

For CA INTERMEDIATE

SM & AUDIT

TODD REVISION BOOK

Edition - 6

KEY FEATURES:

- ✓ **Based on the Institute's New Module**
- ✓ **Updated Content of All Chapters**
- ✓ **Helpful for Revision**
- ✓ **Complete Syllabus in 200 pages**
- ✓ **All Answers in Point Form - Easy to grasp & understand**
- ✓ **Simple and Lucid Language**



CA CS Amit Tated
FCA, CS, DISA



For C.A. Intermediate

SM & Auditing and Ethics

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VISION:

To provide simple yet standardized, short yet complete, conceptual yet affordable, education to students enhancing their knowledge from heart & mind.

MISSION:

Providing personalized and affordable coaching and support of best possible standard, in shortest possible time.

CA. AMIT TATED

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Preface

It gives me immense pleasure to present the Sixth (New Syllabus) edition TRB of SM & Auditing & Ethics. This edition has updated syllabus which is applicable from MAY 2024 and onwards.

This book has everything which student may require to Revise, Recall and Reproduce SM & Auditing & Ethics. The book has been developed keeping in mind the technicality of the subject, so that student can revise easily.

This book will suffice to go with institute language to revise the content.

In recent exam papers we saw that the questions asked are more practical. Thus, students need to understand the concepts and logical reasoning of the Chapter. Only mugging-up shall not suffice to score in this subject.

For Question Bank & Revision, student can refer Amit Tated YouTube Channel.

(Tera Course Mera Guidance)

Every effort has been made to avoid any errors and omissions in this book. Despite all the efforts we believe some errors might have crept in. The students are welcome to point out any errors / suggestions.

Best wishes,

Amit Tated
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April, 2024

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I would like to acknowledge my Parents (Vijay & Shobha), Manish, Allan, Ritesh, Bhavesh & Sumeet for all their support towards my journey of studies, career & experience.

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STRATEGIC MANAGEMENT (SM)

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**STRATEGIC
MANAGEMENT
(SM)**

CHAPTER - 1

INTRODUCTION TO STRATEGIC MANAGEMENT

1.1 INTRODUCTION

This chapter is an attempt to highlight the concepts and significance of 'strategic management'.

1.2 MEANING AND NATURE OF STRATEGIC MANAGEMENT

The term 'management' is used in two senses, such as:

- (a) It is used with reference to a *key group in an organisation in-charge of its affairs*.
- (b) The term 'Management' is also used with reference to a set of interrelated functions and processes carried out by the management of an organisation.

Management is an influence process to make things happen, to gain command over phenomena, to induce and direct events and people in a particular manner.

1.3 CONCEPT OF STRATEGY

We may define the term 'strategy' as a long-range blueprint of an organization's desired image, direction and destination.

Igor H. Ansoff : The common thread among the organization's activities and product-markets that defines the essential nature of business that the organization has or planned to be in future.

William F. Glueck: A unified, comprehensive and integrated plan designed to assure that the basic objectives of the enterprise are achieved.

Strategy is partly proactive and partly reactive: A company's strategy is typically a blend of:

- ◆ Proactive actions on the part of managers to improve the company's market position and financial performance.
- ◆ Reactions to unanticipated developments and fresh market conditions in the dynamic business environment.

Proactive strategy is planned strategy whereas reactive strategy is adaptive reaction to changing circumstances.

1.4 STRATEGIC MANAGEMENT - IMPORTANCE AND LIMITATIONS

The term 'strategic management' refers to the managerial process of developing a strategic vision, setting objectives, crafting a strategy, implementing and evaluating the strategy, and finally initiating corrective adjustments where deemed appropriate.

The overall objectives of strategic management are two-fold:

- ◆ To create competitive advantage
- ◆ To guide the company successfully through all changes in the environment.

1.4.1 Importance of Strategic Management

- ◆ The strategic management gives a direction to the company.
- ◆ Strategic management helps organisations to be proactive instead of reactive.
- ◆ Strategic management provides frameworks for all major decisions.
- ◆ Strategic management seeks to prepare the organisation to face the future.
- ◆ Strategic management serves as a corporate defence mechanism.
- ◆ Strategic management helps to enhance the longevity of the business.
- ◆ Strategic management helps the organisation to develop certain core competencies and competitive advantages.

1.4.2 Limitations of Strategic Management

- ◆ Environment is highly complex and turbulent
- ◆ Strategic management is a time-consuming process
- ◆ Strategic management is a costly process
- ◆ It is difficult to clearly estimate the competitive responses to a firm's strategies.

1.5 STRATEGIC INTENT (VISION, MISSION, GOALS, OBJECTIVES AND VALUES)

Strategic intent can be understood as the philosophical base of strategic management.

Strategic intent provides the framework within which the firm would adopt a predetermined direction and would operate to achieve strategic objectives.

Strategic intent is generally stated in broad terms but when stated in precise terms it is an expression of aims to be achieved operationally, i.e., goals and objectives.

1. **Vision:** Vision implies the blueprint of the company's future position.

- 2. **Mission:** Mission delineates the firm's business, its goals and ways to reach the goals.
- 3. **Goals and Objectives:** These are the base of measurement.
The vision, mission, business definition, and business model explain the philosophy of the organisation but the goals and objectives represent the results to be achieved in multiple areas of business.
- 4. **Values/ Value System:** Values are the deep-rooted principles which guide an organisation's decisions and actions.

1.5.1 Vision

Strategic vision delineates management's aspirations for the business, providing a panoramic view of the "where we are to go" and a convincing rationale for why this makes good business sense for the company.

Essentials of a strategic vision

- ◆ Think creatively about how to prepare a company for the future.
- ◆ Forming a strategic vision is an exercise in intelligent entrepreneurship.
- ◆ A well-articulated strategic vision creates enthusiasm.
- ◆ The best-worded vision statement clearly illuminates the direction.

1.5.2 Mission

A mission is an answer to the basic question 'what business are we in and what we do'.

Why should an organisation have a mission?

- ◆ To ensure unanimity of purpose
- ◆ To develop a basis, or standard, for allocating organisational resources.
- ◆ To provide a basis for motivating.
- ◆ To establish a general tone or organisational climate.
- ◆ To serve as a focal point
- ◆ To facilitate the translation of objective and goals into a work structure.
- ◆ To specify organisational purposes and the translation of these purposes into goals in such a way that cost, time, and performance parameters.

A good mission statement should be precise, clear, feasible, distinctive and motivating.

Following points are useful while writing a mission of a company:

- ◆ Own special identity, business emphasis and path for development.
- ◆ Which customer groups it is targeting and the technologies and competencies it uses.
- ◆ Good mission statements are - unique.

What is our mission? And what business are we in?

Peter Drucker and Theodore Levitt were among the first to agitate this issue through their writings.

According to Peter Drucker, every organisation must ask an important question "What business are we in?" and get the correct and meaningful answer.

What business are we in?

<i>Company</i>	<i>Production-oriented answer</i>	<i>Marketing-oriented answer</i>
<i>Indian Oil</i>	<i>We produce oil and gasoline products.</i>	<i>We provide various types of safe and cost-effective energy.</i>
<i>Indian Railways</i>	<i>We run a railroad.</i>	<i>We offer a transportation and material-handling system.</i>

1.5.3 Goals and Objectives

As such the term objectives are synonymous with goals, however, some authors make an attempt to distinguish the two. However, this distinction is not made by several theorists on the subject. Accordingly, we will also use the term interchangeably.

Objectives, to be meaningful to serve the intended role, must possess the following characteristics:

- ◆ *Objectives should define the organisation's relationship with its environment.*
- ◆ *They should be facilitative towards achievement of mission and purpose.*
- ◆ *They should provide the basis for strategic decision-making.*
- ◆ *They should provide standards for performance appraisal.*
- ◆ *They should be concrete and specific.*
- ◆ *They should be related to a time frame.*
- ◆ *They should be measurable and controllable.*
- ◆ *They should be challenging.*

- ◆ Different objectives should correlate with each other.
- ◆ Objectives should be set within the constraints of organisational resources

A need for both short-term and long-term objectives:

Long-term objectives:

- ◆ Profitability
 - ◆ Productivity
 - ◆ Competitive Position
 - ◆ Employee Development
 - ◆ Employee Relations
 - ◆ Technological Leadership
 - ◆ Public Responsibility
- Long-term objectives represent the results expected from pursuing certain strategies.
 - Short-range objectives can be identical to long-range objectives if an organisation is already performing at the targeted long-term level. Short-range objectives then serve as steps toward achieving long term objective.

1.5.4 VALUES

A company's value sets the tone for how the people of think and behave, especially in situations of dilemma. It creates a sense of shared purpose to build a strong foundation and focus on longevity of the company's success.

Intent vs Values - Which is a broader concept?

Intent is the purpose of doing business while values are the principles that guide decision making of business. They both go hand in hand, while the intent is sometimes driven by values. So values more or so is wider than Intent.

1.6 STRATEGIC LEVELS IN ORGANISATIONS

Generally, there are three main levels of management:

- ◆ Corporate level
- ◆ Business level
- ◆ Functional level

General Managers are found at the first two of these levels, but their strategic roles differ depending on their sphere of responsibility.

The corporate level of management consists of the Chief Executive Officer (CEO),

other senior executives, the board of directors, and corporate staff. The role of *corporate-level managers* is to oversee the development of strategies for the whole organization. This role includes defining the mission and goals of the organization, determining what businesses it should be in, allocating resources among the different businesses, formulating and implementing strategies that span individual businesses, and providing leadership for the organization as a whole.

However, it is not their specific responsibility to develop strategies for competing in the individual business areas, such as financial services. The development of such strategies is the responsibility of those in charge of different businesses called *business level managers*.

In simple words, corporate level managers provide an organisation level view of strategy and what they want to achieve, but it is on the business level managers to ensure that for their particular business, the one they are responsible for.

The principal general manager at the business level, or the business-level manager, is the head of the division. The strategic role of these managers is to translate the general statements of direction and intent that come from the corporate level into concrete strategies for individual businesses.

Functional-level managers are responsible for the specific business functions or operations. Functional managers provide most of the information that makes it possible for business- and corporate-level general managers to formulate realistic and attainable strategies.

Which is better - Top Down Approach or Bottom-Up Approach?

A top-down approach to decision making is when decisions are made solely by leadership at the top i.e. corporate level of management, while the bottom-up approach gives all teams across the levels a voice in decision making.

1.6.1 Network of relationship between the three levels

- ◆ *Functional and Divisional Relationship*
- ◆ *Horizontal Relationship*
- ◆ *Matrix Relationship*

CHAPTER - 2

STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

2.1 INTRODUCTION

The process of strategic formulation begins with a strategic analysis. Its objective is to compile information about internal and external environments in order to assess possibilities while formulating strategic objectives and contemplating strategic activities.

2.2 STRATEGIC ANALYSIS

Environmental scanning is a natural & continuous activity for every business & some do it on an informal basis, while others have a formal structure to collect meaningful information.

The two important situational considerations are:

- (1) industry and competitive conditions, and
- (2) an organisation's own capabilities, resources, internal strengths, weaknesses.

The analytical sequence is from strategic appraisal of the external and internal situation to evaluation of alternatives of strategies, to the final choice of strategy.

There are two major limitations of strategic analysis that we need to be aware of. First, it gives a lot of innovative options but doesn't tell which one to pick. Second, it can be time-consuming.

2.2.1 Issues to consider for Strategic Analysis

- ◆ Strategy evolves over a period of time
- ◆ Balance of external and internal factors
- ◆ Risk:

		Time	
		Short Time	Long Time
Strategic Risks	External	Errors in interpreting the environment cause strategic failure	Changes in the environment lead to obsolescence of strategy.
	Internal	Organizational capacity is unable to cope up with strategic demands.	Inconsistencies with the strategy are developed on account of changes in internal capacities & preferences

Figure: Strategic Risk

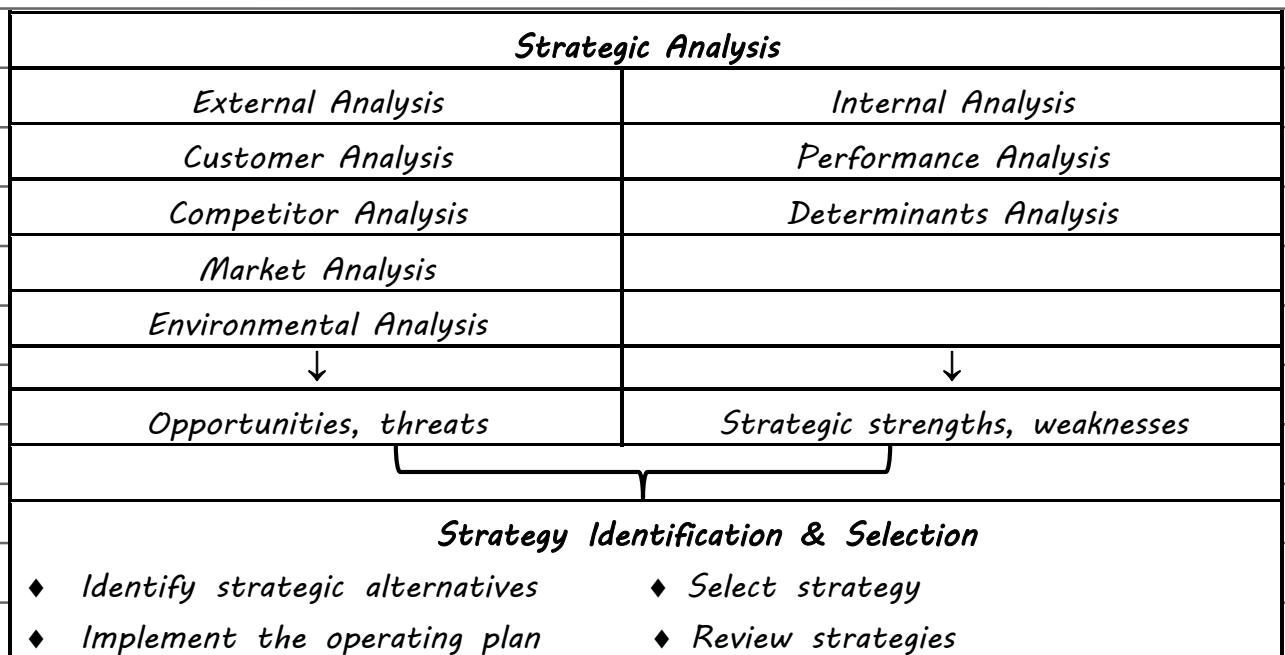


Figure: Framework of Strategic Analysis

2.3. STRATEGY AND BUSINESS ENVIRONMENT

The term "business environment" refers to all external factors, influences, or situations that in some way affect business decisions, plans, and operations.

