits towards interest are not out of fresh/additional credit facilities sanctioned to concerned borrowers.

Memorandum Account

- On account turning NPA, banks reverse interest already charged & not collected by debiting P&L account and stop further application of interest.
- However, banks may continue to record such accrued interest in Memorandum a/c in their books for control purposes.
- For computing Gross Advances, interest recorded in Memorandum a/c should not considered.



Income from Investments

Interest Income on Investments: Includes income derived from Govt securities, bonds and debentures of corporates and other investments by way of interest and dividend, **except income earned by way of dividends, etc., from subsidiaries & joint ventures abroad/in India.**

Broken period interest paid on securities purchased and amortisation of premium on SLR investments is **net off from interest income on investments.**

Profit on Sale of Investments: Net profit or loss on sale of investments is taken to **P&L account.**

Profit/Loss on Revaluation of Investments: As per RBI guidelines, investments to be valued at **periodical intervals** and **depreciation or appreciation in valuation** should be taken to **P&L account.**

Interest Expense [RTP Nov-21]

- **Ratio Analysis:** Auditor is primarily concerned with assessing **overall reasonableness** of **amt of intt expense** by **analysing ratios of intt. paid** on different types of deposits and borrowings to **avg quantum of respective liabilities** during year. In modern day banking, **entries for intt expenses automatically generated** through a batch process in CBS system.
- **Weighted avg intt rate:** Auditor should obtain from bank analysis of various types of deposits o/s at end of each quarter. From such info, auditor may work out weighted avg intt rate. Then **compare this rate with actual avg rate of interest** paid on relevant deposits as per annual a/cs and enquire if difference is material.
- **Compare with PY:** Auditor should also **compare avg rate of interest** paid on relevant deposits with corresponding figures for **previous years** and analyse any material differences.
- **MOM Analysis:** Auditor should obtain **general ledger break-up for intt expense** on deposits (savings and term deposits) **and borrowing** each **month/qtr.** Analyse MOM (or QOQ) cost analysis and document reasons for variances as per benchmark stated. Examine whether intt expense considered in the cost analysis agrees with general ledger.
- **Avg Balance:** Auditor should understand process of computation of average balance and re-compute the same on sample basis.

Auditor should, on a test check basis, verify the calculation of interest and ensure that:

- (a) Intt has been provided **on all deposits** upto date of balance sheet
- (b) Intt rates are **as per bank's internal regulations, RBI directives & agreements** with deposit holder
- (c) Interest on savings a/cs are **as per rules** framed by **bank/RBI** in this behalf.
- (d) Intt **on inter-branch balances** been provided at **rates** prescribed by **HO/RBI.**

- Ascertain if any **changes in intt rate** on saving a/cs and term deposits during the period.
- **Examine completeness** that intt accrued on entire borrowings & agree with general ledgers.

- **Re-compute interest accrual** i.e., by referring to parameters like frequency of payment of intt amount, rate of interest, period elapsed till date of BS, etc. from agreements & ensure that recomputed amt tallying with books of a/cs without any significant difference.

Auditing Operating Expenses of a Bank

- Internal Controls: - Study and **evaluate system of internal control** relating to expenses, including authorization procedures to determine NTE of other audit procedures.
- Divergent Trends: - Examine whether any divergent trends in major items of expenses.
- Substantive analytical Procedures: - Perform substantive analytical procedures in these expenses. eg. **assess reasonableness** of expenses by working out their ratio to total operating expenses and comparing with corresponding fig. for PYs.
- Vouching & Verification: - Verify expenses w.r.t **supporting documents** and check calculations.

Provisions & Contingencies

- Compliances: Ensure **compliances** for various regulatory requirements for provisioning in various circulars been fulfilled.
- Understanding: Obtain understanding as to **how bank computes provision** on std assets and NPAs. **Checking basis of classification** of loans and receivables into std, sub-std, doubtful, loss assets.
- Break up of Loans: Obtain **detailed break up** of std loans, NPA loans and agree with general ledger.
- Tax Provision: Obtain tax provision **computation from bank's mgt & verify nature of items debited & credited** to p&l a/c to ascertain they are considered in tax provision computation.
- Other Provisions: Other provisions for expenses **examined vis-a-vis circumstances** warranting provisioning & adequacy of the same by discussing and obtaining expln from mgt.

"It's ok to Rest, But Not to QUIT, Keep Moving"

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Main idea is that **no expenditure incurred unless**

- voted upon by Parliament or State Legislatures &
- funds must be provided from out of Consolidated Fund of India or State

After expenditure incurred and accounts closed, **Appropriation Accounts** prepared are **scrutinised by Public Accounts Committee** (A committee of selected members of parliament, constituted by Parliament of India, for auditing revenue and expenditure of Govt of India).

U.N. Handbook on Govt Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:

Government auditing is

- ⇒ objective, systematic, professional and independent **examination**
- ⇒ of financial, administrative and other **operations**
- ⇒ of a **public entity**
- ⇒ **made subsequently** to their execution
- ⇒ for **purpose** of evaluating and verifying them,
- ⇒ presenting a **report** with
- ⇒ explanatory comments on **audit findings** together with **conclusions & recommendations** for future **actions**
- ⇒ by **responsible officials**
- ⇒ and in case of examination of **FS**, expressing opinion regarding fairness of presentation.

Objectives:

- a. **Accounting for Public Funds:** Govt audit serves as a mechanism or process for **public accounting of govt funds**.
- b. **Appraisal of Government policies:** Also provides public accounting of **operational, management, programme and policy aspects** of public administration & accountability of officials.
- c. **Base for Corrective actions:** Audit observations based on factual data serve to **highlight lapses** of lower hierarchy, thus helping supervisory level officers to take corrective measures.

Administrative Accountability:

- Govt audit is **neither equipped nor intended to function as investigating agency**, to pursue every irregularity or misdemeanour to its logical end.
- Main objective is combination of **ensuring accountability of administration** to legislature and functioning as an **aid to administration**.
- In India, Govt Audit is done by **C&AG** through **Indian Audit and Accounts Department (IAAD)**.
- Audit is a necessary function to **ensure accountability** of
 - ✓ executive to Parliament, and

Ch-15 Government Audit



- ✓ within executives of **spending agencies to sanctioning** authorities.
- **C&AG watches** that various **authorities act** as per **Constitution and laws** made by Parliament & conform to **rules or orders** made thereunder.

Notes:

- ✓ **C&AG appointed by President of India** & not be removed except on grounds of proven misbehaviour (**not less than 2/3rd Majority of House** present & voting)
- ✓ Union & State Accounts shall be kept in such form as President may on advice of C&AG prescribe.

C&AG's duties & powers

C&AG's (Duties, Powers and Conditions of Service) Act, 1971 defines functions & powers.

Duties of the C&AG [RTP-May19 +Nov-19]

(i) Compile and submit Accounts of Union and States - C&AG responsible for **compiling a/cs** of Union and States from initial and subsidiary a/cs rendered to audit and a/cs offices.

C&AG shall show under respective heads annual receipts and disbursements for purpose of Union, each State and UT having a Legislative Assembly, and **submit those a/cs to President or Governor of State or Administrator of UT having a LA (UTLA)**.

(ii) General Provisions Relating to Audit - It shall be duty of C&AG—

- to audit and report on all expenditure** from Consolidated Fund of India/each State/UTLA and ascertaining whether moneys legally disbursed and applied to authorised service/purpose.
- to audit and report all transn** of Union & States relating to **Contingency Funds & Public Accounts**
- to audit and report on all trading, manufacturing and p&l a/cs** and BS and other subsidiary a/cs kept in any Union or State Deptt.

(iii) Audit of Receipts and Expenditure - Where any body/authority is **substantially financed** from CFI/any State/any UTLA, C&AG shall audit all receipts & expenditure of that body and report.

Meaning of Substantially financed:

- ✓ Grant or loan from CFI/State/UTLA in FY \geq ₹ 25 lakhs &
- ✓ amount \geq 75% of total expenditure of that body or authority.

(iv) Audit of Grants or Loans - If grant/loan given from CFI/State/UTLA to any authority/body, not being foreign State or international org, C&AG shall **scrutinise how sanctioning authority satisfies** about **fulfilment of condn** and have **right to access books and a/cs** of that authority/body.



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(v) Audit of Receipts of Union or States - Its duty of C&AG to **audit all receipts payable into CFI/State/UTLA** and satisfy that **rules and procedures designed** to secure effective **assessment, collection and proper allocation** of revenue and **examine accounts** for this purpose.

(vi) Audit of Accounts of Stores and Inventory - C&AG shall have authority to audit & report on a/cs of stores and inventory kept in **any office or deptt of Union or State**.

(vii) Audit of Govt Cos. and Corporations - As per Cos Act, 2013, he shall appoint auditor u/s 139(5) or 139(7) (i.e. appointment of 1st Auditor or Subsequent Auditor) and **direct such auditor manner** in which a/cs of Govt Co. are to be audited and auditor shall submit a copy of A/R which shall include

- ⇒ **directions** issued by C&AG,
- ⇒ **action** taken thereon and
- ⇒ its **impact** on A/cs and F.S. of Co.

Let's Summarise 😊

Powers of C&AG

C&AG Act gives following powers to C&AG for performance of his duties-

- a. To **inspect any office of a/cs** under control of Union or SG including office responsible for creation of initial or subsidiary A/cs.
- b. To **require that any accounts, books, papers and other documents** which deal with or are otherwise relevant to transactions under audit, be sent to specified places.
- c. To **put such questions or make such observations** he consider necessary to person in charge of office and call for such info he may require for preparation of any a/c or report which is his duty to prepare.
- d. In carrying out audit, C&AG has the **power to dispense with any part of detailed audit** of any a/cs or COTs and apply such **limited checks** as he may determine.