This interaction helps in strengthening the business firm and using its resources more effectively. It helps the business in the following ways:

- | | |
|---|--------------------------------------|
| i. Determine opportunities and threats | ii. Give direction for growth |
| iii. Continuous Learning | iv. Image Building |
| | v. Meeting Competition: |

2.3.1 Micro and Macro Environment

Micro-environment is related to small area or immediate periphery of an organization.

Within the micro or the immediate environment in which a firm operates we need to address the following issues:

- ◆ The employees of the firm, their characteristics and how they are organised.
- ◆ The existing customer base on which the firm relies for business.
- ◆ The ways in which the firm can raise its finance.
- ◆ Who are the firm suppliers and how are the links between the two being developed?
- ◆ The local community within which the firm operates.
- ◆ The direct competition and their comparative performance.

2.3.2 Elements of Macro Environment

“The environment includes factors outside the firm which can lead to opportunities for, or threats to the firm.”

Demographic Environment

Population that have been classified and explained according to certain criteria, such age, gender, and income, in order to understand the features of a specific group.

Demographical analysis considers factors such as race, age, income, education, possession of assets, house ownership, job position, region, and the degree of education.

Particularly, they need to address following issues:

- ◆ *What demographic trends will affect the market size of the industry?*
- ◆ *What demographic trends represent opportunities or threats?*

The size, age distribution, geographic dispersion, ethnic mix, and income distribution of a population are all of great importance to the organisation.

Socio-Cultural Environment

It represents a complex group of factors such as social traditions, values and beliefs, level and standards of literacy, the ethical standards and state of society, the extent of social stratification, conflict, cohesiveness and so forth. It differs from demographics in the sense that it is not the characteristics of the population, but it is the behaviour and the belief system of that population.

Economic Environment

The purchasing power in an economy depends on current income, prices, savings, circulation of money, debt and credit availability. Income distribution pattern determine the business possibilities. The important point to consider is to find out the effect of economic prospect, growth and inflation on the operations of the business.

These include gross domestic product, per capita income, markets for goods and services, availability of capital, foreign exchange reserve, growth of foreign trade, strength of capital market, interest rates, disposable income, unemployment, inflation, etc.

Political-Legal Environment

General level of political development, the degree to which business and economic issues have been politicised, the degree of political morality, the state of law and order, political stability, the political ideology and practises of the ruling party, the effectiveness and purposefulness of governmental agencies.

Business is highly guided and controlled by government policies.

Businesses must understand the relevant laws relating to companies, competition, intellectual property, foreign exchange, labour and so on.

Technological Environment

Businesses help society access the outcomes of technological research and development, raising everyone's standard of living.

With use of technology, many organisations are able to reduce paperwork, schedule payments more efficiently, are able to coordinate inventories efficiently and effectively.

2.3.3 PESTLE- A tool to Analyse Macro Environment

The PESTLE analysis is simple to understand and quick to implement.

Political	Economic
<ul style="list-style-type: none"> ◆ Political stability ◆ Political principles and ideologies ◆ Current and future taxation policy ◆ Regulatory bodies and processes ◆ Government policies ◆ Government term and change ◆ Thrust areas of political leaders 	<ul style="list-style-type: none"> ◆ Economy situation and trends ◆ Market and trade cycles ◆ Specific industry factors ◆ Customer/end-user drivers ◆ Interest and exchange rates ◆ Inflation and unemployment ◆ Strength of consumer spending
Social	Technological
<ul style="list-style-type: none"> ◆ Lifestyle trends ◆ Demographics ◆ Consumer attitudes and opinions ◆ Brand, company, technology image ◆ Consumer buying patterns ◆ Ethnic/religious factors ◆ Media views and perception 	<ul style="list-style-type: none"> ◆ Replacement technology/solutions ◆ Maturity of technology ◆ Manufacturing maturity and capacity ◆ Innovation potential ◆ Technology access, licensing, patents, property rights and copyrights

<i>Legal</i>	<i>Environmental</i>
<ul style="list-style-type: none"> ◆ <i>Business and Corporate Laws</i> ◆ <i>Employment Law</i> ◆ <i>Competition Law</i> ◆ <i>Health & Safety Law</i> ◆ <i>International Treaty and Law</i> ◆ <i>Regional Legislation</i> 	<ul style="list-style-type: none"> ◆ <i>Ecological/environmental issues</i> ◆ <i>Environmental hazards</i> ◆ <i>Environmental legislation</i> ◆ <i>Energy consumption</i> ◆ <i>Waste disposal</i>

2.3.4 Internationalization of Business

Characteristics of a global business

- ◆ *It is a conglomerate of multiple units*
- ◆ *Multiple units draw on a common pool of resources*
- ◆ *The units respond to some common strategy.*

Developing internationally

The steps in international strategic planning are as follows:

- ◆ *Evaluate global opportunities and threats and rate them with the internal capabilities.*
- ◆ *Describe the scope of the firm's global commercial operations.*
- ◆ *Create the firm's global business objectives.*
- ◆ *Develop distinct corporate strategies for the global business and whole organisation.*

Why do businesses go global?

There are several reasons why companies go global. These are explained as follows:

- ◆ *The first and foremost reason is the need to grow.*
- ◆ *There is rapid shrinking of time and distance across the globe.*
- ◆ *It is being realised that the domestic markets are no longer adequate.*
- ◆ *Reliable or cheaper source of raw-materials, cheap labour, etc.*
- ◆ *Companies often set up overseas plants to reduce high transportation costs.*
- ◆ *When exporting organisations find foreign markets to open up or grow big, they may naturally look at overseas manufacturing plants and sales branches.*
- ◆ *The apparent and real collapse of international trade barriers.*
- ◆ *Globalization has made companies in different countries to form strategic alliances.*

2.3.5 International Environment

Assessments of the international environment can be done at three levels: multinational, regional, and country.

1. **Multinational environmental analysis** involves identifying, anticipating, and monitoring significant components of the global environment on a large scale.
2. **Regional environmental analysis** is a more in-depth evaluation of the critical factors in a specific geographical area.
3. **Country environmental analysis** has to take a deeper look at the important environmental factors.

2.4 UNDERSTANDING PRODUCT AND INDUSTRY

Business products have certain characteristics as follows:

- ◆ Products are either tangible or intangible
- ◆ Product has a price
- ◆ Products have certain features that deliver satisfaction
- ◆ Product is pivotal for business
- ◆ A product has a useful life

2.4.1 Product Life Cycle

Essentially, PLC is an S-shaped curve which exhibits the relationship of sales with respect of time for a product that passes through the four successive stages of introduction, growth, maturity and decline.

The first stage of PLC is the introduction stage with slow sales growth.

The second phase of PLC is growth stage with rapid market acceptance.

The third phase of PLC is maturity stage where there is slowdown in growth rate.

In the fourth stage of PLC is declines with sharp downward drift in sales.

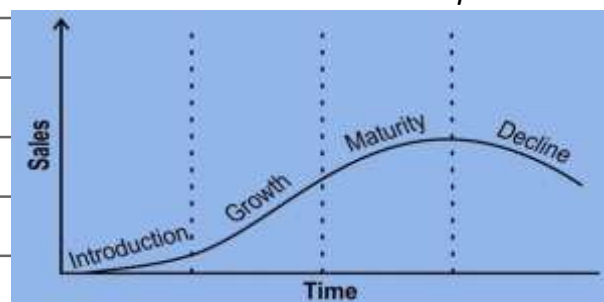


Figure: Product Life Cycle

2.4.2 Value Chain Analysis

Value chain analysis is a method of examining each activity in value chain of a business in order to identify areas for improvements.

The two basic steps of identifying separate activities and assessing the value added from each were linked to an analysis of an organization's competitive advantage by Michael Porter.

The primary activities of the organization are grouped into five main areas

- ◆ Inbound logistics are the activities concerned with receiving, storing and distributing the inputs to the product/service.
- ◆ Operations transform these inputs into the final product or service
- ◆ Outbound logistics collect, store and distribute the product to customers.
- ◆ Marketing and sales provide the means whereby consumers/users are made aware of the product/service.
- ◆ Service are all those activities, which enhance or maintain the value.

Each of these groups of primary activities are linked to support activities. These can be divided into four areas;

- ◆ Procurement: This refers to the processes for acquiring the various resource.
- ◆ Technology development
- ◆ Human resource management
- ◆ Infrastructure

2.5 INDUSTRY ENVIRONMENT ANALYSIS

The goal of the industry environment analysis, which is typically an important step of strategic analysis, is to estimate the amount of competitive pressures the business is presently facing and is expected to face in the near future.

2.5.1 Porter's Five Forces Model

The model holds that the state of competition in an industry is a composite of competitive pressures operating in five areas of the overall market:

- ◆ Market manoeuvring and jockeying for buyer patronage that goes on among rival sellers.
- ◆ Threat of new entrants into the market.
- ◆ Win buyers over to their own substitute products.

◆ *Stemming from supplier bargaining power.*

◆ *Stemming from buyer bargaining power.*

The strategists can use the five-forces model to determine what competition is like in a given industry by undertaking the following steps:

Step 1: Identify the specific competitive pressures associated with each of the five forces.

Step 2: Evaluate how strong the pressures.

Step 3: Determine whether the collective strength of the five competitive forces.

I. The Threat of New Entrants

To discourage new entrants, existing firms can try to raise barriers to entry.

(i) Capital Requirements

(ii) Economies of Scale

(iii) Product Differentiation

(iv) Switching Costs

(v) Brand Identity

(vi) Access to Distribution Channels

(vii) Possibility of Aggressive Retaliation

II. Bargaining Power of Buyers

(i) *Buyers have full knowledge of the sources of products and their substitutes.*

(ii) *They spend a lot of money on the industry's products i.e. they are big buyers.*

(iii) *The industry's product is not perceived as critical to the buyer's needs*

III. Bargaining Power of Suppliers

(i) *Their products are crucial to the buyer*

(ii) *They can erect high switching costs.*

(iii) *They are more concentrated than their buyers.*

IV. The Nature of Rivalry in the Industry

Rivalry among competitors tends to be cutthroat and industry profitability low under various conditions explained as follows:

(i) Industry Leader

(ii) Number of Competitors

(iii) Fixed Costs

(iv) Exit Barriers

(v) Product Differentiation

(vi) Slow Growth

V. Threat of Substitutes

Substitute products offering a price advantage and/or performance improvement to the consumer can drastically alter the competitive character.

2.5.2 Attractiveness of Industry

The important factors on which the management may base such conclusions include:

- ◆ The industry's growth potential, is it futuristically viable?
- ◆ Whether competition currently permits adequate profitability.
- ◆ Whether industry profitability will be favourably or unfavourably.
- ◆ The competitive position of an organisation
- ◆ The potential to capitalize on the vulnerabilities of weaker rivals.
- ◆ Whether the company is able to defend
- ◆ The degrees of risk and uncertainty in the industry's future.
- ◆ The severity of problems confronting the industry as a whole.
- ◆ Whether continued participation in this industry adds importantly to the firm's ability.

2.5.3 Experience Curve

The implication is that larger firms in an industry would tend to have lower unit costs.

Experience curve results from a variety of factors such as learning effects, economies of scale, product redesign and technological improvements in production.

Experience curve has following features:

- ◆ As business organisation grow, they gain experience.
- ◆ Experience may provide an advantage over the competition.
- ◆ Large and successful organisation possess stronger "experience effect".

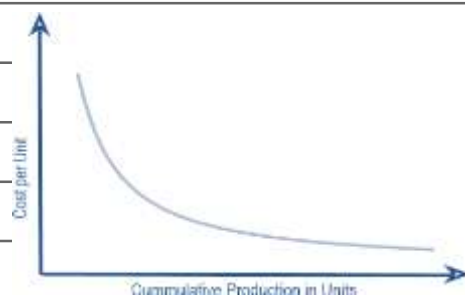


Figure: Experience Curve

2.5.4 Value Creation

Value is measured by a product's features, quality, availability, durability, performance and by its services.

Competitive advantage leads to superior profitability. At the most basic level, how profitable a company becomes depends on three factors:

- (1) the value customers place on the company's products;
- (2) the price that a company charges for its products; and
- (3) the costs of creating those products.

2.6 MARKET AND CUSTOMER

A market is a place for interested parties, buyers and sellers, where items and services can be exchanged for a price. The market might be physical. They may also be virtual. The term market can apply to a wide range of contexts.

The term "marketing" encompasses a wide range of operations, including research, designing, pricing, promotion, transportation, and distribution. Often market activities are categorised and explained in terms of four Ps of marketing - product, place, pricing, and promotion.

There are production-oriented businesses that believe that customers choose low price products. Sales-oriented businesses believe that if they spend enough money on advertisement, sales and promotion, customers can be persuaded to make a purchase.

2.6.1 Customer

The terms customer and consumer are practically synonymous and are frequently used interchangeably. There is, however, a thin distinction. Individuals or businesses that consume or utilise products and services are referred to as consumers. Customers are the purchasers of products and services in the economy.

2.6.2 Customer Analysis

Customer analysis includes the administration of customer surveys, the study of consumer data, the evaluation of market positioning strategies, development of customer profiles, and the selection of the best market segmentation techniques.

2.6.3 Customer Behaviour

Consumer behaviour may be influenced by a number of things. These elements can be categorised into the following three conceptual domains:

- ◆ **External Influences:** External influences, like advertisement, peer recommendations.
- ◆ **Internal Influences:** Internal processes are psychological factors internal to customer.

- ◆ **Decision Making:** After weighing the advantages and disadvantages of each option, they would make a decision. The stages of decision making process can be described as:
 - Problem recognition ➤ Search for desirable alternative and list them
 - Seeking information on available alternatives ➤ Make a final choice
- ◆ **Post-decision Processes:** Evaluating the outcome

2.7 COMPETITIVE STRATEGY

The competitive strategy of a firm within a certain business field is analysed using two criteria: the creation of competitive advantage & the protection of competitive advantage.

2.7.1 Competitive Landscape

Competitive landscape is a business analysis which identifies competitors, either direct or indirect.

Steps to understand the Competitive Landscape

- i. Identify the competitor ii. Understand the competitors
- ii. Determine the strengths of the competitors
- iii. Determine the weaknesses of the competitors v. Put all of the information together

2.7.2 Key factors for competitive success

An industry's Key Success Factors (KSFs) are those things that most affect industry members' ability to prosper in the marketplace.

The answers to three questions help identify an industry's key success factors:

- ◆ On what basis do customers choose between the competing brands of sellers?
- ◆ What resources and competitive capabilities does a seller need to have
- ◆ What does it take for sellers to achieve a sustainable competitive advantage?

Misdiagnosing the industry factors critical to long-term competitive success greatly raises the risk of a misdirected strategy.

Key success factors vary from industry to industry and even from time to time within the same industry as driving forces and competitive conditions change. Only rarely does an industry have more than three or four key success factors at any one time. And even among these three or four, one or two usually outrank the others in importance.

CHAPTER - 3

STRATEGIC ANALYSIS: INTERNAL ENVIRONMENT

3.1 INTRODUCTION

Strategic Analysis is equally important when it comes to internal environment assessment.

3.2 UNDERSTANDING KEY STAKEHOLDERS

Who are Stakeholders and how do we identify them?

A firm may be viewed as a coalition of stakeholders- all those individuals and entities that have a stake in its success and can impact it as well.

Example of Key Stakeholders and their requirements for an OTT Platform

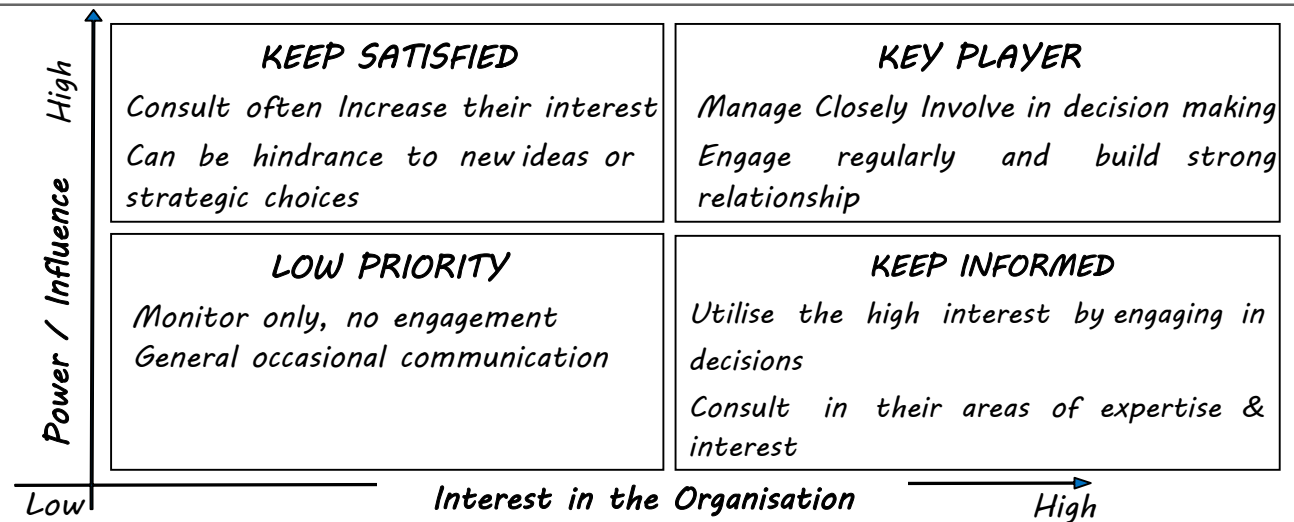
Stakeholders	Requirements
Shareholders	<ul style="list-style-type: none">◆ Innovation and continuous creative content◆ Total shareholder return (RoI)◆ Corporate social responsibility
CEO and Board of Directors	<ul style="list-style-type: none">◆ Prestige◆ Market share◆ Revenue and profit growth
Major Vendors (Production Houses)	<ul style="list-style-type: none">◆ Growth◆ Stability of ordering
Consumers (Viewers)	<ul style="list-style-type: none">◆ New content - Innovation◆ Better deals - Pricing Benefits◆ Value for money
Employees	<ul style="list-style-type: none">◆ Wages and benefits◆ Stability of employment

3.2.1 Mendelow Matrix

The Mendelow Stakeholder matrix (also known as the Stakeholder Analysis matrix and the Power-Interest matrix) is a simple framework to help manage key stakeholders.

Mendelow suggests that one should analyse stakeholder groups based on Power and Interest.

Developing a Grid of Stakeholders



In the above figure, we see categorisation of stakeholders into four groups by Mendelow's;

- ◆ *KEEP SATISFIED* Stakeholders: High power, less interested people
- ◆ *KEY PLAYERS* Stakeholders: High power, highly interested people
- ◆ *LOW PRIORITY* Stakeholders: Low power, less interested people
- ◆ *KEEP INFORMED* Stakeholders: Low power, highly interested people

3.3 STRATEGIC DRIVERS

The key strategic drivers of an organisation include:

- ◆ industry and markets
- ◆ customers
- ◆ products/services
- ◆ channels

3.3.1 Industry and Markets

It is very important for an organisation to understand its relative position in the industry and in the market in which it operates.

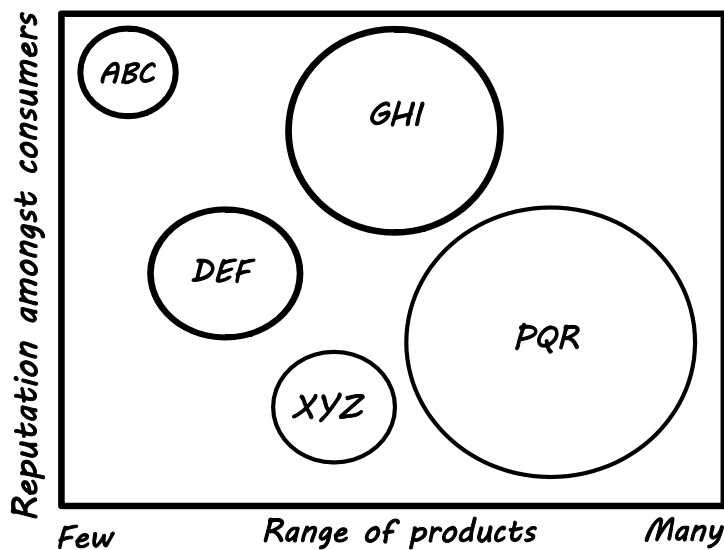
3.3.1.1 Analysing Industry and Markets

Industry and market analysis is extremely important to identify one's position as compared to the competitors, who can be of equal size and value, or bigger in size and value or even smaller and newer. A tool used for this is called - **Strategic Group Mapping**.

The procedure for constructing a strategic group map and deciding which firms belong in which strategic group is straightforward:

- ◆ Identify the competitive characteristics
- ◆ Plot the firms on a two-variable map
- ◆ Assign firms that fall in about the same strategy space.
- ◆ Draw circles around each strategic group making the circles proportional to the size

Strategic Group Mapping



3.3.2 Customers

Different customers may have different needs and require different sales models or distribution channels.

From a pricing perspective - the customer is of more importance and from value creation and design/usability, consumer needs to be kept at the center of decision making.

3.3.3 Products and services

Product stands for the combination of "goods-and-services" that the company offers to the target market.

Products can also be differentiated on the basis of size, shape, colour, packaging, brand names, after-sales service and so on.

For a new product, pricing strategies for entering a market need to be designed and for that matter at least three objectives must be kept in mind:

- ◆ Have customer-centric approach while making a product.
- ◆ Produce sufficient returns through a reasonable margin over cost.
- ◆ Increasing market share.

Products and services need heavy investment in reaching out to customers. A number of marketing strategies.

- | | |
|--------------------------|--------------------------|
| ◆ Social Marketing | ◆ Augmented Marketing |
| ◆ Direct Marketing | ◆ Relationship Marketing |
| ◆ Services Marketing | ◆ Person Marketing |
| ◆ Organization Marketing | ◆ Place Marketing |
| ◆ Enlightened Marketing | ◆ Differential Marketing |
| ◆ Synchro-marketing | ◆ Concentrated Marketing |
| ◆ Demarketing | |

3.3.4 Channels

Channels are the distribution system by which an organisation distributes its product or provides its service.

There are typically three channels that should be considered: sales channel, product channel and service channel.

3.4. ROLE OF RESOURCES AND CAPABILITIES: BUILDING CORE COMPETENCY

Competency is defined as a combination of skills and techniques rather than individual skill or separate technique. For core competencies, it is characteristic to have a combination of skills and techniques, which makes the whole organization utilize these several separate individual capabilities. The optimal way to define core competence is to consider it as sum of 5- 15 areas of developed expertise.

According to C.K. Prahalad and Gary Hamel, major core competencies are identified in three areas -

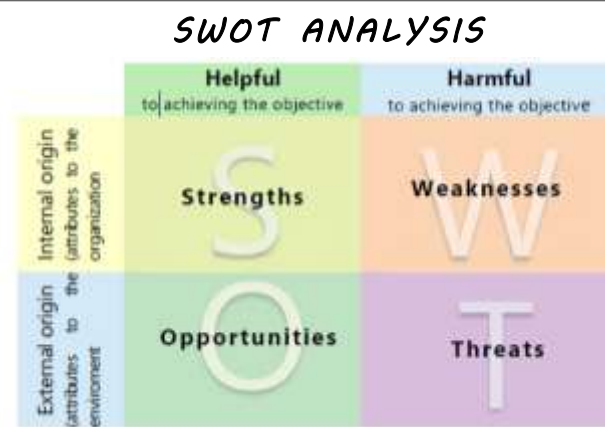
- ◆ competitor differentiation,
- ◆ customer value, and
- ◆ application to other markets

3.4.1 Criteria for building a Core Competencies (CC)?

- i. **Valuable:** That allow the firm to exploit opportunities or avert the threats.
- ii. **Rare:** Very few of the competitors possess this.
- iii. **Costly to imitate:** That competing firms are unable to develop easily.
- iv. **Non-substitutable:** Capabilities that do not have strategic equivalents

3.5 COMBINING EXTERNAL AND INTERNAL ANALYSIS (SWOT ANALYSIS)

SWOT analysis is the analysis of a business's strengths, weaknesses, opportunities and threats.



SWOT Analysis Example

The benefit of this analysis is that it identifies the complex issues for an organisation and puts them into a simple framework. One of the major criticisms of this tool is that it does not generally provide for evaluation of strengths, weaknesses, opportunities and threats in the competitive context.

3.6. COMPETITIVE ADVANTAGE: USING MICHAEL PORTER'S GENERIC STRATEGIES

An organization is said to have competitive advantage if its profitability is higher than the average profitability for all companies in its industry.

"If you don't have a competitive advantage, don't compete" - Jack Welch

3.6.1 Sustainability of Competitive Advantage

The sustainability of competitive advantage and a firm's ability to earn profits from its competitive advantage depends upon four major characteristics of resources and capabilities:

- i. **Durability:** The period over which a competitive advantage is sustained depends in part on the rate at which a firm's resources and capabilities deteriorate.
- ii. **Transferability:** The easier it is to transfer resources and capabilities between companies, the less sustainable will be the competitive advantage.
- iii. **Imitability:** How easily and quickly can the competitors build the resources and capabilities on which a firm's competitive advantage is based?
This is the true test of imitability.
- iv. **Appropriability:** Appropriability refers to the ability of the firm's owners to appropriate the returns on its resource base.

3.6.2 Michael Porter's Generic Strategies

According to Porter, strategies allow organizations to gain competitive advantage from three different bases: cost leadership, differentiation, and focus.

3.6.2.1 Cost Leadership Strategy

It is a low-cost competitive strategy that aims at broad mass market.

A primary reason for pursuing forward, backward, and horizontal integration strategies is to gain cost leadership benefits.

Striving to be a low-cost producer in an industry can especially be effective

- ◆ when the market is composed of many price-sensitive buyers and
- ◆ when there are few ways to achieve product differentiation.

Achieving Cost Leadership Strategy

1. Prompt forecasting of demand of a product or service.
2. Optimum utilization of the resources to achieve cost advantages.
3. Achieving economies of scale; thus, lower per unit cost of product/service.
4. Standardisation of products
5. Invest in cost saving technologies
6. Resistance to differentiation till it becomes essential.

Advantages of Cost Leadership Strategy

1. Rivalry

2. Buyers
3. Suppliers
4. Entrants
5. Substitutes

Disadvantages of Cost Leadership Strategy

1. Cost advantage may not last long as competitors may imitate cost reduction techniques.
2. Cost leadership can succeed only if the firm can achieve higher sales volume.
3. Cost leaders tend to keep their costs low by minimizing cost of advertising, this approach can prove to be expensive in the long run.
4. Technological advancement areas a great threat to cost leaders.

3.6.2.2. Differentiation Strategy

This strategy is aimed at broad mass market and involves the creation of a product or service that is perceived by the customers as unique.

Product development is an example of a strategy that offers the advantages of differentiation.

Differentiation strategy should be pursued only after a careful study of buyers' needs and preferences to determine the feasibility of incorporating one or more differentiating features into a unique product that features the customers' desired attributes.

Basis of Differentiation

- ◆ **Product:** Innovative products that meet customer needs can be an area where a company has an advantage over competitors.
- ◆ **Pricing:** It fluctuates based on its supply and demand and may also be influenced by the customer's ideal value for a product.
- ◆ **Organisation:** Organisational differentiation is yet another form of differentiation. Location advantage, name recognition and customer loyalty.

Achieving Differentiation Strategy

1. Offer utility to the customers and match products with their tastes and preferences.

2. Elevate/Improve performance of the product.
3. Offer the high-quality product/service for buyer satisfaction.
4. Rapid product innovation to keep up with dynamic environment.
5. Taking steps for enhancing brand image and brand value.
6. Fixing product prices based on the unique features.

Advantages of Differentiation Strategy

1. Rivalry
2. Buyers
3. Suppliers
4. Entrants
5. Substitutes

Disadvantages of Differentiation Strategy

1. In the long term, uniqueness is difficult to sustain.
2. Charging too high a price for differentiated features may cause the customer to switch-off to another alternative.
3. Differentiation fails to work if its basis is something that is not valued.

3.6.2.3. Focus Strategies

A successful focus strategy depends on an industry segment that is of sufficient size, has good growth potential, and is not crucial to the success of other major competitors. Strategies such as market penetration and market development offer substantial focusing advantages.