Inspect office of a/cs → require a/cs, books, papers & other docs → Question → Itd checks



Expenditure Audit

Standards set for audit of exp to ensure that there is provision of funds authorised by competent authority fixing limits within which expenditure can be incurred.

These standards are—

- i) Exp. conforms to relevant provisions of statutory enactment and as per Financial Rules and Regulations framed by competent authority. Such audit is called audit against 'rules and orders'.
- ii) there is sanction, either special or general, accorded by competent authority authorising the expenditure. Such an audit is called as audit of sanctions.
- iii) there is provision of funds out of which expenditure can be incurred and same has been authorised by competent authority. Such an audit is called audit against provision of funds.
- iv) expenditure is incurred with due regard to principles of financial propriety. Such an audit is also called as propriety audit.
- v) Various programmes, schemes and projects where large financial expenditure incurred being run economically & yielding results expected of them. Such an audit is termed as performance audit.

Audit against Rules & Orders

- ✓ Function of executive govt to frame rules, regulations & orders, for subordinate authorities.
- ✓ Job of audit to see rules, regulations & orders applied properly by subordinate authorities.
- ✓ However, not function of audit to prescribe what such rules, regulations and orders shall be.

But, it is function of audit to carry out examination of various rules, regulations and orders issued by executive authorities to see that:

- a. they are not inconsistent with provisions of Constitution or any laws made thereunder
- b. they are consistent with requirements of audit and a/cs determined by C&AG
- c. they don't come in conflict with orders of, or rules made by, any higher authority and
- d. in case they have not been approved by competent authority, issuing authority possesses necessary rule-making power.

Not consistent (Constitution) + Consistent (C&AG) + Not conflicting (Higher Authority) +
Approved (competent authority) → Rule making power

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Audit of sanctions - Ensure that each item of **expenditure** is covered by a **sanction, either general or special**, of competent authority.

Audit of sanctions is directed in ensuring that:

- ✓ expenditure is properly **covered by a sanction**, &
- ✓ satisfy that **authority sanctioning it is competent** by virtue of powers by Constitution & law, rules or orders, or rules of delegation of financial powers made by competent authority.

Propriety Audit

Auditors try to bring out **cases of improper, avoidable, or ineffective expenditure** even though expenditure been incurred in conformity with existing rules and regulations.

Eg. :- Building may be constructed for installing a telephone exchange but may not be used for same purpose resulting in unproductive expenditure or a school building may be constructed but used after 5 years of its completion is a case of avoidable expenditure.

Audit should, therefore, try to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions.

3 Principles of Propriety Audit

Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

- a. **Expenditure shouldn't be prima facie more** than what occasion demands. Every public officer is expected to exercise same vigilance in respect of exp. incurred from public moneys as a person of ordinary prudence would exercise in respect of exp. of his own money.
- b. No authority should exercise powers of sanctioning expenditure to pass an order which will be directly or indirectly accrue to its **own advantage**.
- c. Public moneys should **not utilised for benefit of particular person or section of community** unless:
 - i) amount of expenditure involved is **insignificant** or
 - ii) a **claim** for amount could be enforced in a Court of law or
 - iii) expenditure is in pursuance of a **recognised policy or custom** and
 - iv) amt of **allowances**, eg. travelling allowances, granted to meet expenditure of a particular type should be so regulated that allowances aren't sources of profit to recipients.



Performance Audit

Scope covers efficiency, economy and effectiveness audit or performance audit, or full scope audit:-

Economy audit checks whether govt have **acquired financial, human and physical resources** in economical manner, & **whether** sanctioning and spending **authorities have observed economy.**

Efficiency audit looks into whether various **schemes/projects are executed & operations conducted economically & are yielding expected results, i.e., relationship between goods and services produced (output) and resources used to produce them (input) and examination to find out extent to which operations carried out in economical & efficient manner.**

Effectiveness audit is **appraisal of performance** of programmes, schemes, projects w.r.t **overall targeted objectives as well as efficiency of means** adopted for attainment of the objectives.

Efficiency-cum-performance audit is **objective examination of financial and operational performance** of an organisation, programme, authority or function and oriented towards **identifying opportunities for greater economy and effectiveness.**

Procedure for conducting performance audit covers:

- ✓ identification of **topic,**
- ✓ preliminary **study,**
- ✓ **planning,**
- ✓ **execution** of audit, and
- ✓ **reporting.**

Audit of Receipts

Such an audit provides for checking:

- i) whether all revenues or other debts due to govt been **correctly assessed, realised and credited** to government a/c by designated authorities
- ii) whether **adequate regulations & procedures** been framed by concerned deptt/agency to secure effective check on assessment, collection and proper allocation of cases
- iii) whether such regulations and procedures **actually being carried out**
- iv) whether **adequate checks** imposed to ensure prompt detection & investigation of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue
- v) **review of systems and procedures** to see that internal procedures adequately secure correct and regular a/c of demands collection and refunds and suggest improvement.
- vi) **Extent and quantum** of audit required to be done under each category of audit determined by C&AG. These are neither negotiable nor questioned.

Audit of Stores and Inventories

Audit of a/cs of stores and inventories been developed as part of expenditure audit with reference to duties and responsibilities entrusted to C&AG.

Audit is conducted :-

- ✓ to ascertain whether **Regulations** governing purchase, receipt and issue, custody, sale and inventory taking of stores are **well devised and properly carried out**.
- ✓ to **bring to notice of govt any deficiencies** in qty of stores held or any defects in IC.
- ✓ to verify that **purchases are properly sanctioned**, made economical and as per Rules for purchase laid down by competent authority.
- ✓ to ensure that **prices paid are reasonable** and in agreement with contract for supply of stores, and **certificates of quality and qty** furnished by inspecting and receiving units.
- ✓ to **check a/cs of receipts, issues and balances** regarding accuracy, correctness and reasonableness of balances in inventories w.r.t specified norms for level of consumption of inventory holding.

Role of C&AG in Government Co. Audit

Role of C&AG is prescribed u/s 143(5)/(6)/(7) of the Companies Act, 2013.

(1) Power to appoint Government Company Auditor :-

Section 143(5) → Govt Co. or any other Co. owned/controlled, by CG/SG(s)/partly by CG & one or more SGs, C&AG shall appoint auditor u/s 139(5)/(7) and **direct such auditor manner** in which a/cs to be audited and auditor shall submit a copy of A/R to C&AG which include

- ⇒ **directions**, if any, issued by C&AG,
- ⇒ **action** taken thereon and
- ⇒ its **impact** on a/cs and FS of Co.

(2) Power to conduct Supplementary Audit & comment thereupon :-

C&AG shall **within 60 days from receipt of A/R** have a right to,

- a. conduct **supplementary audit u/s 143(6)(a)**, of FS of Co. by such person(s) as he may authorize in this behalf & for purposes of such audit, require info or add. info to be furnished to any person(s), so authorised, on such matters, by such person(s), & in such form, as C&AG may direct
- b. **comment upon or supplement such A/R u/s 143(6)(b)**.

Comments given by C&AG upon, or supplement to, A/R → sent by Co. to every person entitled to copies of audited FS & also placed before AGM at same time & manner as A/R.

(3) Test Audit u/s 143(7): C&AG may by order, cause test audit be conducted and provisions of **Sec 19A** of C&AG's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to such test audit.

Audit as per Sec 17 of Co-Operative Societies Act, 1912

- 1) Registrar shall audit or authorise person to audit a/cs of every regd society **at least once a year**.
- 2) Audit includes examination of overdue debts, if any, & valuation of assets & liabilities of society.
- 3) Auditor shall all times have access to all books, accounts, papers and securities of society, & every officer of society shall furnish such info as person making inspection may require.

Following points should be kept in mind in connection with audit of a co-operative society:

1. Qualifications of Auditors - Apart from a CA as per CA Act, 1949, some State Co-operative Acts permitted persons holding **govt diploma in co-operative a/cs** or in co-operation and accountancy and also person who has served as **auditor in co-operative deptt of a govt** to act as an auditor.

2. Appointment of Auditor - Auditor of a co-op society is appointed **by Registrar of Co-operative Societies** and such auditor conducts audit on behalf of Registrar & submits report to him & society. Audit fees paid by society on **basis of statutory scale of fees prescribed by Registrar**, according to category of society audited.

3. Books, Accounts and other records of Co-op Societies - State govt can frame rules prescribing books and a/cs to be kept by a co-op society.

For example, in Maharashtra, co-op societies are reqd to maintain books of a/c in terms of instructions of Registrar as following:

- i) All **sums of money received and expended** by society and matters in respect of which receipts and expenditure take place.
- ii) All **sales and purchases** of goods by society.
- iii) **Assets and liabilities** of society.

Depending upon nature & object of society, different kinds of books and registers will be maintained. In case of large scale co-operative organisation, different subsidiary books and registers shall be maintained and daily summary totals will be transferred to main Cash Book. For eg:

- a. Daily **cash sales summary** register.
- b. A register of **collection from debtors** if credit sales are allowed by bye-laws of society.
- c. A register of **recovery of loans from salaries** and directly by receipts from members in case of credit society.
- d. **Loan disbursement register** in case of credit society.
- e. **Any other columnar subsidiaries** depending upon the nature and functions of society.

4. Restrictions on shareholdings - In case of a society where **liability of member is limited**, no member other than a regd society can hold shares of society exceeding **maximum of 20% of total no. of shares** or **value of shareholding to ₹ 1,000/-**. Auditor shall check compliance with this provision. Check any

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provision in bye-laws of society isn't contrary to this. State Acts may provide limits as to the shareholding, other than that provided in Central Act.