Focus strategies are most effective when consumers have distinctive preferences or requirements, and when the rival firms are not attempting to specialize in the same target segment. An organization using a focus strategy may concentrate on a particular group of customers, geographic markets, or on particular product-line segments in order to serve a well-defined but narrow market better than competitors who serve a broader market.

Focused cost leadership: A focused cost leadership strategy requires competing based on price to target a narrow market. Instead, it charges low prices relative to other firms that compete within the target market.

Focused differentiation: A focused differentiation strategy requires offering unique features that fulfil the demands of a narrow market. Some firms using a focused differentiation strategy concentrate their efforts on a particular sales channel.

Achieving Focused Strategy

1. Selecting specific niches which are not covered by cost leaders and differentiators.
2. Creating superior skills for catering such niche markets.
3. Generating high efficiencies for serving such niche markets.
4. Developing innovative ways in managing the value chain.

Advantages of Focused Strategy

1. Premium prices can be charged by the organisations for their focused product/services.
2. Rivals and new entrants may find it difficult to compete.

Disadvantages of Focused Strategy

1. The firms lacking in distinctive competencies may not be able to pursue focus strategy.
2. Due to the limited demand of product/services, costs are high, which can cause problems.
3. In the long run, the niche could disappear.

3.6.2.4. Best-Cost Provider Strategy

Best-cost provider strategy involves providing customers more value for the money by emphasizing on lower cost and better-quality differences. It can be done through:

- (a) offering products at lower price than what is being offered by rivals for products with comparable quality and features
- Or
- (b) charging similar price as by the rivals for products with much higher quality and better features.

CHAPTER - 4

STRATEGIC CHOICE

4.1 INTRODUCTION

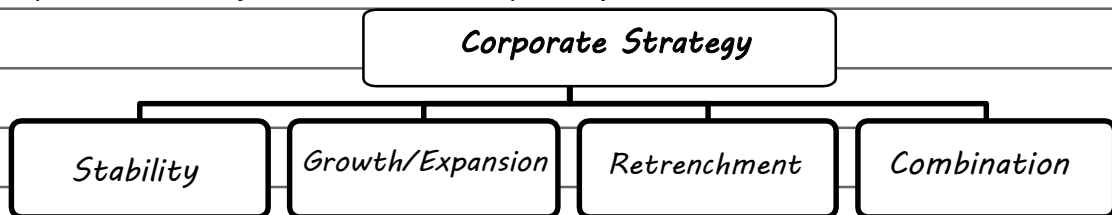
Strategies are formulated at different levels of an organization.

4.2 STRATEGIC CHOICES

Different types of strategies on the basis of their classification

<i>Basis of Classification</i>	<i>Types</i>
<i>Level of the organisation</i>	<i>Corporate Level</i> <i>Business Level</i> <i>Functional Level</i>
<i>Stages of Business Life Cycle</i>	<i>Entry/Introduction Stage - Market Penetration Strategy</i> <i>Growth Stage - Growth/Expansion Strategy</i> <i>Maturity Stage - Stability Strategy</i> <i>Decline Stage - Retrenchment/ Turnaround Strategy</i>
<i>Competition oriented</i>	<i>Competitive Strategies - Cost Leadership, Differentiation, Focus</i> <i>Collaboration Strategies - Joint Venture, Merger & Acquisition, Strategic Alliance</i>

The corporate strategies a firm can adopt may be classified into four broad categories:



4.2.1 Stability Strategy

A stability strategy is pursued by a firm when:

- ◆ *It continues to serve in the same or similar markets and deals in same or similar products and services.*

- ◆ *This strategy is typical for those firms whose product have reached the maturity stage of product life cycle or those who have a sufficient market share but need to retain that. They have to remain updated and have to pace with the dynamic and volatile business world to preserve their market share. Hence, stability strategy should not be confused with 'do nothing' strategy. Small organizations may also follow stability strategy to consolidate their market position and prepare for the launch of growth strategies.*

4.2.1.1. Characteristics of Stability Strategy

- ◆ *Same business, same product-market posture and functions.*
- ◆ *Enhance functional efficiencies.*
- ◆ *Does not involve a redefinition of the business.*
- ◆ *It is a safe strategy.*
- ◆ *It does not warrant much of fresh investments.*
- ◆ *The risk involved in this strategy is less.*
- ◆ *The organization can concentrate on its resources and existing businesses/products.*
- ◆ *Modest growth objective.*

4.2.1.2 Major Reasons for Stability Strategy

- ◆ *A product has reached the maturity stage.*
- ◆ *The staff feels comfortable.*
- ◆ *Environment in which an organisation is operating is relatively stable.*
- ◆ *Not advisable to expand as it may be perceived as threatening.*
- ◆ *After rapid expansion, a firm might want to stabilize and consolidate itself.*

4.2.2 Growth/Expansion Strategy

Growth/Expansion strategy is implemented by redefining the business by enlarging the scope of business and substantially increasing investment in the business.

4.2.2.1 Characteristics of Growth/Expansion Strategy

- ◆ *Involves a redefinition of the business.*

	<ul style="list-style-type: none"> ◆ <i>Opposite of stability strategy.</i> ◆ <i>Leads to business growth. Mammoth growth ambition.</i> ◆ <i>Fresh investments and new businesses/products/markets.</i> ◆ <i>Highly versatile strategy.</i> ◆ <i>Two major strategy routes: Intensification Diversification.</i>
4.2.2.2	<i>Major Reasons for Growth/Expansion Strategy</i>
	<ul style="list-style-type: none"> ◆ <i>When environment demands increase in pace of activity.</i> ◆ <i>Strategists may feel more satisfied.</i> ◆ <i>Expansion may lead to greater control over the market.</i> ◆ <i>Experience curve and scale of operations may accrue.</i> ◆ <i>Expansion also includes intensifying, diversifying, acquiring and merging businesses.</i>
4.2.2.3	<i>Types of Growth/ Expansion Strategy</i>
	<i>The growth strategies can be classified into two main types:</i>
A.	<i>Internal growth strategies</i>
I.	<i>Expansion through Intensification</i>
II.	<i>Expansion through Diversification</i>
I	<i>Expansion or growth through Intensification</i>
(i)	<i>Market Penetration: The firm directs its resources to the profitable growth of its existing product in the existing market.</i>
(ii)	<i>Market Development: It consists of marketing present products, to customers in related market areas.</i>
(iii)	<i>Product Development: Product development involves substantial modification of existing products or creation of new but related items that can be marketed to current customers.</i>
II	<i>Expansion or Growth through Diversification</i>
	<i>Based on the nature and extent of their relationship to existing businesses, diversification can be classified into two broad categories:</i>
(i)	<i>Concentric Diversification: Concentric diversification takes place when the products are</i>

related. It diversifies into is linked to the existing businesses through process, technology or marketing. The new product is a spin-off from the existing facilities and products/processes.

Concentric diversification is generally understood in two directions, vertical and horizontal integration;

(a) Vertically Integrated Diversification: The firm remains vertically within the same process sequence moves forward or backward in the chain and enters specific product/process steps with the intention of making them into new businesses for the firm.

Forward and Backward Integration:

Backward integration is concerned with creation of effective supply by entering business of input providers.

On the other hand, forward integration is moving forward in the value chain and entering business lines that use existing products.

(b) Horizontal Integrated Diversification: A firm gets horizontally diversified by integrating through acquisition of one or more similar businesses operating at the same stage of the production-marketing chain.

(ii) Conglomerate Diversification: In conglomerate diversification, no linkages related to product, market or technology exist; the new businesses/products are disjointed from the existing businesses/products in every way; it is a totally unrelated diversification.

(iii) Innovation: Innovation drives upgradation of existing product lines or processes, leading to increased market share, revenues, profitability and most important, customer satisfaction. Innovation offers the following;

◆ **Helps to solve complex problems:** A business strives to find opportunities in existing problems of the society, and it does so through planned innovation in areas of expertise.

◆ **Increases Productivity:** Innovation leads to simplification and in most cases automation of existing tasks.

◆ **Gives Competitive Advantage:** The faster a business innovates, the farther it goes from its competitor's reach.

B. External Growth Strategies

I. Expansion through Mergers and Acquisitions

Merger is a process when two or more companies come together to expand their business operations.

When one organization takes over the other organization and controls all its business operations, it is known as acquisition.

Types of Mergers

- (a) Horizontal Merger
- (b) Vertical Merger
- (c) Co-generic Merger
- (d) Conglomerate Merger

II. Expansion through Strategic Alliance

The strategic partners maintain their status as independent and separate entities, share the benefits and control over the partnership, and continue to make contributions to the alliance until it is terminated.

Advantages of Strategic Alliance

- 1. **Organizational:** Strategic partners may also help to enhance productive capacity, provide a distribution system, or extend supply chain.
- 2. **Economic:** There can be reduction in costs and risks by distributing them across the members of the alliance.
- 3. **Strategic:** Rivals can join together to cooperate instead of competing with each other.
- 4. **Political:** To gain entry into a foreign market either because of local prejudices or legal barriers to entry.

Disadvantages of Strategic Alliance

The major disadvantage is **sharing**. Strategic alliances require sharing of resources and profits. Strategic alliances may also create potential competition when an ally becomes an opponent in future when it decides to separate out.

4.3 STRATEGIC EXITS

Strategic Exits are followed when an organization substantially reduces the scope of its activity.

1. Turnaround Strategy

For internal retrenchment to take place, emphasis is laid on improving internal efficiency, known as turnaround strategy.

These danger signals are:

- ◆ Persistent negative cash flow from business
- ◆ Uncompetitive products or services
- ◆ Declining market share
- ◆ Deterioration in physical facilities
- ◆ Over-staffing, high turnover of employees, and low morale
- ◆ Mismanagement

Action Plan for Turnaround

- ◆ **Stage One - Assessment of current problems:** The first step is to assess the current problems and get to the root causes and the extent of damage the problem has caused.
- ◆ **Stage Two -Analyze the situation and develop a strategic plan:** Determine the chances of the business's survival. Identify appropriate strategies and develop a preliminary action plan.
- ◆ **Stage Three -Implementing an emergency action plan:** An appropriate action plan must be developed to stop the bleeding and enable the organization to survive.
- ◆ **Stage Four -Restructuring the business:**
During the turnaround, the "product mix" may be changed, requiring the organization to do some repositioning.
- ◆ **Stage Five -Returning to normal:** The organization should begin to show signs of profitability, return on investments and enhancing economic value-added.

The important elements of turnaround strategy are as follows:

- ◆ Changes in the top management
- ◆ Initial credibility-building actions
- ◆ Neutralising external pressures
- ◆ Identifying quick payoff activities

- ◆ Quick cost reductions
- ◆ Revenue generation
- ◆ Asset liquidation for generating cash
- ◆ Better internal coordination

II. Divestment Strategy

Divestment strategy involves the sale or liquidation of a portion of business, or a major division, profit centre or SBU.

A divestment strategy may be adopted due to various reasons:

- ◆ A business that had been acquired proves to be a mismatch
- ◆ Persistent negative cash flows
- ◆ Severity of competition
- ◆ It is not possible for the business to do Technological up gradation
- ◆ A better alternative may be available for investment

Characteristics of Divestment Strategy

- ◆ This strategy involves divestment of some of the activities in a given business of the firm or sell-out of some of the businesses as such.
- ◆ Divestment is to be viewed as an integral part of corporate strategy

Major Reasons for Retrenchment/Turnaround Strategy

- ◆ The management no longer wishes to remain in business.
- ◆ Liquidation of unprofitable activities.
- ◆ A business that had been acquired proves to be a mismatch
- ◆ Persistent negative cash flows
- ◆ Severity of competition
- ◆ Technological upgradation is required
- ◆ A better alternative

4.4 STRATEGIC OPTIONS

4.4.1 Ansoff's Product Market Growth Matrix

The Ansoff's product market growth matrix (proposed by Igor Ansoff) is a useful tool that helps businesses decide their product and market growth strategy.

	<i>Existing Products</i>	<i>New Products</i>
<i>Existing Markets</i>	<i>Market Penetration</i>	<i>Product Development</i>
<i>New Markets</i>	<i>Market Development</i>	<i>Diversification</i>

4.4.2 ADL matrix

The ADL matrix (derived its name from Arthur D. Little) is a portfolio analysis technique that is based on product life cycle.

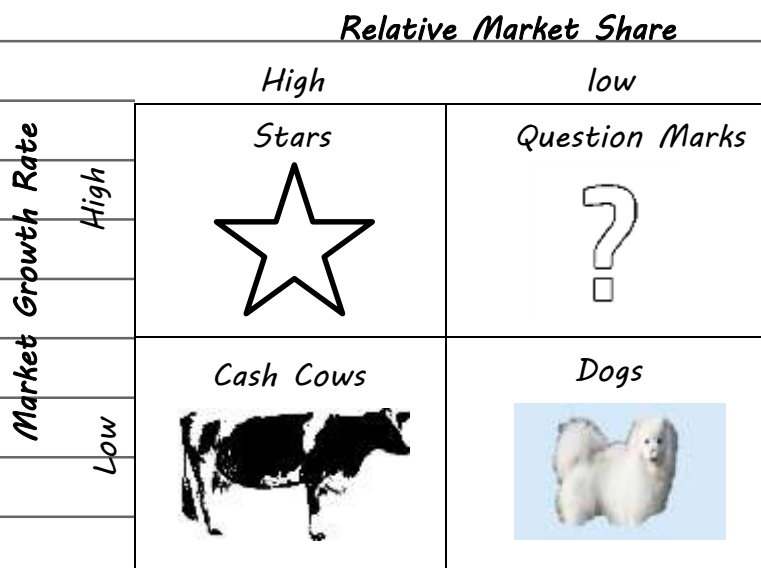
<i>Stage of industry maturity - Arthur D. Little (ADL) Matrix</i>				
<i>Competitive position</i>	<i>Embryonic</i>	<i>Growth</i>	<i>Mature</i>	<i>Ageing</i>
<i>Dominant</i>	<ul style="list-style-type: none"> - Fast grow - Build barriers - Act offensively 	<ul style="list-style-type: none"> - Fast grow - Attend cost leadership - Renew - Defend position - Act offensively 	<ul style="list-style-type: none"> - Defend position - Attend cost leadership - Renew - Fast grow - Act offensively 	<ul style="list-style-type: none"> - Defend position - Renew - Focus - Consider withdrawal
<i>Strong</i>	<ul style="list-style-type: none"> - Differentiate - Fast grow 	<ul style="list-style-type: none"> - Differentiate - Lower cost - Attack small firms 	<ul style="list-style-type: none"> - Lower cost - Focus - Differentiate - Grow with industry 	<ul style="list-style-type: none"> - Find niche - Hold niche - Harvest
<i>Favorable</i>	<ul style="list-style-type: none"> - Differentiate - Focus - Fast grow 	<ul style="list-style-type: none"> - Focus - Differentiate - Defend 	<ul style="list-style-type: none"> - Focus - Differentiate - Harvest - Find niche - Hold niche - Turnaround - Grow with industry - Hit smaller firms 	<ul style="list-style-type: none"> - Harvest - Turnaround