5. Restrictions on loans - Regd society shall **not make a loan to any person other than a member**. However, with **special sanction of Registrar**, may make a loan to another regd society. State Govt may further put such restrictions as it thinks fit on loaning powers of society to its members or to other societies in interest of the society concerned and members.

6. Restrictions on borrowings - A regd society shall accept loans and deposits from persons who aren't members subject to restrictions and limits of **bye-laws of society**. Auditor will have to examine bye-laws in this respect.

7. Investment of funds - Sec 32 of Central Act, society may invest its funds in following:

- In **Central or State Co-operative Bank**.
- In any of securities specified in Sec 20 of **Indian Trusts Act, 1882**.
- In shares, securities, bonds or debentures of **any other society with limited liability**.
- In any **co-op bank**, other than Central/State co-op bank, **approved by Registrar** as per T&Cs.
- In any **other moneys permitted** by the Central or State Government.

In principal provision relating to investments of funds of a co-op society, Central as well as State Acts doesn't mention anything about investment of reserve fund outside the business specifically.

8. Appropriation of profits - A prescribed %age of profits should be transferred to Reserve Fund, before distribution as dividends or bonus to members.

9. Contributions to Charitable Purposes - A regd society may, with **sanction of Registrar**, contribute an **amount upto 10% of net profits** remaining **after compulsory transfer to reserve fund** for any charitable purpose as defined in Sec 2 of Charitable Endowments Act, 1890.

10. Investment of Reserve Fund outside the business or utilisation as working capital - Some of State Acts provide that a society may use the Reserve Fund:

- in business of a society, as **working capital** (subject to rules made in this behalf).
- may **invest** as per provisions of the Act.
- may be used for **some public purposes** likely to promote the object of society.

Auditor should ensure strict compliance with State Act and Rules in this regard.

11. Contribution to Education Fund - Some of State Acts provide that every society shall contribute **annually** towards Education Fund of State Federal Society, at appropriate rate as per the class of society. **Contribution to Education Fund is a charge on profits** and not an appropriation.



Auditor may have regard to provisions in bye-laws and Rules and Regulations of society regarding appropriation of profits. Transfers to other reserves, dividends to members etc. are other appropriations. **Appropriations of profits must be approved by General Body of society**, which is supreme authority in co-operative mgt. Further, it may be noted that necessary accounting entries for appropriation of profits must be passed after the date of approval by General Body. Here there is a departure from corporate a/c practice, where entries are passed for proposed appropriations, subject to approval of Annual General Meeting.

According to certain State Acts, transfers to Dividend Equalization Reserve and Share Capital Redemption Fund are stated as charges against profits. According to GAAP these items are not charges, but appropriation of profits. Auditor should point out such spots where statutory provisions of any law are in contradiction with GAAP.

Special Features of Co-Operative Audit

1. Examination of overdue debts - Overdue debts for a period **from 6 months to 5 years & more than 5 years** will have to be classified and reported by auditor. Overdue debts affect its working capital position. They'll have to be classified as good or bad. Auditor ascertain whether provisions for doubtful debts are made.
2. Overdue Interest - Overdue intt should be **excluded from interest o/s and accrued due** while **calculating profit**. Overdue interest is interest accrued or accruing in a/cs, amount of which the principal is overdue. In practice an overdue interest **reserve is created** and overdue intt credited to interest account is reduced.
3. Certification of Bad Debts - As per Maharashtra State Co-operative Rules, 1961, → Bad debts w/off **only when certified as bad by auditor**. Where no such requirement exists, managing committee of society must authorise write-off.
4. Valuation of Assets and Liabilities - There are **no specific provisions** or instructions under the Act and Rules and as such due regard shall be had to general principles of accounting and auditing conventions and standards adopted.
 - ✓ Auditor will have to ascertain existence, ownership and valuation of assets.
 - ✓ **Fixed assets** valued at **cost less adequate provision for depreciation**. Incidental expenses incurred in acquisition and installation expenses should be properly capitalised. If difference in original COA and present mkt price significant, a note regarding present market value may be appended; to have proper disclosure in light of present inflatory conditions.
 - ✓ **Current assets** valued at **cost or market price, whichever is lower**. Regarding liabilities, auditor should see that all known liabilities accounted, and contingent liabilities stated by way of a note.

5. Adherence to Co-operative Principles -

- Auditor will have to ascertain in general, how far **objects been achieved** in course of its working.
- Assessment **isn't necessarily in terms of profits**, but in terms of extending of benefits to members who have formed the society. Considered from viewpoint of **social benefits** it may be looked into that how far sales could be affected at lower prices.
- For achievement of these activities, **cost accounting methods**, store control methods, techniques of **std costing, budgetary control** etc. be adopted. However, these modern techniques are **mostly not in application** and in **practice wide gap** found in goals to be achieved & actual achievements.
- While **auditing expenses**, auditor should see that they are **economical and no wastage of funds**.
 - ✓ **Middlemen commissions are avoided** and purchases made directly from wholesalers.
 - ✓ **Principles of propriety audit** should be followed.

6. Observations of the Provisions of the Act and Rules - Auditor is required to point out infringement with provisions of Co-op Societies Act & Rules & bye-laws. Financial implications of such infringements be assessed and reported.

7. Verification of Members' Register and examination of their pass books - Examination of entries in members pass books regarding loan given and repayments, and confirmation of loan balances in person is important to assure that entries in books of a/cs are free from manipulation. Specifically in rural and agricultural credit societies, members aren't literate and this is a good safeguard on their part. This checking is done on test basis, which is matter of judgement of auditor.

8. Special report to Registrar - During audit, if auditor notices some **serious irregularities** in working of society, may report these special matters to Registrar, drawing his attention to the points. Registrar on receipt of such report may take necessary action against society.

In following cases, for instance, a special report may become necessary:

- i) **Personal profiteering** by members of managing committee in transactions of society, which are ultimately detrimental to interest of society.
- ii) **Detection of fraud** relating to expenses, purchases, property and stores of society.
- iii) Specific examples of **mis-management**. Decisions of mgt against cooperative principles.
- iv) In case of **urban co-operative banks, disproportionate advances** to vested interest groups, such as relatives of mgt, and deliberate negligence about recovery thereof. Cases of reckless advancing, not taking adequate security and not judging credit worthiness of party.

9. Audit classification of society - After judgement of overall performance, auditor has to award a class to society. This judgement to be **based on criteria specified by Registrar**. If **mgt of society not**

satisfied about award of audit class, can make **appeal to Registrar**, and Registrar may direct to review audit classification. Auditor should be very careful, while making a decision about the class of society.

10. Discussion of draft audit report with managing committee - At conclusion of audit, auditor should ask Secretary of society to convene managing committee meeting to discuss draft audit report. Audit report never be finalised without discussion with managing committee. Minor irregularities may be get settled and rectified. Matters of policy should be discussed in detail.

Audit of Multi-State Co-operative Society [MSCS]

Books of Accounts - Every MSCS shall keep books of a/c w.r.t

- all **sum of money received and expended**
- all **sale and purchase** of goods
- the **assets and liabilities**
- in case of a MSCS engaged in production, processing and manufacturing, particulars relating to utilization of materials or labour or other items of cost as may be specified in the bye-hours of such a society.

1. Qualification of Auditors - Person who is a **CA** within meaning of CA Act, 1949 can only be appointed as auditor of MSCS.

Following persons are not eligible for appointment as auditors of a MSCS-

- Body corporate.
- Officer or employee of MSCS.
- Person who's member or in employment, of an officer or employee of MSCS.
- Person indebted or given guarantee or security in connection with indebtedness of any 3rd person to MSCS > ₹1,000.

2. Appointment of Auditors - 1st auditor(s) appointed by board **within 1 month of Date of Registration** of such society and hold office until conclusion of 1st AGM.

- If board fails MSCS in GM may appoint 1st auditor(s).
- Subsequent auditor(s) are appointed by MSCS, at each AGM. Auditor so appointed shall hold office from conclusion of that meeting until the conclusion of the next AGM

3. Power and duties of Auditors - Every auditor shall have right of access at all times to books a/c and vouchers, whether kept at head office or elsewhere, & entitled to require from officers or other employees such info and explanation necessary for performance of his duties.

As per Sec 73(2), auditor shall make following inquiries:

- Whether **loans & advances** made by MSCS on basis of security been properly secured and whether terms are not prejudicial to interests of MSCS or its members,

- b. Whether transactions represented merely by **book entries** not prejudicial to interests of MSCS,
- c. Whether **personal expenses** have been charged to revenue a/c, and
- d. Where 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 received, whether position stated in account books and BS as correct, regular and not misleading.

Content of Auditor's Report

Audit report shall state whether, in his opinion and to best of his info and explanation give a true and fair view:

- (a) In case of B.S, of state of MSCS's affairs as at end of its FY; and
- (b) In case of P&L a/c, of profit or loss for its FY.

Auditor's report shall also state:

- i) Whether he has obtained **all info and explanation** which to best of his knowledge and belief necessary for purpose of audit.
- ii) Whether, in his opinion, **proper books of a/c** been kept by MSCS as appears from examination of these books and proper returns been recd from branches or offices of MSCS not visited by him.
- iii) Whether **report on A/Cs of any branch office** audited by a person other than MSCS's auditor been forwarded to him and how he dealt with same in preparing auditor's report.
- iv) Whether MSCS's **BS and p&l a/c in agreement** with books of a/c and return.

Where any of above matters is answered in negative or with qualification, report shall state reason.

Power of Central Government to direct spl audit in certain cases:

Sec 77 of MSCS Act, 2002, where CG is of the opinion:

- a. that **affairs** of any MSCS **aren't managed** as per **self-help and mutual deed and co-operative principles** or prudent commercial practices or with sound business principles or
- b. that any MSCS being managed in a manner **likely to cause serious injury or damage to interests of trade** industry or business to which it pertains or
- c. that **financial position** of any MSCS is such as to **endanger its solvency**.

1. Central Government's Order :- CG may at any time by order direct that a spl audit of MSCS's accounts for such period(s) as may be specified in order shall be conducted.
2. Appointment of Auditor :- May appoint either a CA or MSCS's auditor himself to conduct spl audit.
3. Shareholding Restriction :- However, CG shall order for spl audit only if that Govt or SG either by itself or both hold **51% or more of paid-up share capital** in such MSCS.

4. **Special Auditor's Powers , Duties & Report** :- Spl auditor shall have same powers and duties in relation to special audit as an auditor of MSCS u/s 73. However spl auditor shall instead of making his report to members make the report to CG. Report of spl auditor shall, include all matters reqd to be included in auditor's report u/s 73 and any other matter directed by CG.
5. **Action by the CG** :- On receipts of report of spl auditor CG may take action as it considers necessary as per provision of Act or law in force. However, if CG **doesn't take any action on report within 4 months from date of its receipt**, Govt shall send to MSCS either a copy of, or relevant extract from, report with its comments and require MSCS either to circulate that copy or extracts to members or have such copy or extracts read before its next general meeting.
6. **Expenses pertaining to Spl Audit** :- Expenses determined by CG shall be final and **paid by MSCS** and in default shall be recoverable from MSCS as arrear of land revenue.

Inquiry by Central Registrar under Section 78

1. **When:-** Central Registrar may, on a request from :-
- a **federal co-operative** to which a MSCS is affiliated or
 - a **creditor** or **not less than 1/3rd** of Board Members or
 - **not less than 1/5th** of total no. of members of a MSCS,
2. **How:-** hold an inquiry or direct some person authorized by him by order in writing to hold an inquiry into the constitutions, working and financial condition of a MSCS.
3. **Opportunity of being Heard:-** Before holding such inquiry 15 days' notice must be given to MSCS.
4. **Powers given:-** Central Registrar or person authorized by him shall have following powers:
- a. **Access & Summon:** he shall at all reasonable times have **free access to the books, accounts, documents**, securities, cash and other properties belonging to or in custody of MSCS and may **summon any person** in possession or responsible for custody of such books, a/cs, documents, securities, cash or other properties to produce the same at any place specified by him.
 - b. **Call Meeting:** he may, notwithstanding any bye-law specifying the period of notice for a general meeting of the MSCS, **require officers of society to call a general meeting** of society by giving **notice of not less than 7 days** at such time and place at headquarters of society to consider such matters as may be directed to him, and where officers of society refuse or fail to call such a meeting, he shall have power to call it himself.



- c. Summon: he may **summon any person** who is reasonably believed by him to have any knowledge of the affairs of MSCS to appear before him at any place at headquarters of society or any branch thereof and may examine such person on oath.
5. Follow up :- Central Registrar shall, **within a period of 3 months of date of receipt of report**, communicate report of inquiry to MSCS, financial institutions, if any, to which society is affiliated, and to person or authority, if any at whose instance the inquiry is needed.

Inspection of Multi-State Co-operative societies under Section 79

1. When :- Central Registrar may, on a request from
 - o **federal co-operative** to which a MSCS is affiliated or a creditor or
 - o not less than **1/3rd** of members of the board or
 - o not less than **1/5th** of total no. of members of a MSCS
2. How :- By general/special order in writing inspect or direct any person authorized by him by order in writing to make inspection into constitution, working and financial condition of a MSCS.
3. Opportunity of Being heard :- No inspection shall be made unless a **notice of not less than 15 days** has been given to MSCS.
4. Powers available :- Central Registrar or person authorized by him shall have following powers:
 - a. He shall have **access** to all books, a/cs, papers, vouchers, securities, stock and other property of society and in the event of serious irregularities discovered during inspection, take them into **custody** and have power to **verify cash balance** of society and subject to general/special order of central registrar **call a meeting** of society where such general meeting is, in his opinion necessary.
 - b. **Every officer or member of a MSCS shall furnish such info** with regard to working of society as central registrar or person making inspection may require.
5. Inspection Report :- Copy of report shall be communicated to MSCS **within a period of 3 months from date of completion** of such inspection.

Audit of Local Bodies

Municipality can be defined as a unit of local self-govt in urban area. (Eg DMC)

'local self-govt' is administration of a locality -village, town, city or any other area smaller than a state - by a body representing local inhabitants, possessing fairly large autonomy, raising part of revenue through local taxation and spending its income on local services and, therefore, distinct from state and central services.

Municipal govt in India covers 5 distinct types of urban local authorities-

- i) municipal corporations,
- ii) municipal councils,
- iii) notified area committees,
- iv) town area committees and
- v) cantonment committees.

Municipal authorities are endowed with specific local functions covering

- a. regulatory,
- b. maintenance and
- c. development activities.

Expenditure incurred by municipalities and corporations broadly classified under following heads:

- a. general administration and revenue collection,
- b. public health,
- c. public safety,
- d. education,
- e. public works, and
- f. others such as interest payments, etc. [Nov-22]

Note: Property taxes and octroi are major sources of revenue of municipal authorities; other municipal taxes are profession tax, non-mechanised vehicles tax, taxes on ads, taxes on animals & boats, tolls, show-tax, etc. Tax powers of corporations confined to few items and generally compulsive nature; on other hand, tax powers of other types of urban local authorities cover wider range, optional in nature & subject to final sanction of SGs.

Local bodies may receive different types of grants from state administration as well.

Broadly, revenue grants are of 3 categories:

- a. General purpose grants: These are primarily intended to substantially **bridge gap between needs and resources** of the local bodies.

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- b. Specific purpose grants: These grants which are tied to provision of certain services or performance of certain tasks.
- c. Statutory and compensatory grants: These grants are given to local bodies as compensation on account of loss of revenue on taking over a tax by state govt from local govt.

Financial Administration

Some of the aspects are as under:

- (a) Budgetary Procedure: This is geared to subserve twin considerations of financial accountability and control of expenditure.
 - Main objective is to ensure funds are raised and moneys spent by as per rules and regulations and within limits of sanction and authorisation by legislature or council.
 - Budget preparation is for determining levels of taxation and rates and ceilings on expenditure.
 - Budget formats and heads of accounts vary from state to state. There are variations between corporation and municipalities. One important feature of municipal budgets is that there is no strict separation between revenue and capital items; usually there is a 'head' called extraordinary items which cover most of capital transactions.
 - There are no. of special funds (e.g. roads) or in some cases separate budgets for specific municipal functions (e.g. education) or enterprise activities (e.g., water supply and sanitation, transport, electricity, etc.)
- (b) Expenditure Control: System of financial control existing in state and central govt level is that there is a clear demarcation between the legislature and executive.
 - Integration of legislation and executive powers in municipal council makes it difficult for its executive to function as its inquisitorial body as well.
 - This leaves system of external audit by state govt as only way of controlling municipal expenditure.
- (c) Accounting System: Municipal accounting and budget format been criticised as neither simple nor comprehensible, sometimes providing inadequate info. and other times excess info. Both these situations are not conducive to a proper system of management info.

Objective of Audit of Local Bodies

Objectives of audit are:

- a. reporting on fairness of content and presentation of FS
- b. reporting upon strengths and weaknesses of systems of financial control
- c. reporting on adherence to legal and/or administrative requirements
- d. reporting upon whether value is being fully received on money spent and
- e. detection and prevention of error, fraud and misuse of resources.



Audit Programme for Local Bodies

(i) Appointment: **Local Fund Audit Wing of State Govt.** is generally in charge of audit of municipal a/cs. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc have power to appoint their own auditors for regular external audit. So the auditor should ensure his appointment.

(ii) Auditor's Concerns:- Auditor while auditing local bodies should report on.

- ⇒ **fairness** of the contents and presentation of financial statements,
- ⇒ the **strengths and weaknesses** of system of financial control,
- ⇒ the **adherence** to legal and/or administrative requirements;
- ⇒ whether **value is being fully received** on money spent.
- ⇒ His objective should be to **detect errors and fraud** and misuse of resources.

(iii) Rules & Regulations :- Ensure that expenditure incurred conforms to relevant provisions of law and as per financial rules and regulations framed by competent authority.

(iv) Authorisation :- Ensure that all types of sanctions, either special or general, accorded by competent authority.

(v) Provisioning :- Ensure there is provision of funds and expenditure is incurred from provision & authorized by competent authority.

(vi) Performance :- Check that different schemes, programmes and projects, where large financial exp has been incurred, are running economically and getting the expected results.



Audit of NGOs

Sources & Application of Funds

Sources:

- a. **Donations & grants received in nature of promoter's contribution** are in nature of capital receipts and shown as **liabilities** in BS of NGO. Either in form of corpus contribution or contribution towards revolving fund. Contribution towards capital or corpus of NGO known as corpus contribution. Donors generally specify whether donation/grant shall form part of corpus of NGO.
- b. Sec 11(1)(d) of Income Tax Act 1961 also states **income in form of voluntary contributions made with a specific direction** that they shall **form part of corpus shall not be included in computation of total income.**
- c. Objective of a contribution/grant towards a **Revolving Fund** is to **rotate the amount by giving temporary loans from fund to other NGO or beneficiaries** and then recover the loan to give temporary loans again. However, **interest earned from beneficiary** on such temporary loans could be either added back to fund or credited to **Income and Expenditure Account** depending on restrictions laid down by authority providing the contribution (for revolving fund) or by rules and regulations of NGO.
- d. **Donations and grants received for acquisition of specific fixed assets** are those grants whose condition is that NGO accepting them should purchase, construct or otherwise acquire assets for which grant is given.
- e. Many a times NGOs receive **contributions in kind**. These contributions include assets such as land, buildings, vehicles, office equipment, etc. and articles related to programmes / projects such as food, books, building materials, clothes, beds, and raw material for training purposes, e.g., Wool, reeds, cloth, etc.