Tenable	- Grow with industry - Focus	- Hold niche - Turnaround - Focus - Grow with industry - Withdraw	- Turnaround - Hold niche - Retrench	- Divest - Retrench
Weak	- Find niche - Catch-up - Grow with industry	- Turnaround - Retrench - Niche or withdraw	- Withdraw - Divest	- Withdraw

4.4.3 Boston Consulting Group (BCG) Growth Share Matrix

Growth share matrix also known for its cow and dog metaphors is popularly used for resource allocation in a diversified company. In the matrix:

- ◆ The vertical axis represents market growth rate
- ◆ The horizontal axis represents relative market share



4.4.3.1 BCG Matrix: Post Identification Strategies

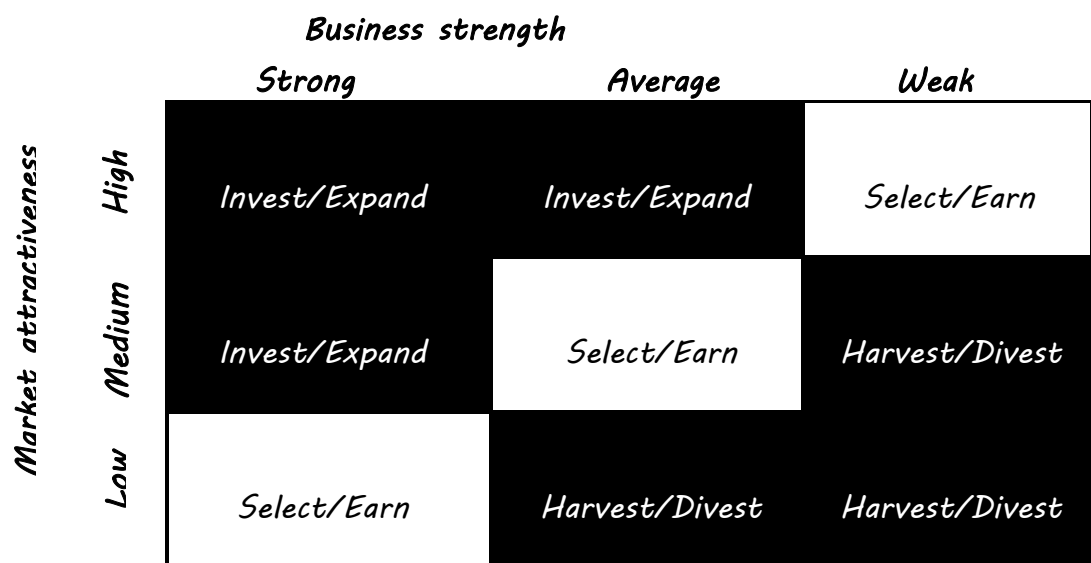
1. **Build:** Building a strong future with large market share.
2. **Hold:** Preserve market share.
3. **Harvest:** Increase short-term cash flow
4. **Divest:** Sell or liquidate the business

Is BCG Matrix really helpful?

BCG matrix can be difficult, time-consuming, and costly to implement. Management may find it difficult to define SBUs provide little advice for future planning. Placing too much emphasis on market-share growth or growth through entry into attractive new markets.

4.4.4 General Electric Matrix [“Stop-Light” Strategy Model]

This model has been used by General Electric Company (developed by GE with the assistance of the consulting firm McKinsey and Company). This model is also known as Business Planning Matrix, GE Nine-Cell Matrix and GE Model. The strategic planning approach in this model has been inspired from traffic control lights. The lights that are used at crossings to manage traffic are: green for go, amber or yellow for caution, and red for stop. This model uses two factors while taking strategic decisions: Business Strength and Market Attractiveness.



If a product falls in the green section, the business is at advantageous position. To reap the benefits, the strategic decision can be to expand, to invest and grow. If a product is in the amber or yellow zone, it needs caution and managerial discretion is called for making the strategic choices. If a product is in the red zone, it will eventually lead to losses that would make things difficult for organisations.

CHAPTER - 5

STRATEGY IMPLEMENTATION AND EVALUATION

5.1 INTRODUCTION

Strategy implementation and evaluation are critical phases of the process of strategic management in an organization.

5.2 STRATEGIC MANAGEMENT PROCESS

The strategic management process is dynamic and continuous. A change in any one of the major components in the model can necessitate a change in any or all of the other components.

Therefore, strategy formulation, implementation, and evaluation activities should be performed on a continual basis, not just at the end of the year or semi-annually. The strategic management process never really ends.

5.2.1 Stages in Strategic Management

Strategic management involves the following stages:

1. Developing a strategic vision and formulation of statement of mission, goals and objectives.
2. Environmental and organisational analysis.
3. Formulation of strategy.
4. Implementation of strategy.
5. Strategic evaluation and control

In most situations, strategy-execution process includes the following principal aspects:

- ◆ Developing budgets that steer ample resources into those activities.
- ◆ Staffing the organisation
- ◆ Ensuring that policies and operating procedures facilitate.
- ◆ Using the best-known practices to perform core business.
- ◆ Installing information and operating systems.

- ◆ *Motivating people to pursue the target objectives energetically.*
- ◆ *Creating a company culture and work climate conducive.*
- ◆ *Exerting the internal leadership.*

◆ **Corporate Strategy**

1. **Strategic planning**

Characteristics of Strategic planning

- ◆ *Shapes the organisation and its resources.*
- ◆ *Assesses the impact of environmental variables.*
- ◆ *Takes a holistic view of the organisation.*
- ◆ *Develops overall objectives and strategies.*
- ◆ *Is concerned with the long-term success of the organisation.*
- ◆ *Is a senior management responsibility.*

2. **Operational planning**

Characteristics of Operational planning

- ◆ *Deals with current deployment of resources.*
- ◆ *Develops tactics rather than strategy.*
- ◆ *Projects current operations into the future.*
- ◆ *Makes modifications to the business functions but not fundamental changes.*
- ◆ *Is the responsibility of functional managers*

Strategic Planning: *The game plan that really directs the company towards success is called "corporate strategy". The formation of corporate strategy is the result of a process known as strategic planning.*

- ◆ *Strategic planning is the process of determining the objectives of the firm, resources required to attain these objectives and formulation of policies to govern the acquisition, use and disposition of resources.*

Strategic uncertainty and how to deal with it?

Dealing with strategic uncertainty can be challenging and organizations need to have the flexibility, resilience, and agility to quickly respond to changes in the environment

and minimize its impact. To be manageable, they need to be grouped into logical clusters or themes.

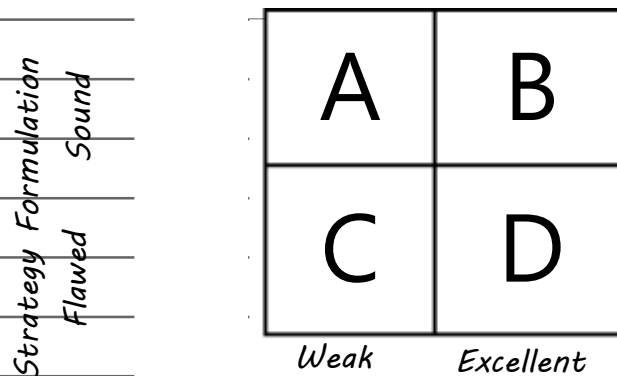
- ◆ Flexibility
- ◆ Diversification
- ◆ Monitoring and Scenario Planning
- ◆ Building Resilience
- ◆ Collaboration and Partnerships

Impact of uncertainty: Each element of strategic uncertainty involves potential trends or events that could have an impact on present, proposed, and even potential businesses.

5.2.3 Strategy Implementation

Strategy implementation concerns the managerial exercise of putting a freshly chosen strategy into action.

- ◆ Relationship with strategy formulation



Square A is the situation where a company apparently has formulated a very competitive strategy but is showing difficulties in implementing it successfully. In such a situation the company will aim at moving from square A to square B, given they realize their implementation difficulties. Square B is the ideal situation

When a company finds itself in square D the first thing, they have to do is to redesign their strategy before readjusting their implementation/execution skills.

Square C path to success also goes through business model redesign and implementation/execution readjustment.

		<i>Strategic Formulation</i>	
		<i>Effective</i>	<i>Ineffective</i>
<i>Operational Management</i>	<i>Efficient</i>	1 <i>Thrive</i>	2 <i>Die Slowly</i>
	<i>Inefficient</i>	3 <i>Survive</i>	4 <i>Die Quickly</i>

Figure: Principal combinations of efficiency and effectiveness

5.2.4 *Difference between Strategy formulation and Implementation*

Strategy Formulation Vs. Strategy Implementation

<i>Strategy Formulation</i>	<i>Strategy Implementation</i>
<i>Includes planning and decision-making</i>	<i>Involves all those means related to executing the strategic plans.</i>
<i>Placing the Forces before the action.</i>	<i>Managing forces during the action.</i>
<i>Entrepreneurial Activity</i>	<i>Administrative Task</i>
<i>Effectiveness</i>	<i>Efficiency</i>
<i>Intellectual and rational process.</i>	<i>Operational process.</i>
<i>Initiative, logical skills, conceptual intuitive and analytical skills.</i>	<i>Motivational and leadership traits.</i>
<i>Strategic Formulation precedes Strategy Implementation.</i>	<i>Strategy Implementation follows Strategy Formulation.</i>

5.2.5 *Linkages and Issues in Strategy Implementation*

- ◆ *Forward Linkages: With the formulation of new strategies, or reformulation of existing strategies, many changes have to be affected within the organization.*
- ◆ *Backward Linkages: Organizations tend to adopt those strategies which can be implemented with the help of the present structure of resources combined with some additional efforts.*

Issues in Strategy Implementation

- ◆ *Strategies, by themselves, do not lead to action.*

- ◆ Strategies should lead to formulation of different kinds of programmes.
- ◆ Programmes lead to the formulation of projects. A project is a highly specific programme for which the time schedule and costs are predetermined.

Given below in sequential manner the issues in strategy implementation which are to be considered:

- | | |
|-----------------------------|------------------------------|
| ◆ Project implementation | ◆ Procedural implementation |
| ◆ Resource allocation | ◆ Structural implementation |
| ◆ Functional implementation | ◆ Behavioural implementation |

5.3 STRATEGIC CHANGE THROUGH DIGITAL TRANSFORMATION

5.3.1 Strategic Change

Steps to initiate strategic change: For initiating strategic change, three steps can be identified as under:

- (i) Recognize the need for change
- (ii) Create a shared vision to manage change
- (iii) Institutionalise the change

Kurt Lewin's Model of Change: To make the change lasting, Kurt Lewin proposed three phases of the change process for moving the organization from the present to the future. These stages are unfreezing, changing and refreezing.

- (a) Unfreezing the situation
- (b) Changing to the new situation: H.C. Kellman has proposed three methods for reassigning new patterns of behaviour. These are compliance, identification and internalization.
 - Compliance
 - Identification
 - Internalization
- (c) Refreezing

5.3.2 How does digital transformation work?

The use of digital technologies to develop fresh, improved, or entirely new company procedures, goods, or services is known as "digital transformation."

Change management in the digital transition consists of four essential elements:

1. Defining the goals and objectives of the transformation

2. *Assessing the current state of the organization and identifying gaps*
3. *Creating a roadmap for change*
4. *Implementing and managing the change at every level of the organization*

How does change management work?

Change management is a process or set of tools and best practices used to manage changes in an organization.

The role of change management in digital transformation

A good change management strategy is necessary for a successful digital transformation.

A properly implemented change management strategy can help an organization to:

- ◆ *Specify the parameters and goals of the digital transformation*
- ◆ *Determine which procedures and tools need to be modified.*
- ◆ *Make a plan for implementing the improvements.*
- ◆ *Involve staff members and parties involved in the transformation process.*
- ◆ *Track progress and make required course corrections*

5.3.3 Change Management Strategies for Digital Transformation

The five best practices for managing change in small and medium-sized businesses are:

1. ***Begin at the top***
2. ***Ensure that the change is both necessary and desired***
3. ***Reduce disruption: It is possible to reduce workplace disruption by:***
 - a. *Getting the word out early and preparing for some interruption.*
 - b. *Giving staff members the knowledge and tools, they need to adjust to change.*
 - c. *Creating an environment that encourages transformation or change.*
 - d. *Empowering change agents*
 - e. *Ensuring that IT department is informed of changes*
4. ***Encourage communication***
5. ***Recognize that change is the norm, not the exception***

5.3.4 How to manage change during digital transformation?

1. ***Specify the digital transformation's aims and objectives***

2. Always, always, always communicate

3. Be ready for resistance

4. Implement changes gradually

5. Offer assistance and training

5.4 ORGANISATIONAL FRAMEWORK

The McKinsey 7S Model refers to a tool that analyzes a company's "organizational design." The McKinsey 7s Model focuses on how the "Soft Ss" and "Hard Ss" elements are interrelated, suggesting that modifying one aspect might have a ripple effect on the other elements in order to maintain an effective balance.

The Hard elements are directly controlled by the management. The following elements are the hard elements in an organization.

- ◆ Strategy
- ◆ Structure
- ◆ Systems

The Soft elements are difficult to define as they are more governed by the culture. The following are the soft elements in this model;

- ◆ Shared Values
- ◆ Style
- ◆ Staff
- ◆ Skills

But like any other strategic model, this model has its limitations as well;

- ◆ It ignores the importance of the external environment
- ◆ The model does not clearly explain the concept of organizational effectiveness.
- ◆ The model is considered to be more static and less flexible for decision making.
- ◆ It is generally criticized for missing out the real gaps

5.4.1 Organizational structure

According to Chandler, changes in strategy lead to changes in organizational structure.