Areas of application of funds for NGO include Establishment Costs, Office & Admin Expenses, Maintenance Expenses, Programme / Project Expenses, Charity, Donations & Contributions given, etc.

Planning the Audit

While PLANNING the audit, auditor may concentrate on following:

- i) **Knowledge** of NGO's work, mission & vision, areas of operations & environment in which it operate.
- ii) **Updating knowledge of relevant statutes** especially w.r.t recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 1976, Societies Registration Act, 1860, Income Tax Act 1961 etc. and Rules related to the statutes.
- iii) Reviewing **legal form** of Organisation and its MOA, AOA, Rules and Regulations.
- iv) Reviewing **NGO's Organisation chart**, Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.

- v) Examination of **minutes** of Board/Managing Committee/Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.
- vi) Study **accounting system**, procedures, internal controls and internal checks existing for the NGO and verify their applicability.
- vii) Setting of **materiality levels** for audit purpose.
- viii) Nature and timing of **reports or other communications**.
- ix) Involvement of **experts** and their reports.
- x) Review the **previous year's Audit Report**.

Audit Programme

Audit programme should include in sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted.

- i) Corpus Fund: **Contributions/grants received** towards corpus be vouched with reference to **letters from donor(s)**. Intt income checked with Investment Register and Physical Investments in hand.
- ii) Reserves: Vouch trfr from projects/prog. with **donors letters and board resolutions** of NGO. Check trfr of gross value of asset sold from capital reserve to general reserve and adjustments during year.
- iii) Ear-marked Funds: Check **requirements of donors institutions, board resolution** of NGO, rules and regulations of the schemes of ear-marked funds.
- iv) Project / Agency Balances: Vouch disbursements and expenditure as per **agreements with donors** for each of the balances.
- v) Loans: Vouch loans with **loan agreements**, counterfoil of receipt issued.
- vi) Fixed Assets: Vouch all **acquisitions/sale or disposal of assets** including depreciation and authorisations for same. Also check donor's letters/agreements for grant. For immovable property check title, etc.
- vii) Investments: Check **Investment Register and investments physically** ensuring they are in name of NGO. Verify further investments and dis-investments for approval by appropriate authority and reference in bank a/cs for principal amount and intt.
- viii) Cash in Hand: Physically **verify cash in hand and imprest balances**, at close of year and whether it tallies with books of a/c.
- ix) Bank Balance: Check **BRS** and ascertain details for old o/s and unadjusted amts.
- x) Inventory: Verify **inventory in hand and obtain certificate from mgt** for quantities and valuation of same.
- xi) Programme and Project Expenses: Verify **agreement with donor/contributor(s) supporting particular programme or project** to ascertain conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify terms of contract.

- xii) Establishment Expenses: Verify that PF, life insurance premium, ESIC and their admin charges are deducted, contributed and deposited within prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

Income of NGO

Receipt of income of NGO may be checked on the following lines:

- (i) Contributions and Grants for projects and programmes: Check agreements with donors and grants letters to ensure that funds recd been a/c for. Check that all foreign contribution receipts deposited in foreign contribution bank a/c as notified under Foreign Contribution (Regulation) Act, 1976.
- (ii) Receipts from fund raising programmes: Verify in detail IC system and ascertain persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.
- (iii) Membership Fees: Check fees received with Membership Register. Ensure proper classification is made between entrance & annual fees & life membership fees. Reconcile fees received with fees to be received during the year.
- (iv) Subscriptions: Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine / circulars / periodicals. Check receipts with subscription rate schedule.
- (v) Interest and Dividends: Check interest and dividends received and receivable with investments held during year.

Audit of Firm

Matters to be considered before starting audit:

Before starting audit, examine partnership agreement and note provisions about following matters:

1. Name and style under which business shall be conducted.
2. Duration of partnership, if any, that has been agreed upon.
3. Amount of capital to be contributed by each partner—fixed or varied from year to year.
4. Period at end of which a/cs will be closed periodically & proportions in which profit shall be divided among partners or losses to be contributed by them; whether losses shall be borne by partners or whether any of the partners will not be required to do so.
5. Provisions for maintenance of books of a/c and determining profits available for division among partners.
6. Borrowing capacity of partnership (when it is not implied as in case of non-trading firms).

7. **Rate at which interest allowed on capitals and loans** provided by partners and rate at which it will be charged on drawings and current a/c.
8. Whether any **salaries are payable to the partners or withdrawals permitted** against shares of profits and, if so, to what extent?
9. **Duties of partners for mgt of business**; partners who shall act as managing partners.
10. Who shall **operate bank a/c of firm**? How will surplus funds of partnership be invested?

Advantages of Audit of a Partnership Firm :-

- 1) Disputes :- Audited a/cs provide convenient & reliable means of **settling a/cs b/w partners** & possibility of occurrence of dispute among them is mitigated.
- 2) Dissolution :- On **retirement or death of partner**, audited a/cs, constitute a reliable evidence for computing amounts due to retiring partner or to representative of deceased partner in respect of his **share of capital, profits and goodwill**.
- 3) Reliable :- Audited statement of a/cs are **relied upon by banks** when advancing loans, & by prospective purchasers of business, as evidence of profitability and financial position.
- 4) Admission :- Audited statements of a/cs can be helpful in **negotiations to admit** a person as a partner, especially when they are available for a no. of past years.
- 5) Control :- Audit is effective **safeguard against any undue advantage** being taken by a working partner(s) especially for partners not actively associated with working of firm.

Matters which should be specially considered in the audit of accounts of a partnership:

- i) Letter of Appointment :- Confirming that LOA, **signed by a partner**, duly authorised, clearly states **nature and scope of audit** contemplated by partners, specially limitation, if any, under which auditor shall have to function.
- ii) Partnership Documents :- Studying **minute book**, if any, maintained to record policy decision taken by partners specially minutes relating to authorisation of extraordinary and capital expenditure, raising of loans; purchase of assets, extraordinary contracts entered into and other such matters not of routine nature.
- iii) Objects of Partnership :- Verifying that business in which partnership is engaged is authorised by **partnership agreement**;
- iv) Books of Account :- Examining whether books of a/c appear to be **reasonable and considered adequate** in relation to nature of business of partnership.
- v) Mutual Interest :- Verifying generally that **interest of no partner has suffered prejudicially** by an activity engaged in by partnership which, it was not authorised to do under partnership deed or by any violation of provision in partnership agreements.
- vi) Provision for Taxes :- Confirming that a provision for firm's tax payable has been made in accounts before arriving at amount of profit divisible among partners.
- vii) Division of Profits :- Verifying that profits and losses have been divided among partners in their **agreed profit-sharing ratio**.

LLP Audit

Basics: Min 2 partners & atleast 2 designated partners need to take DPIN (Designated Partner Identification No)

Small LLP

- Contribution $\leq ₹25L$ or such higher amount, not exceeding ₹5 Cr and
- Turnover for immediately preceding FY, $\leq ₹40 L$ or such higher amount, not exceeding ₹50 Cr

Books of A/cs

LLP's are required to maintain books of a/c which shall contain:

- Particulars of all sums of **money received and expended** by LLP and matters in respect of which receipt and expenditure takes place,
- Record of **assets and liabilities** of the LLP,
- Statements of **costs of goods** purchased, inventories, work-in-progress, finished goods and costs of goods sold,
- Any **other particulars** which partners may decide.

Audit of the Accounts of an LLP

Any LLP, whose t/o $\leq ₹40 L$, or contribution $\leq ₹25L$, \rightarrow No Audit.

In other words only if t/o $> ₹40 L$ & Contribution $> ₹25 L \rightarrow$ Audit is Required

However, if partners of such LLP decide to get a/cs of such LLP audited, a/cs shall be audited only in accordance with such rule.

Returns to be maintained and filed by an LLP :-

Annual return in **Form 11** with ROC **within 60 days of closer of FY**.

Eg: For FY 2023-24 \rightarrow Filed by 30th May'24

Statement of Account and Solvency in **Form 8** \rightarrow filed **within 30 days from end of 6 months of FY** to which Statement of Account and Solvency relates. Eg:- For FY 2023-24 \rightarrow filed by 30th Oct'24

Appointment of Auditor: Auditor may be appointed by DPs of LLP -

- At any time for 1st FY but before end of 1st FY,
- At least 30 days prior to end of each FY (other than 1st FY),
- To fill casual vacancy in the office of auditor,
- To fill casual vacancy caused by removal of auditor.

Partners may appoint the auditors if the DPs have failed to appoint them.

Auditor's Duty Regarding Audit of LLP

1. Engagement Letter :- Auditor should get instructions in writing as to work to be performed by him.
2. Minutes Book :- If partners maintain minute book he shall refer it for any resolution passed regarding the accounts
3. LLP Agreement :- The auditor should read LLP agreement & note the following provisions
 - a. Nature of **business** of the LLP.
 - b. Amount of **capital** contributed by each partner.
 - c. **Interest** - in respect of additional capital contributed.
 - d. **Duration** of partnership.
 - e. **Drawings** allowed to the partners.
 - f. **Salaries**, commission etc payable to partners.
 - g. **Borrowing powers** of the LLP.
 - h. **Rights & duties** of partners.
 - i. Method of **settlement of a/c** between partners at time of admission, retirement, admission etc.
 - j. Any **loans advanced** by the partners.
 - k. **Profit sharing ratio**
4. Reporting :- The auditor should mention
 - a. Whether records of firm appear to be **correct & reliable**.
 - b. Whether he was able to **obtain all information & explanation** necessary for his work.
 - c. Whether any **restriction was imposed** upon him.