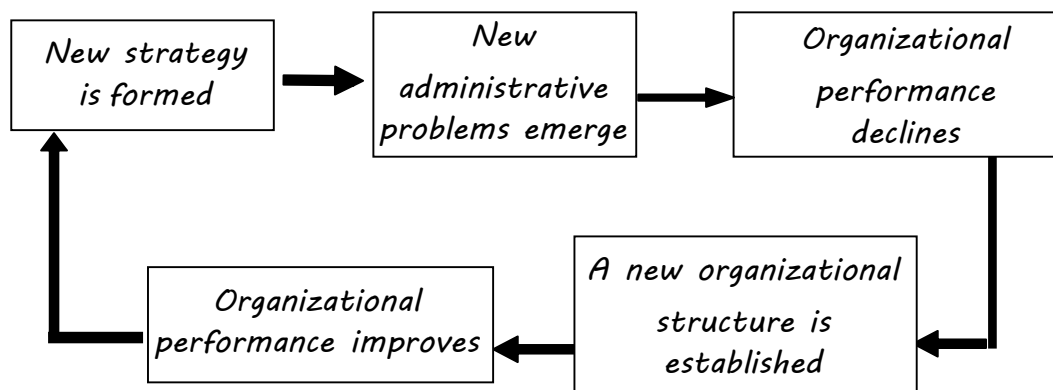


Figure: Chandler's Strategy-Structure Relationship

Types of Organization Structure

A Simple Structure

Simple organizational structure is most appropriate for companies that follow a single-business strategy and offer a line of products in a single geographic market. The simple structure also is appropriate for companies implementing focused cost leadership or focused differentiation strategies. A simple structure is an organizational form in which the owner-manager makes all major decisions directly and monitors all activities, while the company's staff merely serves as an executor.

Little specialization of tasks, few rules, little formalization, unsophisticated information systems and direct involvement of owner-manager in all phases of day-to-day operations.

A simple organizational structure may result in competitive advantages for some small companies. These potential competitive advantages include a broad-based openness to innovation, greater structural flexibility, and an ability to respond more rapidly to environmental changes.

B. Functional Structure

A widely used structure in business organisations is functional type because of its simplicity and low cost. A functional structure groups tasks and activities by business function, such as production/operations, marketing, finance/accounting, research and development, and management information systems. Besides being simple and inexpensive, a functional structure also promotes specialization of labour, encourages efficiency, minimizes the need for an elaborate control system, and allows rapid decision making.

Differences in functional specialization and orientation may impede communications and coordination. Functional specialists often may develop a myopic (or narrow) perspective.

C. Divisional Structure

As a firm, grows year after year it faces difficulty in managing different products and services in different markets. The divisional structure can be organized in one of the

four ways: by geographic area, by product or service, by customer, or by process.

A divisional structure has some clear advantages. Accountability is clear extensive delegation of authority, employees can easily see the results.

Employee morale is generally higher career development opportunities.

The divisional design is not without some limitations. Costly division requires functional specialists duplication of staff services, managers must be well qualified can also be costly.

D. Multi Divisional Structure

Multidivisional (M-form) structure is composed of operating divisions where each division represents a separate business to which the top corporate officer delegates responsibility for day-to-day operations and business unit strategy to division managers.

Multidivisional or M-form structure was developed in the 1920s, in response to coordination- and control-related problems in large firms.

Multidivisional structure calls for:

- ◆ Creating separate divisions, each representing a distinct business
- ◆ Each division would house its functional hierarchy;
- ◆ Division managers would be given responsibility for managing day-to-day operations;
- ◆ A small corporate office that would determine the long-term strategic direction.

E. Strategic Business Unit (SBU) Structure

An SBU is a grouping of related businesses, which is amenable to composite planning treatment.

The three most important characteristics of a SBU are:

- ◆ It is a single business or a collection of related businesses
- ◆ It has its own set of competitors.
- ◆ It has a manager who has responsibility for strategic planning and profit performance.

Historically, large, multi-business firms were handling business planning on a territorial basis since their structure was territorial. And in many cases, such a structure was the outcome of a manufacturing or distribution logistics. Often, the territorial structure did not suit the purpose of strategic planning.

The concept of strategic business units (SBU) breaks away from this practice.

The endeavour should be to group the businesses into an appropriate number of strategic business units before the firm takes up the strategy formulation task.

The principle underlying the grouping is that all related products-related from the standpoint of "function"-should fall under one SBU.

The attributes of an SBU and the benefits a firm may derive by using the SBU Structure are as follows:

- ◆ A scientific method of grouping the businesses.
- ◆ An improvement over the territorial grouping of businesses.
- ◆ Taken up for strategic planning distinct from the rest of the businesses.
- ◆ Regrouping them into a few, well defined, distinct, scientifically demarcated business units.
- ◆ Unrelated products/businesses in any group are separated.
- ◆ Grouping the businesses on SBU lines helps the firm in strategic planning.
- ◆ Each SBU is a separate business from the strategic planning standpoint.
- ◆ Each SBU will have its own distinct set of competitors.
- ◆ Each SBU will have a CEO.

This issue of relatedness in turn has direct implications on decisions about diversification relatedness might exist in different ways:

- ◆ SBUs might build on similar technologies
- ◆ SBUs might be serving similar or different markets.
- ◆ Or it may be that other competences on which the competitive advantage.

F. Matrix Structure

Employees have two superiors, a product or project manager and a functional manager.

The "home" department - that is, engineering, manufacturing, or marketing - is usually functional and is reasonably permanent. People from these functional units are often assigned temporarily to one or more product units or projects. The product units or projects are usually temporary and act like divisions in that they are differentiated on a product-market basis.

A matrix structure is the most complex of all designs. A matrix structure can result in higher overhead. Other characteristics of a matrix structure contribute to overall complexity include dual lines of budget authority dual sources of reward and punishment, shared authority, dual reporting channels, and a need for an extensive and effective communication system.

Some advantages of a matrix project objectives are clear, workers can see the visible results of their work, and shutting down a project is accomplished relatively easily.

Matrix structure was developed to combine the stability of the functional structure with the flexibility of the product form.

The matrix structure is often found in an organization or within an SBU when the following three conditions exist: 1) Ideas need to be cross-fertilised 2) Resources are scarce 3) Abilities to process information.

For development of matrix structure Davis and Lawrence, have proposed three distinct phases:

1. **Cross-functional task forces:** Temporary cross-functional task forces.
2. **Product/brand management:** If the cross-functional task forces become more permanent.
3. **Mature matrix:** The third and final phase of matrix development involves a true dual-authority structure.

6. Network Structure

A radical organizational design, the network structure is an example of what could be termed a "non-structure" by its virtual elimination of in-house business functions.

Many activities are outsourced. A corporation organized in this manner is often called a virtual organization because it is composed of a series of project groups or collaborations linked by constantly changing non-hierarchical, cobweb-like networks. Electronic markets and sophisticated information systems reduce the transaction costs of the marketplace, thus justifying a "buy" over a "make" decision.

The network organization structure provides an organization with increased flexibility

and adaptability to cope with rapid technological change. It allows a company to concentrate on its distinctive competencies. The network does, however, have disadvantages. The availability of numerous potential partners can be a source of trouble. It runs the risk of choosing the wrong functions.

Employees may lack the level of confidence necessary to participate actively in organization-sponsored learning experiences.

H. Hourglass Structure

The role played by middle management is diminishing. Hourglass organization structure consists of three layers with constricted middle layer. The structure has a short and narrow middle-management level.

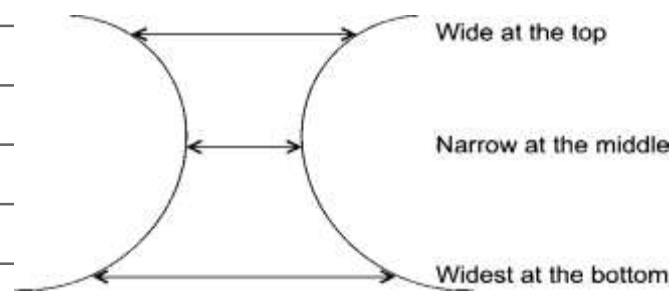


Figure: Hourglass Organisation Structure

Hourglass structure has obvious benefit of reduced costs. It also helps in enhancing responsiveness by simplifying decision making. However, with the reduced size of middle management the promotion opportunities for the lower levels diminish significantly. Continuity at same level may bring monotony and lack of interest.

5.4.2 Organisation Culture

Where Does Corporate Culture Come From?

A company's culture is manifested in the values and business principles that management preaches and practices.

Culture: ally or obstacle to strategy execution?

The beliefs, vision, objectives, and business approaches and practices underpinning a company's strategy may or may not be compatible with its culture.

Role of culture in strategy execution

Strong culture promotes good strategy execution when there's fit and impedes execution when there's negligible fit.

Strategy- supportive cultures shape the mood, temperament, and motivation the workforce, positively affecting organizational energy, work habits and operating practices, the degree to which organizational units cooperate, and how customers are treated.

Perils of Strategy-Culture Conflict: While correcting a strategy- culture conflict can occasionally mean revamping strategy to produce cultural fit, more usually it means revamping the mismatched cultural features to produce strategy fit.

Creating a strong fit between strategy and culture: It is the strategy maker's responsibility to select a strategy compatible with the "sacred" or unchangeable parts of prevailing corporate culture. It is the strategy implementer's task, once strategy is chosen, to change whatever facets of the corporate culture hinder effective execution.

Changing a problem culture

The first step is to diagnose which facets of the present culture are strategy supportive and which are not. Then, managers have to talk openly and forthrightly to all concerned about those aspects of the culture that have to be changed.

The talk has to be followed swiftly by visible, aggressive actions to modify the culture- actions that everyone will understand are intended to establish a new culture more in tune with the strategy.

The task of making culture supportive of strategy is not a short-term exercise.

In conclusion, an excessive focus on the hard management, at best will result in a linear improvement in performance. On the other hand, performance can be improved exponentially by concentrating on the soft side of the management.

5.5 STRATEGIC LEADERSHIP

A strategic leader is a change agent to initiates strategic changes in the organisations and ensure that the changes successfully implemented. Managers have five leadership roles to play in pushing for good strategy execution:

1. *Staying on top of what is happening*
2. *Promoting a culture of esprit de corps*
3. *Keeping the organization responsive to changing conditions*
4. *Exercising ethical leadership*
5. *Pushing corrective actions to improve strategy execution*

A Strategic leader has several responsibilities, including the following:

- ◆ *Making strategic decisions.*
- ◆ *Formulating policies and action plans to implement strategic decision.*
- ◆ *Ensuring effective communication in the organisation.*
- ◆ *Managing human capital*
- ◆ *Managing change in the organisation.*
- ◆ *Creating and sustaining strong corporate culture.*
- ◆ *Sustaining high performance over time.*

Two basic approaches to leadership can be transformational leadership style and transactional leadership style.

- ◆ *Transformational leadership style uses charisma and enthusiasm to inspire people to exert them for the good of the organization. Such a leadership motivates followers to do more than originally affected to do by stretching their abilities.*
- ◆ *Transactional leadership style focuses more on designing systems and controlling the organization's activities and are more likely to be associated with improving the current situation.*
They prefer a more formalized approach to motivation, setting clear goals with explicit rewards or penalties for achievement or non-achievement.

5.6 STRATEGIC CONTROL

The controlling function involves monitoring the activity and measuring results against pre-established standards, analysing and correcting deviations as necessary.

The process of control has the following elements:

- (a) *Objectives of the business system*
- (b) *A mechanism for monitoring and measuring the performance of the system.*

(c) A mechanism (i) actual results with reference to the standards (ii) for detecting deviations.

(d) A mechanism for feeding back corrective and adaptive information.

Primarily there are three types of organizational control, viz., operational control, management control and strategic control.

Operational Control: The thrust of operational control is on individual tasks or transactions as against total or more aggregative management functions.

Management Control: Management control is more inclusive and more aggregative, in the sense of embracing the integrated activities of a complete department, division or even entire organisation.

Strategic Control: According to Schendel and Hofer "Strategic control focuses on the dual questions of whether: (1) the strategy is being implemented as planned; and (2) the results produced by the strategy are those intended."

Types of Strategic Control: There are four types of strategic controls, which are as follows:

◆ **Premise control:** Premise control is a tool for systematic and continuous monitoring of the environment to verify the validity and accuracy of the premises on which the strategy has been built.

◆ **Strategic surveillance:** Contrary to the premise control, the strategic surveillance is unfocussed.

◆ **Special alert control:** At times, unexpected events may force organizations to reconsider their strategy.

◆ **Implementation control**

The two basic forms of implementation control are:

(i) **Monitoring strategic thrusts:** Monitoring strategic thrusts helps managers to determine whether the overall strategy is progressing as desired.

(ii) **Milestone Reviews:** All key activities necessary to implement strategy are segregated in terms of time, events or major resource allocation.

5.7 STRATEGIC PERFORMANCE MEASURES

SPM is a method that increases line executives' understanding of an organization's strategic goals and offers a continuous system for tracking progress towards these objectives using clear-cut performance measurements.

Types of Strategic Performance Measures

- ◆ Financial Measures
- ◆ Market Measures
- ◆ Innovation Measures
- ◆ Customer Satisfaction Measures
- ◆ Employee Measures
- ◆ Environmental Measures

Toward More Holistic Measures of Strategic Performance

Development of management thought and practice has persistently pushed the frontier of strategic performance beyond financial metrics. Thus, the Triple Bottom Line framework (TBL) emphasises People and Planetary Concerns besides profitability or Economic Prosperity alone. The Quadruple Bottom-line adds the 4th P to add a spiritual dimension named 'Purpose.'

The Importance of Strategic Performance Measures

- ◆ Goal Alignment
- ◆ Resource Allocation
- ◆ Continuous Improvement
- ◆ External Accountability

Choosing the Right Strategic Performance Measures

In selecting the right measures, organizations should consider the following factors:

- ◆ Relevance
- ◆ Data Availability
- ◆ Data Quality
- ◆ Data Timeliness

**AUDITING
AND
ETHICS

(AUDIT)**

CHAPTER - 1

NATURE, OBJECTIVE AND SCOPE OF AUDIT

1. INTRODUCTION

What do we mean by auditing? What is its nature and scope?

2. ORIGIN OF AUDITING

The word "audit" originates from Latin word "audire" meaning "to hear".

The Institute of Chartered Accountants of India was established as a statutory body under an Act of Parliament in 1949.

3. MEANING AND NATURE OF AUDITING

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

4. INTERDISCIPLINARY NATURE OF AUDITING- RELATIONSHIP WITH DIVERSE SUBJECTS

1. Auditing and Accounting

2. Auditing and Law

3. Auditing and Economics

4. Auditing and Behavioural Science

5. Auditing and Statistics & Mathematics

6. Auditing and Data Processing

7. Auditing and Financial Management

8. Auditing and Production

5. OBJECTIVES OF AUDIT

SA-200 "Overall Objectives of the Independent auditor"

(a) *To obtain RA about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.*

(b) *To report on the financial statements, and communicate.*

6. SCOPE OF AUDIT-WHAT IT INCLUDES

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

(1)	Coverage of all aspects of entity
(2)	Reliability and sufficiency of financial information Study and assessment of accounting systems and internal controls and by carrying out appropriate tests, enquiries and procedures.
(3)	Proper disclosure of financial information He should also keep in mind applicable statutory requirements in this regard. "Historical financial information" means information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.
6.1	Scope of audit-What it does not include
◆	Auditor is not expected to perform duties which fall outside domain of his competence.
◆	An auditor is not an expert in authentication of documents.
◆	Audit is distinct from investigation.
7.	INHERENT LIMITATIONS OF AUDIT
(1)	Nature of financial reporting These judgments may involve subjective decisions or a degree of uncertainty. Controls may not have operated to produce reliable financial information
(2)	Nature of Audit procedures Management may not provide complete information as requested by auditor. The management may consist of dishonest and unscrupulous people.
(3)	Not in nature of investigation
(4)	Timeliness of financial reporting and decrease in relevance of information over time Balance has to be struck between reliability of information and cost of obtaining it.
(5)	Future events The business may cease to exist in future due to change in market conditions, emergence of new business models or products.
8.	WHAT IS AN ENGAGEMENT? Engagement means an arrangement to do something.

1-1	External audit engagements
	<i>The purpose of external audit engagements is to enhance the degree of confidence of intended users of financial statements.</i>
9.	BENEFITS OF AUDIT-WHY AUDIT IS NEEDED?
◆	<i>Audited accounts provide high quality information.</i>
◆	<i>Independent mechanism so that financial information is qualitative and reliable.</i>
◆	<i>Moral check on employees.</i>
◆	<i>Helpful to government authorities.</i>
◆	<i>Relied upon by lenders, bankers for making their credit decisions.</i>
◆	<i>Audit may also detect fraud or error or both.</i>
◆	<i>Audit reviews existence and operations of various controls.</i>
10.	AUDIT- MANDATORY OR VOLUNTARY?
	<i>There are entities like companies who are compulsorily required to get their accounts audited under law. Many entities may get their accounts audited voluntarily because of benefits from the process of audit.</i>
11.	WHO APPOINTS AN AUDITOR?
	<i>Generally, an auditor is appointed by owners or in some cases by constitutional or government authorities in accordance with applicable laws and regulations.</i>
	<i>However, in case of government companies in India, auditor is appointed by Comptroller and Auditor General of India (CAG), an independent constitutional authority.</i>
12.	TO WHOM REPORT IS SUBMITTED BY AN AUDITOR?
	<i>The report is submitted to person making the appointment.</i>
13.	MEANING OF ASSURANCE ENGAGEMENT
	<i>Engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.</i>

13.1 Elements of an Assurance Engagement

1. A three-party relationship involving a practitioner, a responsible party, and intended users
2. An appropriate subject matter
3. Suitable criteria
4. Sufficient appropriate evidence
5. A written assurance report in appropriate form

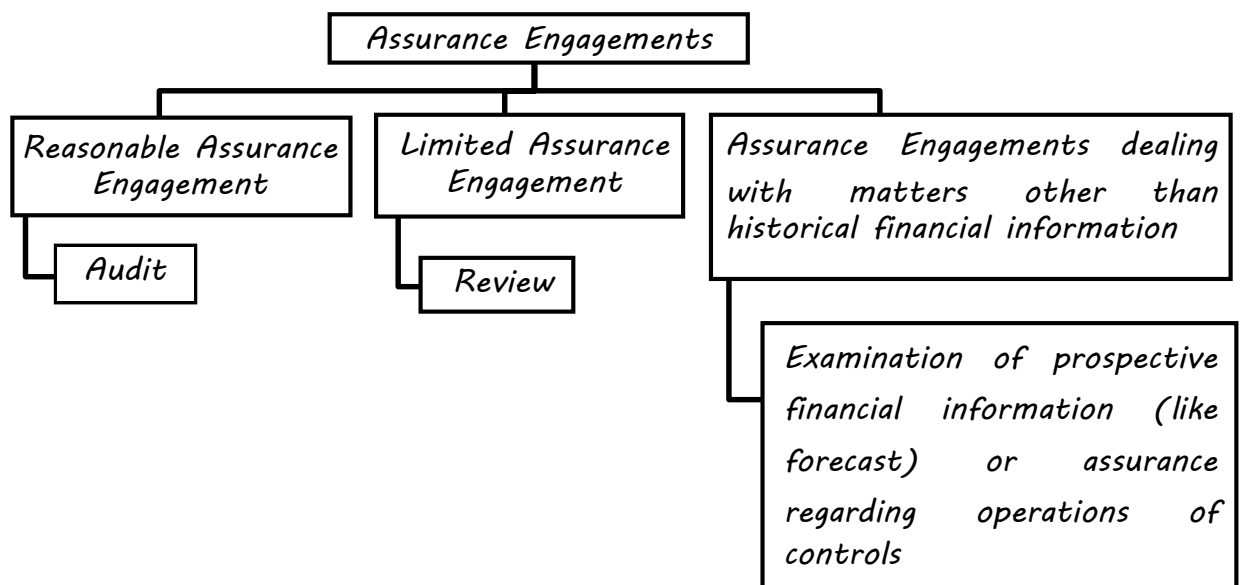
13.2 Meaning of Review; Audit Vs. Review

Review is a limited assurance engagement. Review involves fewer procedures and gathers sufficient appropriate evidence on the basis of which limited conclusions can be drawn up.

13.3 Types of Assurance Engagements

Reasonable assurance engagement	Limited assurance engagement
High level of assurance.	Lower level of assurance.
Elaborate and extensive procedures	Fewer procedures
Reasonable conclusions	Limited conclusions.
Reasonable assurance engagement is an audit engagement.	Limited assurance engagement is review engagement.

“Prospective financial information” means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It can be in the form of a forecast or projection or combination of both.



14.	QUALITIES OF AUDITOR
	<i>Tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability are some of qualities which an auditor should have.</i>
	<i>He must have the highest degree of integrity backed by adequate independence.</i>
	<i>The auditor, who holds a position of trust, must have the basic human qualities.</i>
15.	ENGAGEMENT AND QUALITY CONTROL STANDARDS: AN OVERVIEW
1.	<i>Standards on auditing (SAs) which apply in audit of historical financial information.</i>
2.	<i>Standards on review engagements (SREs) which apply in review of historical financial information.</i>
3.	<i>Standards on Assurance engagements (SAEs) which apply in assurance engagements</i>
4.	<i>Standards on Related Services (SRSs) which apply in agreed upon procedures to information, compilation engagements and other related service engagements.</i>
15.1	Standards on Auditing
◆	<i>SA 200 Overall Objectives</i>
◆	<i>SA 230 Audit Documentation</i>
◆	<i>SA 315 Identifying and Assessing the Risks of Material Misstatement</i>
◆	<i>SA 500 Audit Evidence</i>
◆	<i>Revised SA 700 Forming an Opinion and Reporting on Financial Statements</i>
15.2	Standards on Review Engagements
◆	<i>SRE 2400 (Revised) Engagements to Review Historical Financial Statements</i>
◆	<i>SRE 2410 Review of Interim Financial Information</i>
15.3	Standards on Assurance Engagements
◆	<i>SAE 3400 The Examination of Prospective Financial Information</i>
◆	<i>SAE 3420 Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus</i>
15.4	Standards on Related Services

◆ *SRS 4400 Engagements to perform agreed-upon procedures regarding financial information*

◆ *SRS 4410 (Revised) Compilation engagements*

15.5 Standards on Quality Control

Standards on Quality Control (SQCs) are to be applied for all services covered by Engagement Standards.

15.6 Why are Standards needed?

- *Audit against established benchmarks.*
- *Improve quality of financial reporting.*
- *Promote uniformity*
- *Equip professional accountants with professional knowledge and skill.*
- *Ensure audit quality.*

15.7 Duties in relation to Engagement and Quality Control Standards

A situation may arise when a specific procedure as required in Standards would be ineffective in a particular engagement. In such a case, he is required to document how alternative procedures performed achieve the purpose of required procedure. Also, reason for departure has also to be documented unless it is clear. Further, his report should draw attention to such departures.

CHAPTER - 2

AUDIT STRATEGY, AUDIT PLANNING AND AUDIT PROGRAMME

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

SA 300- Planning an audit of financial statements

1.1 Why planning an audit is necessary? - Its Benefits

1. Helping the auditor to devote appropriate attention to important areas of the audit.
2. Helping the auditor identify and resolve potential problems on a timely basis.
3. Helping the auditor properly organize and manage the audit engagement.
4. Assisting in the selection of engagement team members with appropriate levels of capabilities and competence.
5. Facilitating the direction and supervision of engagement team members.
6. Assisting, where applicable, in coordination of work done by others.

1.2 Nature of Audit Planning- A Continuous and iterative process

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

1. The analytical procedures to be applied as risk assessment procedures.
 2. Obtaining a general understanding of the legal and regulatory framework
 3. The determination of materiality.
 4. The involvement of experts.
 5. The performance of other risk assessment procedures.
- ◆ *Involvement of key engagement team members in planning audit*
 - ◆ *Discussion of elements of planning with entity's management*

2 PLANNING PROCESS - ELEMENTS OF PLANNING

The elements of planning can be categorized as under: -

- (I) *Preliminary engagement activities*
 - (II) *Planning activities*
- (I) *Preliminary engagement activities*

(A)	<i>Performing procedures regarding the continuance of the client relationship</i>
(B)	<i>Evaluating compliance with ethical requirements, including independence</i>
(C)	<i>Establishing an understanding of terms of engagement</i>
(II)	Planning activities
	<i>Planning activities involve:-</i>
[A]	Establishing the overall audit strategy
[B]	Developing an audit plan
(A)	Establishing the overall audit strategy- Assistance for the auditor
	<i>Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.</i>
	<i>The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:-</i>
(i)	<i>The resources to deploy for specific audit areas</i>
(ii)	<i>The amount of resources to allocate to specific audit areas</i>
(iii)	<i>When these resources are to be deployed</i>
(iv)	<i>How such resources are managed, directed and supervised</i>
	<i>The auditor shall take following factors into consideration while establishing audit strategy:-</i>
(a)	Identify the characteristics of the engagement that define its scope
	➤ <i>Applicable financial reporting framework applicable to the entity</i>
	➤ <i>Nature of business segments to be audited</i>
	➤ <i>Industry specific reporting requirements required by industry regulators</i>
	➤ <i>Expected use of audit evidence obtained in previous audits</i>
(b)	Ascertain the reporting objectives of the engagement
	➤ <i>The entity's timetable for reporting</i>
	➤ <i>Organization of meetings to discuss of nature, timing and extent of audit work</i>
	➤ <i>Discussion with management regarding the expected type and timing of reports</i>
	➤ <i>Discussion with management regarding the expected communications</i>
	➤ <i>Expected nature and timing of communications among engagement team members</i>
(c)	Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts

	➤ <i>Volume of transactions</i>
	➤ <i>Significant industry developments</i>
	➤ <i>Significant changes in the financial reporting framework</i>
	➤ <i>Other significant relevant developments</i>
(d)	<i>Consider the results of preliminary engagement activities</i>
(e)	<i>Ascertain the nature, timing and extent of resources</i>
(B)	<i>Development of Audit plan</i>
	<i>SA-300 states that auditor shall develop an audit plan that shall include description of</i>
(i)	<i>The nature, timing and extent of planned risk assessment procedures</i>
(ii)	<i>The nature, timing and extent of planned further audit procedures at assertion level</i>
(iii)	<i>Other planned audit procedures.</i>
3	<i>RELATIONSHIP BETWEEN AUDIT STRATEGY AND AUDIT PLAN</i>
	<i>The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes but are closely inter - related</i>
4.	<i>OVERALL AUDIT STRATEGY AND THE AUDIT PLAN- THE AUDITOR'S RESPONSIBILITY</i>
5	<i>CHANGES TO PLANNING DECISIONS DURING THE COURSE OF AUDIT</i>
	<i>As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan.</i>
6	<i>PLANNING SUPERVISION AND REVIEW OF WORK OF ENGAGEMENT TEAM MEMBERS</i>
1.	<i>The size and complexity of the entity.</i>
2.	<i>The area of the audit.</i>
3.	<i>The assessed risks of material misstatement</i>
4.	<i>The capabilities and competence of the individual team members</i>

7.	DOCUMENTATION
(a)	<i>the overall audit strategy</i>
(b)	<i>the audit plan and</i>
(c)	<i>any significant changes made during the audit engagement</i>
8.	AUDIT PROGRAMME
	<i>An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given entity for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on financial statements.</i>
8.1	<i>Evolving one audit programme- Not Practicable for All businesses</i>
	<i>Businesses vary in nature, size and composition;</i>
8.2	<i>The Assistant to keep an open mind</i>
	<i>The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him.</i>
8.3	<i>Periodic review of the audit programme</i>
	<i>Whether the same continues to be adequate for obtaining requisite knowledge and evidence.</i>
	<i>Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review is undertaken to keep the programme as up-to- date as possible.</i>
8.4	<i>Constructing an audit programme</i>
	<i>For the purpose of programme construction, the following points should be kept in mind:</i>
(1)	<i>Stay within the scope and limitation of the assignment.</i>
(2)	<i>Prepare a written audit programme</i>
(3)	<i>Determine the evidence reasonably available</i>
(4)	<i>Apply only those steps and procedures.</i>
(5)	<i>Include the audit objectives</i>
(6)	<i>Consider all possibilities of error</i>
(7)	<i>Co-ordinate the procedures to be applied to related items.</i>

8.5 Audit Programme- Designed to provide audit evidence

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

8.6 Advantages and disadvantages of an audit programme

The advantages of an audit programme are:-

- (a) Total and clear set of instructions.
- (b) Total perspective of the work to be performed.
- (c) Selection of assistants for the jobs.
- (d) Without a written and pre-determined programme, there is always a danger of ignoring or overlooking certain books and records.
- (e) The assistants, by putting their signature on programme, accept the responsibility.
- (f) The principal can control the progress.
- (g) It serves as a guide for audits to be carried out in the succeeding year.
- (h) Serves as evidence in the event of any charge of negligence.