Audit of Charitable Institution(CI)

General

- i) Studying **constitution** under which charitable institution has been set up.
- ii) Verifying whether **institution being managed in manner contemplated by law** under which it has been set up.
- iii) Examining the **system of internal check**, especially for accounting of amounts collected.
- iv) Verifying in detail **income** & confirming that amounts received have been **deposited in bank regularly** and promptly.
- v) Examine **Trust Deed** or Regulations as laid down.

Subscriptions and donations

- i) Ascertaining, if any, **changes** made in **amount of annual or life membership subscription** during the year.
- ii) Whether **official receipts are issued**;
 - a. confirming **adequate control** imposed over unused receipt books
 - b. obtaining **all receipt books** covering period under review
 - c. **test checking counterfoils with cash book**; any cancelled receipts being looked into;
 - d. obtaining **printed list of subscriptions & donations** & agreeing with collections in accounts

Legacies - Verifying amounts received by reference to correspondence with any figures and other available info.

Grants

- i) Vouching amount recd with relevant **correspondence, receipts and minute books**.
- ii) Obtaining a **certificate** from responsible official showing amount of grants received.

Investments Income

- i) Vouching amounts received with **dividend and interest counterfoils**.
- ii) Checking **calculations of interest recd** on securities bearing fixed rates of interest.
- iii) Checking that **appropriate dividend received** where **investment been sold ex-dividend or purchased cum-dividend**.
- iv) Comparing amts of dividend recd with **schedule of investments** making **enquiries into investments held** for which **no dividend recd**.

Rent

- i) Examining the rent roll and inspecting tenancy agreements, noting in each case:
 - a. amounts of rent, and

- b. due dates.
- ii) Vouching rent on to the rent roll from counterfoils of receipt books and checking totals of cash book.

Special function, etc.

Vouching **gross receipts & outgoings** in respect of any **special functions**, e.g. concerts, dramatic performance, etc., held in aid of charity with such vouchers and cash statements as necessary.

Verifying proceeds of all tickets issued been accounted for, after making allowance for returns.

Income Tax Refunds

Where income-tax been deducted at source from Investment income, it should be seen that a refund been obtained since charitable institutions are exempt from payment of Income tax. This involves:

- i) vouching **Income-tax refund** with correspondence with Income- tax Deptt &
- ii) checking **calculation** of repayment of claims.

Expenditure

- i) Vouching **payment of grants**, also verifying grants paid only for charitable purpose(s) within purview of objects for which it was set up & no trustee, director or member of Managing Committee been benefited.
- ii) Verify **schedules of securities** & inventories of both movable & immovable properties by inspecting securities & title deeds of property & physical verification of movable properties on test basis.
- iii) Verifying the **cash and bank payments**.
- iv) Ascertaining that **funds contributed for a special purpose** been utilised for the purpose.

Audit of Educational Institutions (School, College or University)

Fees from Students

1. Check **names entered in Students Fee Register** for each month or term, with respective Class Registers and test amount of fees charged
2. **Check fees received** by comparing counterfoils of receipts granted with Cash Book.
3. **Total up various columns of Fees Register** for each month or term to ascertain fees paid in advance been carried forward and arrears irrecoverable been written-off.
4. Check **admission fees** with admission slips signed by head of institute & credited to Capital fund.
5. Check **free studentship & concessions** granted by an authorised person.
6. Confirm **finer for late payment or absence etc.** collected or remitted under proper authority.
7. Confirm **hostel dues** recovered before student's a/cs closed & caution money deposits refunded.

Expenditure

1. Verify that **Provident Fund money** of staff been invested in appropriate securities.
2. Vouch **donations** with list published with annual report. If some donations meant for specific purpose, see that money was utilised for the purpose.
3. Vouch, all **capital expenditure** and verify with sanction for Committee contained in minute book.
4. Vouch all **establishment expenses** and enquire any unduly heavy exp. under any head. If there was any annual budget prepared, see that any excess was duly sanctioned by Managing Committee. If not, report to Committee.
5. See **increase in the salaries** of staff been sanctioned and minuted by the Committee.

Assets & Liabilities

1. Report **old heavy arrears** on account of fees, dormitory rents, etc. to Managing Committee.
2. Confirm that **caution money & other deposits** paid by students on admission, been shown as liability in BS not transferred to revenue, unless not refundable.
3. See that **investments representing endowment funds** for prizes are kept separate and any income in excess of prizes been accumulated & invested along with corpus.
4. Ascertain that **system** of ordering, inspection on receipt and issue of provisions, foodstuffs, clothing & other equipment is efficient and all bills duly authorised and passed before payment.
5. Verify **inventories** of furniture, stationery, clothing, provision and all equipment etc. These should be checked by reference to Inventory Register or corresponding inventories of PY and values applied to various items should be test checked.

Compliances

1. Confirm **refund of taxes deducted** from income from investment (interest on securities etc.) claimed & recovered since institutions are generally exempted from payment of income-tax.
2. **Verify annual statements of a/c** and see that separate statements of a/c prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of staff, etc.

Audit of Hospitals

Special steps involved in such an audit are stated below:

1. Register of Patients: Vouch Register of patients **with copies of bills issued**. Verify bills for a **selected period with patients' attendance record** to see that bills been correctly prepared. Ensure **bills issued to all patients** from whom **amount was recoverable** as per rules of hospital.
2. Collection of Cash: Check cash collections as entered in Cash Book with **receipts, counterfoils and other evidence** for eg, copies of patients bills, copies of rent bills, etc.
3. Income from Investments, Rent etc: See by reference to **property and Investment Register** that all **income** that should have been received by way of rent on properties, dividends, and interest on securities have been **collected**.



4. Legacies and Donations: Ascertain that legacies and donations received for a **specific purpose** been **applied in the manner** agreed upon.
5. Reconciliation of Subscriptions: Trace all collections of subscription and donations from **Cash Book to respective Registers**. Reconcile total subscriptions due (as shown by the Subscription Register and amount collected and that still outstanding).
6. Authorisation and Sanctions: Vouch all purchases & expenses & verify that capital expenditure incurred only with **prior sanction of Trustees or Managing Committee & appointments & increments** to staff have been duly **authorised**.
7. Grants and TDS: Verify that grants recd from Govt or local authority has been **duly accounted** for. Also, that **refund in respect of TDS has been claimed**.
8. Budgets: Compare totals of various **items of expenditure and income** with amount budgeted for them and **report** to Trustees or Managing Committee, **significant variations**.
9. Internal Check: Examine internal check for **receipt and issue of stores**; medicines, linen, apparatus, clothing, instruments, etc. to ensure that **purchases been properly recorded** in Inventory Register and issues made only against **proper authorisation**.
10. Depreciation: Depreciation has been **w/off against all assets at appropriate rates**.
11. Registers: Inspect the bonds, share scrips, title deeds of properties and compare their particulars with **property and Investment Registers**.
12. Inventories: Obtain inventories, especially of stocks and stores as at **end of year** and check a **%age of items physically**; also compare their total values with **respective ledger** balances.
13. Management Representation and Certificate: Get proper Mgt Representation and Certificate w.r.t various aspects covered during course of audit.

AUDIT OF CLUB

Special steps involved in such an audit are stated below-

1. Entrance Fee: Vouch receipt of entrance fees with **members' applications, counterfoils issued to them**, with reference to **minutes of Managing Committee**.
2. Subscriptions: Vouch members' subscriptions with **counterfoils of receipt issued to them**, trace receipts for a selected period to Register of Members; also **reconcile** total subscriptions due with amount collected and outstanding.
3. Arrears of Subscriptions: Ensure arrears of subscriptions for PY been **correctly brought over & arrears for year under audit and subscriptions received in advance been correctly adjusted**.
4. Arithmetical accuracy: Check totals of various columns of Members Register.
5. Irrecoverable Member Dues: See Register of Members to ascertain Member's dues in arrear and enquire whether necessary **steps taken for recovery**; amount considered irrecoverable be **mentioned in Audit Report**.

6. Pricing: Verify internal check as regards **members being charged with price of foodstuffs and drinks provided to them** and their guests, as well as, with fees chargeable for special services rendered, such as billiards, tennis, etc.
7. Member Accounts: Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that account of every member been **debited with amounts recoverable** from him.
8. Purchases: Vouch purchase of **sports items, furniture, crockery, etc.** and trace their entries into respective **inventory registers**.
9. Margins earned: Vouch purchases of foodstuffs, cigars, wines, etc and test their sale price to confirm that **normal rates of gross profit** been earned on their sales. Inventory of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.
10. Inventories :- Check **inventory of furniture, sports material** and other assets physically with the respective **inventory registers** or inventories prepared at the end of the year.
11. Investments :- Inspect **share scrips and bonds** in respect of investments, check their **current values** for disclosure in final a/cs
12. Management Powers :- Examine **financial powers** of **secretary** and, if these have been exceeded, report specific case for confirmation by Managing Committee.

Audit of Cinema

Receipts from Sale of Tickets

(1) Verify **internal control mechanism**-

(a) **entrance** to cinema-hall during show only through printed tickets

(b) they are **serially numbered** and bound into books

(c) no. of tickets issued for each show and class, are different though numbers of same class for the show on same day, each week, run serially

(d) for **advance booking** a separate series of tickets is issued and

(e) **inventory of tickets** is kept in custody of a responsible official.

(2) Confirm that at **end of show, Statement of tickets sold prepared** & agreed with cash collected.

(3) Verify record is kept of '**free passes**' and they are issued under proper authority.

(4) Reconcile **amount of Entertainment Tax** collected with total no. of tickets issued for each class and vouch and verify tax returns filed each month.

(5) Vouch **entries in Cash Book w.r.t cash collected** on sale of tickets for different shows considering daily Statements test checked with **record of tickets issued** for different shows held.

Others:

(6) Verify **charges collected for advertisement slides and shorts** w.r.t. Register of Slides and Shorts Exhibited kept at cinema & agreements, entered with advertisers in this regard.

- (7) Vouch **expenditure incurred on advertisement, repairs and maintenance**. No part of such expenditure be capitalized.
- (8) Confirm **depreciation on machinery and furniture** been charged at appropriate rate.
- (9) Vouch **payments on account of film hire with bills of distributors** and in process, the agreements concerned should be referred to.
- (10) Examine **unadjusted balance out of advance paid to distributors** against film hire contracts to see that they are good and recoverable.
- (11) Arrangement for **collection of share in the restaurant income** should be enquired into either a fixed sum or a fixed %age of the taking may be receivable annually.

Audit of Hire Purchase & Leasing Companies

Hire-purchase agreement means agreement in which **goods let on hire & hirer** has **option to purchase** them as per terms of agreement & includes an agreement under which-

- i) **possession of goods delivered by owner** to a person on condition that person pays **periodical instalments**,
- ii) **property in goods to pass** to such person on **payment of last instalment**, and
- iii) such **person has right to terminate** agreement any time before the property so passes.

While checking hire- purchase transaction, auditor may examine the following:

- i) Hire purchase **agreement** is in **writing** and **signed** by all parties.
- ii) Hire purchase agreement specifies clearly-
 - a. **Hire-purchase price of goods** to which the agreement relates
 - b. **Cash price of goods**, that is to say, price at which goods may be purchased by hirer for cash
 - c. **Date** on which agreement deemed to have **commenced**
 - d. **No. of instalments** by which hire- purchase price is to be paid, **amount** of each of those instalments, and **date**, or mode of determining the date, upon which it is payable, and **person** to whom and **place** where it is payable; and
 - e. **Goods** to which agreement relates, in a manner sufficient to identify them.

LEASES

In a lease agreement, a **party** (called 'lessee') **acquires right to use an asset** for an **agreed period of time** in **consideration of payment of rent** to another party (called 'lessor').

Auditor's Procedures:-

1. **Object clause of leasing company** to see that goods like capital goods, consumer durables etc. in respect of which Co. can undertake such activities. Further, to ensure that whether Co. can undertake financing activities or not.

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2. Whether there is **procedure to ascertain credit analysis of lessee** like lessee's ability to meet commitment under lease, past credit record, capital strength, availability of collateral, etc.
3. **Lease agreement** should be examined and following points may be noted:
 - i) **description of lessor, lessee, equipment and location** where equipment is to be installed. (Stipulation that equipment shall not be removed from described location except for repairs. For identification, lessor may also require plates or markings to be attached to equipment).
 - ii) **tenure of lease, dates of payment, late charges, deposits** or advances etc. be noted.
 - iii) **whether equipment shall be returned** to lessor on termination of agreement and cost shall be borne by lessee.
 - iv) whether **agreement prohibits lessee from subletting the equipment** and authorises lessor to do so.
4. Examine **lease proposal form submitted by lessee** requesting lessor to provide equipment on lease.
5. Ensure that **invoice is retained safely** as lease is a long-term contract.
6. Examine **acceptance letter** obtained from lessee indicating that equipment has been received in order and acceptable to lessee.
7. See **Board resolution** authorising a director to execute lease agreement been passed by lessee.
8. See **copies of insurance policies** been obtained by lessor for his records.

Finance Lease

Arrangement with following attributes qualifies as a Finance Lease:

- Lease arrangement **transfers ownership** of asset to lessee at end of lease term
- **Lessee has option to purchase asset at a price** expected to be **sufficiently lower than fair value** at the date option becomes exercisable for it to be reasonably certain, at inception of lease, that option will be exercised
- **Lease term** is for the **major part of economic life of asset** even if title not transferred
- At inception of lease, **present value of minimum lease payments** amounts to at least **substantially all of fair value of leased asset** and
- **Leased assets are of specialized nature** that only lessee can use them without major modifications

Audit of Hotels

1) Internal Controls -

- **Pilfering** is one of greatest problems in any hotel. It is responsibility of mgt to introduce controls which will minimise leakage as far as possible.
- Mgt should prepare regular perhaps **weekly, trading a/cs** for each sales point and detailed scrutiny of resulting profit %, with any deviation from anticipated.
- Auditor should obtain these regular trading a/cs for period under review, examine them and obtain expln for any apparent deviations.
- Auditor should **verify few restaurant bills by reference to K.O.T.s** (Kitchen Order Tickets) or basic record. This would enable auditor to ensure controls regarding revenue cycle are in order.
- Auditor should satisfy that all **taxes collected** from occupants on food & occupation been paid to proper authorities.
- If **IC is weak**, then very serious problem exists for auditor. As a result of **transient nature of many of clients' records**, auditor must rely to a very large extent on gross margin shown by a/cs.
- As a result, audit **tests will increase** and, in event of a **material margin discrepancy** being **unexplained**, he will have to consider **qualifying** his audit report.

(2) Room Sales & Hall Bookings-

- Charge for room sales is normally **posted to guest bills by receptionist/ front office** or in case of large hotels by night auditor.
- Source of these entries is invariably **guest register & audit tests** should be carried out to ensure that correct nos. of guests are charged for correct period.
- Any **difference** b/w charged rates used on guests' bills & std room rate should be **investigated** to ensure they were properly authorised.
- In many hotels, **housekeeper prepares daily report** of rooms which were occupied the previous night and no. of beds kept in each room.
- This report isn't permanently retained & auditor should ensure sufficient no. of reports are available for him to test with guest register & individual guest's bill.
- Auditor should ensure that **proper valuation of occupancy-in-progress at BS date** made & included in accounts.
- Auditor should ensure **proper records are maintained for booking of halls & other premises** for special parties and recovered on the basis of tariff.

(3) Inventories

- Inventories in any hotel are both **readily portable and saleable** particularly food and beverage inventories.

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- All movements and transfer of such inventories be properly documented to enable control to be exercised over each individual stores areas and sales point.
- Auditor should ensure documentation is accurately processed.
- Areas where large quantities of inventory held should be kept locked, key being retained by departmental manager.
- Key be released only to trusted personnel and unauthorised persons should not be permitted in stores areas except under constant supervision.
- Many hotels use specialised professional valuers to take and value inventories on a continuous basis throughout the year.
- Such a valuation is then almost invariably used as basis of balance sheet inventory figure at year end. Although such valuers are independent of audit client, it is important that auditor satisfies himself that amounts included for such inventories are reasonable.
- Auditor should consider attending physical inventory taking and carrying out certain pricing and calculation tests.

(4) Fixed Assets -

A/c policies for assets of individual hotels are likely to differ. Auditor should see that costs of repairs and minor renovation and redecoration are treated as revenue expenditure, whereas costs of major alterations and additions to hotel building and facilities capitalised.

(5) Casual Labour - Hotel trade operates to very large extent on casual labour. Records maintained of such wage payments are frequently inadequate. Auditor should ensure that defalcation on this account does not take place by suggesting proper controls to mgt.

(6) Travel Agents & Shops -

- i) For ledgers coming through travel agents or other booking agencies, bills are usually made on travel agents or booking agencies. Auditor should ensure money are recovered from travel agents or booking agencies as per terms of credit allowed.
- ii) Commission, if any, paid to travel agents or booking agents should be checked by reference to agreement on that behalf.

Audit of Trusts & Societies

There are 3 basic legal forms of charitable entities under Indian law: trusts, societies, and Sec 8 companies. Legal framework governing charitable institution will depend on form of business organization charitable institution takes.

- Public Trust will be governed by **Public Trust Act** applicable in relevant State. However, **if no Public Trust Act exists**, then applicable legislation will be **Indian Trusts Act, 1882**.
- Society will be governed by **Societies Registration Act, 1860**.
- Non-profit company under **Sec 8 of Companies Act, 2013**.
- Apart from the above, **Income Tax Act 1961** applicable to charitable institutions.
- In case of **foreign contributions** to these charitable institutions, **Foreign Contribution (Regulation) Act, 2010** applicable.

Books of Accounts

Auditor is required to report whether the Trust has maintained proper books of accounts, including:

- i) cash book
- ii) ledger
- iii) journal
- iv) copies of bills, whether machine numbered or otherwise serially numbered, wherever such bills are issued by trust, and copies or counterfoils of machine numbered or otherwise serially numbered receipts issued by the trust
- v) original bills wherever issued to person and receipts in respect of payments made by the person
- vi) any other book

TRUSTS

Auditor has to ascertain :-

- a. whether **accounts maintained regularly** and as per provisions of applicable Act and rules
- b. whether **receipts and disbursements are properly and correctly shown** in accounts and money received in form of donations being applied as per objects of trust and as per specific direction by donor, if any.
- c. whether **cash balance and vouchers** in custody of manager or trustee on date of audit were in agreement with accounts
- d. whether **all books, deeds, accounts, vouchers or other documents** or records required by auditor were produced before him
- e. whether **maximum and minimum number of trustees** maintained
- f. whether **meeting are held regularly** as provided in such instrument
- g. whether **minute books of proceedings** of meeting maintained

Societies

Auditor's considerations:-

- a. Auditor should ascertain **governing legislation of society** i.e. Societies Registration act, 1860 or any applicable state law under which it has been registered.
- b. **Object of society** needs to be ascertained from its **memorandum of association/bye laws**. Its activities may include charitable, social, cultural or educational activities.
- c. Ascertain whether society obtained **registration under Foreign Contribution (Regulation) Act, 2010** in case foreign contributions are received.
- d. Ascertain whether also **registered under Income Tax Act** which may make it eligible for tax exemption on its income.
- e. Obtain an **understanding of internal control** to design audit procedures with special reference to donations and various expenditures in relation to achievements of objects of society.



Ch-19 Internal Audit & SA 610

Internal audit function refers to

- ⇒ a **function** of entity that
- ⇒ performs **assurance & consulting** activities designed
- ⇒ to **evaluate & improve** effectiveness of
- ⇒ entity's **Governance, Risk mgt & Internal Control** processes.

Objective & Scope of Internal Audit

(1) Activities Relating to Governance

Assess governance process in its **accomplishment of objectives** on **ethics and values**, performance mgt & accountability, communicating risk and control info to areas of organization & communication among TCWG, external and internal auditors, and mgt.

(2) Activities Relating to Risk Management

- May assist entity by identifying & evaluating **significant risk** & contributing to **improvement of risk mgt and internal control** (including effectiveness of financial reporting process).
- May perform procedures to assist entity in **detection of fraud**.

(3) Activities Relating to Internal Control

Assigned specific responsibility for **reviewing controls, evaluating** their **operation**, and **recommending improvements** thereto. In doing so, internal audit provides assurance on control.

For eg internal audit fn plan and perform tests to provide assurance to mgt & TCWG regarding design, implementation and operating effectiveness of IC, controls relevant to audit.

(4) Examination of financial and operating information.

To **review the means to identify, recognize, measure, classify and report** financial and operating info, and make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

(5) Review of operating activities.

To **review economy, efficiency and effectiveness** of operating activities, including non- financial activities of entity.

(6) Review of compliance with laws and regulations.

To review compliance with laws, regulations, and other external requirements, and with mgt policies & directives & other internal requirements.



Ways in which external auditor may make use of the function for purposes of audit

External auditor may make use of function for purposes of audit in one or more of following ways:

- (i) to **obtain info** relevant to external auditor's **assessments of RoMM** due to error or fraud.
- (ii) **Unless prohibited, or restricted**, by L/R, external auditor, after appropriate evaluation, may decide to use work performed by I/A fn in partial substitution for audit evidence to be obtained directly by external auditor.
- (iii) **Unless prohibited, or restricted**, by L/R, external auditor, may use internal auditors to perform audit procedures under **direction, supervision & review** of external auditor (ref. as "direct assistance").

SA 610: Using the work of Internal Auditor (IA)

- Sole responsibility of audit opinion → External Auditor (EA)
- EA has to obtain SAAE that work of IA Function or Internal auditor providing direct assistance is adequate for purpose of audit

Internal Audit Function: Fn. of entity that performs assurance & consulting activities to evaluate and improve effectiveness of entity's governance, risk mgt and internal control processes (GRC).

Direct Assistance: Use of internal auditors to perform audit procedures under direction, supervision and review (DSR) of external auditor.

Scope of SA

- a) Using work of IA Function in obtaining audit evidence &
- b) Using IA to provide direct assistance under direction, supervision and review (DSR) of EA

This SA doesn't apply if entity doesn't have IA function/I.A.

Objectives of Auditor where entity has internal audit function

- To determine if work of IA function or direct assistance of Internal auditor **can be used**, if so, in what **areas** & to what **extent**
- If using work of **IA Function**, determine whether work is **adequate** for Audit purpose
- If using Internal Auditor to provide Direct Asst, to **DSR their work**

Evaluating whether work of Internal Audit Function can be used for Audit Purpose

- a. Extent to which IA function's organizational status and relevant policies and procedures support **objectivity** of internal auditors
- b. Level of **competence** of internal audit function &
- c. Whether IA function applies a **systematic and disciplined approach**, including quality control.

Objectivity & Its evaluation

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

Factors that affect external auditor's evaluation of Objectivity include following:

1. Whether **organizational status** of IA fn, supports its ability to be free from bias, conflict of interest or undue influence of others to override professional judgments.

For eg

whether internal audit fn reports to TCWG or an officer with appropriate authority, or if function reports to mgt, whether it has direct access to TCWG.

2. Whether **TCWG oversee employment decisions** related to internal audit function.

For eg appropriate remuneration policy.

3. Whether any **constraints or restrictions placed on IA** fn by mgt or TCWG, for eg, in communicating IA fn's findings to external auditor.

4. Whether IA fn is **free of conflicting responsibilities**, for eg, managerial or operational duties outside of IA fn.

Status >> TCWG >> Constraints >> Free

Competence and its evaluation

Competence refers to attainment & maintenance of knowledge & skills at level required to enable to be perform assigned tasks diligently and as per applicable professional standards.

Factors that may affect external auditor's determination of competence include following:

1. Whether IA fn **adequately & appropriately resourced** relative to size of entity & its operations.
2. Whether there are **established policies for hiring, training & assigning** internal auditors.
3. Whether IA have adequate **technical training & proficiency** in auditing.
4. Whether IA possess **required knowledge** of entity's financial reporting and applicable FRF.

Circumstances When Work of IA Function Can't Be Used

External auditor shall not use work of IA fn if external auditor determines:

- a. Function's organizational status & policies & procedures **don't support objectivity** of IA
- b. Function **lacks sufficient competence** or
- c. Function **doesn't apply systematic and disciplined approach**, including quality control.

Examples of Work of IA function that can be used by external auditor include following:

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



Circumstances in which EA shall plan to use

less of work of IA fn & perform more work directly

EA shall make all significant judgments in audit engg and prevent undue use of work of IA function, shall plan to use less work of function & perform more work directly if:

- a. More judgment is involved in:
 - (i) Planning and performing relevant audit procedures and
 - (ii) Evaluating the audit evidence gathered
- b. Higher assessed RoMM at assertion level, with special consideration given to risks identified as significant;
- c. Less the IA fn's organizational status & policies & procedures support objectivity of IA;
- d. Lower the level of competence of IA fn.

Using the Work of the Internal Audit Function

EA shall

- a. discuss planned use of its work with IA as a basis for coordinating their respective activities.
- b. read reports of IA fn relating to work that EA plans to use to understand nature & extent of audit procedures performed and findings.
- c. perform sufficient audit procedures on work of IA fn as whole that EA plans to use to determine its adequacy for audit purpose.

Discussion and Coordination with the Internal Audit Function

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

1. Timing of such work.
2. Nature of work performed.
3. Extent of audit coverage.
4. Materiality for FS as a whole (and, if applicable, materiality level(s) for particular ABCD), & performance materiality.
5. Proposed methods of item selection & sample sizes.
6. Documentation of work performed.
7. Review and reporting procedures.

Coordination between EA and IA fn is effective when, for example:

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

Direct Assistance by IA

Written Agreements: Prior to using IA to provide direct assistance for purposes of audit

- a. **From authorized representative of entity** that IA will be allowed to follow external auditor's instructions, & entity will not intervene in work IA performs for external auditor &
- b. **From internal auditors** that they will keep **confidential** specific matters instructed by external auditor and inform about any threat to their objectivity.

Areas where Internal auditor can't provide Direct Assistance

- a. Involve making significant **judgments** in audit
- b. Relate to **higher assessed ROMM** where judgment required in performing relevant audit procedures or evaluating audit evidence gathered is more than limited
- c. Relate to work with which **internal auditors have been involved and which has already been**, or will be, reported to Mgt or TCWG by internal audit function or
- d. Relate to **decisions external auditor** makes as per this SA regarding internal audit function and use of its work or direct assistance.



Assertions refer to

Assertions

- ✓ representations by management, explicit or otherwise,
- ✓ that are embodied in F.S.,
- ✓ as used by auditor
- ✓ to consider different types of potential misstatements that may occur.

Classes of transactions and events	Account balances	Presentation and Disclosure
Occurrence	Existence	Occurrence and rights and obligations
Completeness	Rights & Obligations	Completeness
Accuracy	Completeness	Classification and understandability
Cut-off	Valuation and Allocation	Accuracy and valuation
Classification		

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

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

Example

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

Assertions are as follows:

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

Negative assertions are also in FS & may be expressed or implied. For eg, if it's stated there's **no contingent liability** it would be an **expressed negative assertion**; on other hand, if in BS there is **no item as "building"**, it'd be **implied negative assertion** that entity did not own any building on BS date.

Audit Trail

Audit trail is a **documented flow of a transaction**.

- **Used to investigate** how **source document** was translated into **a/c entry** and from there it was inserted into **FS** of an entity.
 - **Used as audit evidence** to establish authentication & integrity of a transaction.
 - Help in maintaining **record of system and user activity**.
 - **Step-by-step record** by which accounting, trade details, or other financial data can be traced to their source. Audit trails are used to verify and track many types of transactions including accounting and financial transactions.
 - Help to **enhance internal controls and data security**.
 - Help in **fixing responsibility**, rebuilding events and thorough analysis of problem areas. For example, audit trails can track activities of users thus fixing responsibility for users.
 - Can also be used to **rebuild events** upon occurring of some problem.
 - Audit trail analysis can **specify reason of the problem**.
 - Also help in **ensuring operation of system** as intended.
- In this way, audit trails can **help entities in their regular system operations**.

However, audit trails **involve costs**. Cost is not only in terms of **system expenditure** but **also** in terms of **time involved in analysing data** made available by audit trails.

However, can **use of automated tools** to analyse large volume of data thrown up by audit trails.

Advantages for Auditor:-

- Systems which have a feature of audit trail **inspires confidence in auditors**.
- It **helps** auditors in verifying whether **controls** devised by mgt **were operating effectively or not**.
- It aids in **verification** whether a **transaction was indeed performed by an authorised person**.
- Since audit trails **also enhance data security**, these can be used by auditor while performing audit procedures thus increasing **reliability of audit evidence obtained**. [SM]