The disadvantages are:-

- (a) The work may become mechanical and particular parts of the programme may be carried out without any understanding.
- (b) The programme often tends to become rigid and inflexible
- (c) Inefficient assistants
- (d) A hard and fast audit programme may kill the initiative of efficient

CHAPTER - 3

RISK ASSESSMENT AND INTERNAL CONTROL

1 AUDIT RISK

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

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

1.1 Risks of material misstatement

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

Few examples of misstatements could be:-

- Charging of an item of capital expenditure to revenue or vice-versa
- Difference in disclosure of a financial statement
- Selection or application of inappropriate accounting policies
- Difference in accounting estimate
- Intentional booking of fake expenses
- Overstating of receivables in financial statements
- Overstating or understating inventories

The risks of material misstatement may exist at two levels:-

- (i) The overall financial statement level
- (ii) The assertion level for classes of transactions, account balances, and disclosures.

1.2 Components of risk of material misstatement

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

1.2A Inherent risk

Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements before consideration of any related controls.

Few examples of inherent risks could include:-

- ◆ *An accounting standard provides guidance on some complex issue*
- ◆ *There are large number of business failures in an industry.*

1.2B Control risk

Control risk is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Examples of control risk could include:-

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

1.3 Detection risk

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

Detection risk comprises sampling and non-sampling risk.

- ◆ *Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.*
- ◆ *Non-sampling risk is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.*

1.4 Audit risk-What is not included?

It does not refer to the auditor's business risks such as loss from litigation, adverse publicity.

For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.

1.5 Assessment of risks- A matter of professional Judgment

The assessment of risks is a matter of professional judgment, rather than a matter

capable of precise measurement.

1.5.1 Combined Assessment of the Risk of Material Misstatement

$Audit\ risk = Risks\ of\ material\ misstatement \times Detection\ risk$

$Audit\ risk = Inherent\ risk \times Control\ risk \times Detection\ risk$

1.6 SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment".

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

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

(a) the financial statement level

(b) the assertion level

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

(a) Identify risks throughout the process of obtaining an understanding of the entity

(b) Assess the identified risks

(c) Relate the identified risks to what can go wrong at the assertion level.

(d) Consider the likelihood of misstatement.

1.7 Risk Assessment Procedures

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

◆ Inquiries directed toward internal audit personnel

◆ Inquiries of employees

◆ Inquiries directed toward in-house legal counsel

◆ Inquiries directed towards marketing or sales personnel

◆ Inquiries directed to the risk management function

◆ Inquiries directed to information systems personnel

(b) **Analytical Procedures:**

Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement.

However, when such analytical procedures use data aggregated at a high level

(c) **Observation and Inspection:** Observation and inspection may support inquiries of

	<i>management and others</i>
	<ul style="list-style-type: none"> ▪ <i>The entity's operations</i> ▪ <i>Documents</i> ▪ <i>Reports prepared by management</i> ▪ <i>The entity's premises and plant facilities</i>
1.8	<i>Information obtained by performing risk assessment procedures - Used as audit evidence</i>
	<i>The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.</i>
2	<i>MATERIALITY</i>
2.1	<i>What is meant by materiality?</i>
	<i>SA 320 Materiality in Planning and Performing an Audit</i>
	<i>Materiality is not always a matter of relative size.</i>
2.2	<i>Materiality in Planning and performing an audit- Auditor's responsibility</i>
	<i>Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:</i>
	<ul style="list-style-type: none"> • <i>Could reasonably be expected to influence the economic decisions of users.</i> • <i>Size or nature of a misstatement, or a combination of both;</i> • <i>Based on a consideration of the common financial information needs of users as a group.</i>
	<i>In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:</i>
	(a) <i>Determining the nature, timing and extent of risk assessment procedures;</i>
	(b) <i>Identifying and assessing the risks of material misstatement; and</i>
	(c) <i>Determining the nature, timing and extent of further audit procedures.</i>
	<i>If there is any statutory requirement of disclosure, it is to be considered material irrespective of the value of amount.</i>
2.3	<i>Determination of materiality- a matter of professional judgment</i>
	<i>In this context, it is reasonable for the auditor to assume that users:</i>
	(a) <i>Have a reasonable knowledge of business and economic activities</i>
	(b) <i>Understand that financial statements are prepared, presented and audited.</i>

(c)	<i>Recognize the uncertainties inherent in the measurement of amounts.</i>
(d)	<i>Make reasonable economic decisions.</i>
2.4	<i>Performance Materiality</i>
	<i>Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.</i>
2.5	<i>Determining Materiality and Performance Materiality when Planning the Audit</i>
	<i>When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. The auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.</i>
2.6	<i>Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole</i>
	<i>Factors that may affect the identification of an appropriate benchmark.</i>
	<ul style="list-style-type: none"> ▪ <i>The elements of the financial statements.</i> ▪ <i>Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused.</i> ▪ <i>The nature of the entity, where the entity is at in its life cycle.</i> ▪ <i>The relative volatility of the benchmark.</i>
	<i>Examples of benchmarks profit before tax, total revenue, gross profit and total expenses, total equity or net asset value.</i>
2.6.1	<i>Chosen Benchmark - Relevant financial data</i>
	<ul style="list-style-type: none"> ▪ <i>Prior periods' financial results and financial positions,</i> ▪ <i>The period to-date financial results and financial position, and</i> ▪ <i>Budgets or forecasts for the current period</i>
2.6.2	<i>Determining a percentage to be applied</i>
	<i>A percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.</i>
2.7	<i>Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures</i>
	<i>Factors that may indicate</i>
1.	<i>Whether law, regulations or the applicable financial reporting framework</i>

2.	<i>The key disclosures in relation to the industry</i>
3.	<i>Whether attention is focused on a particular aspect of the entity's business</i>
2.8	<i>Revision in Materiality level as the Audit Progresses</i>
	<i>Actual financial results are likely to be substantially different from the anticipated period end financial results.</i>
2.9	<i>Documenting the Materiality</i>
(a)	<i>Materiality for the financial statements as a whole</i>
(b)	<i>If applicable, the materiality level or levels for particular classes of transactions</i>
(c)	<i>Performance materiality and</i>
(d)	<i>Any revision of (a)-(c) as the audit progressed</i>
2.10.	<i>Materiality and Audit Risk</i>
3.	<i>UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT</i>
	<i>Auditor shall obtain an understanding of the following:-</i>
(a)	<i>Relevant industry, regulatory, and other external factors including the applicable financial reporting framework</i>
(b)	<i>The nature of the entity, including</i>
(c)	<i>The entity's selection and application of accounting policies, including the reasons for changes thereto</i>
(d)	<i>The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.</i>
(e)	<i>The measurement and review of the entity's financial performance</i>
3.1	<i>Why understanding the entity and its environment is significant?</i>
3.2	<i>Understanding the entity-a continuous process</i>
	<ul style="list-style-type: none"> ▪ <i>Assessing risks of material misstatement of the financial statements.</i> ▪ <i>Determining materiality in accordance with SA 320.</i> ▪ <i>Considering the appropriateness of the selection and application of accounting policies.</i> ▪ <i>Identifying areas where special audit consideration may be necessary.</i> ▪ <i>Developing expectations for use when performing analytical procedures.</i> ▪ <i>Evaluating the sufficiency and appropriateness of audit evidence.</i>
4.	<i>INTERNAL CONTROL</i>

4.1	Meaning of Internal Control - Defined in purpose
4.2	As derived from above definition, the purpose of Internal Control is as under
	<ul style="list-style-type: none"> ▪ The reliability of the entity's financial reporting; ▪ The effectiveness and efficiency of its operations; ▪ Its compliance with applicable laws and regulations; and ▪ Safeguarding of assets.
4.3	Benefits of Understanding of Internal Control
(i)	Identifying types of potential misstatements;
(ii)	Identifying factors that affect the risks of material misstatement, and
(iii)	Designing the nature, timing, and extent of further audit procedures.
4.4	Limitations of Internal Control
(i)	Internal control can provide only reasonable assurance
(ii)	Human judgment in decision-making
(iii)	Lack of understanding the purpose
(iv)	Collusion among People
(v)	Judgements by Management
(vi)	Limitations in case of Small Entities
4.5	Components of Internal Control
(A)	The control environment
(B)	The entity's risk assessment process
(C)	The information system
(D)	Control activities
(E)	Monitoring of controls
4.5(A)	Control Environment
	What is included in Control Environment?
(i)	the governance and management functions and
(ii)	the attitudes, awareness, and actions of those charged with governance
(iii)	the control environment
	Elements of the Control Environment
(a)	Communication and enforcement of integrity and ethical values
(b)	Commitment to competence
(c)	Participation by those charged with governance

(d)	<i>Management's philosophy and operating style</i>
(e)	<i>Organisational structure</i>
(f)	<i>Assignment of authority and responsibility</i>
(g)	<i>Human resource policies and practices</i>
	<i>Existence of a satisfactory control environment-not an absolute deterrent to fraud</i>
	<i>The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud.</i>
4.5 (B)	<i>The Entity's Risk Assessment Process</i>
(a)	<i>Identifying business risks relevant to financial reporting objectives</i>
(b)	<i>Estimating the significance of the risks</i>
(c)	<i>Assessing the likelihood of their occurrence</i>
(d)	<i>Deciding about actions to address those risks</i>
4.5 (C)	<i>The information system, including the related business processes, relevant to financial reporting and communication</i>
(a)	<i>The classes of transactions in the entity's operations that are significant</i>
(b)	<i>The procedures by which those transactions are initiated, recorded, processed</i>
(c)	<i>The related accounting records</i>
(d)	<i>How the information system captures events and conditions</i>
(e)	<i>The financial reporting process</i>
(f)	<i>Controls surrounding journal entries.</i>
4.5 (D)	<i>Control Activities</i>
	<i>Control activities relevant to audit generally include policies and procedures relating to performance reviews information processing physical controls and segregation of duties.</i>
4.5 (E)	<i>Monitoring of Controls</i>
	<i>Monitoring of controls is a process to assess the effectiveness of internal control performance over time.</i>
	<i>Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two.</i>
4.6	<i>Are all Controls Relevant to the audit?</i>

	<i>Factors relevant to the auditor's judgment</i>
▪	<i>Materiality.</i>
▪	<i>The significance of the related risk.</i>
▪	<i>The size of the entity.</i>
▪	<i>The nature of the entity's business</i>
▪	<i>The diversity and complexity of the entity's operations.</i>
▪	<i>Applicable legal and regulatory requirements.</i>
▪	<i>The circumstances and the applicable component of internal control.</i>
▪	<i>The nature and complexity of the systems</i>
▪	<i>Whether, and how, a specific control</i>
4.7	<i>Controls over the completeness and accuracy of Information</i>
4.8	<i>Internal control over safeguarding of assets</i>
4.9	<i>Controls relating to objectives that are not relevant to an audit</i>
	<i>In certain circumstances, the statute or the regulation governing the entity may require the auditor to report on compliance with certain specific aspects of internal controls as a result, the auditor's review of internal control may be broader and more detailed.</i>
4.10	<i>Nature and Extent of the Understanding of Relevant Controls</i>
	<i>Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include-</i>
▪	<i>Inquiring of entity personnel.</i>
▪	<i>Observing the application of specific controls.</i>
▪	<i>Inspecting documents and reports.</i>
▪	<i>Tracing transactions through the information system relevant to financial reporting.</i>
	<i>Inquiry alone, however, is not sufficient for such purposes.</i>
5.	<i>RISKS THAT REQUIRE SPECIAL AUDIT CONSIDERATION</i>
(a)	<i>Whether the risk is a risk of fraud</i>
(b)	<i>Whether the risk is related to recent significant economic, accounting</i>
(c)	<i>The complexity of transactions</i>
(d)	<i>Whether the risk involves significant transactions with related parties</i>
(e)	<i>The degree of subjectivity</i>

	(f) <i>Whether the risk involves significant transactions that are outside the normal course.</i>
5.1	Identifying Significant Risks
	<i>The following are always significant risks:</i>
	<ul style="list-style-type: none"> ▪ <i>Risks of material misstatement due to fraud</i> ▪ <i>Significant transactions with related parties that are outside the normal course of business for the entity</i>
5.2	Risks of Material Misstatement Greater for Significant Non-Routine Transactions
	<ul style="list-style-type: none"> ▪ <i>Greater management intervention to specify the accounting treatment.</i> ▪ <i>Greater manual intervention for data collection and processing.</i> ▪ <i>Complex calculations or accounting principles.</i> ▪ <i>The nature of non-routine transactions.</i>
5.3	Risks of material misstatement- Greater for Significant Judgmental Matters
	<ul style="list-style-type: none"> ▪ <i>Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.</i> ▪ <i>Required judgment may be subjective or complex</i>
6.	EVALUATION OF INTERNAL CONTROL SYSTEM
6.1	Benefits of Evaluation of Internal Control to the Auditor
	(i) <i>whether errors and frauds are likely to be located</i>
	(ii) <i>whether an adequate internal control system is in use</i>
	(iii) <i>whether an effective internal auditing department is operating.</i>
	(iv) <i>whether any administrative control has a bearing on his work.</i>
	(v) <i>whether the controls adequately safeguard the assets.</i>
	(vi) <i>how far and how adequately the management is discharging its function.</i>
	(vii) <i>how reliable the reports</i>
	(viii) <i>the extent and the depth of the examination that he needs to carry out</i>
	(ix) <i>what would be appropriate audit technique.</i>
	(x) <i>what are the areas where control is weak.</i>
	(xi) <i>whether some worthwhile suggestions.</i>
6.2	Evaluation of Internal Control - Methods
	(A) <i>Narrative record</i>
	(B) <i>Check List</i>

(C)	Internal Control questionnaire and
(D)	Flow chart
6.2(A)	The Narrative Record
	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.
6.2 (B)	Check List
	This is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer.
	The complete checklist is studied by the Principal/Manager/Senior to ascertain existence of internal control and evaluate its implementation and efficiency.
6.2 (C)	Internal Control Questionnaire
	This is a comprehensive series of questions concerning internal control. This is the most widely used form for collecting information about the existence, operation and efficiency of internal control in an organisation.
6.2 (D)	Flow Chart
	It is a graphic presentation of each part of the company's system of internal control. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form.
	It gives bird's eye view of the system.
7.	TESTING OF INTERNAL CONTROL
	Test of controls may include:
	<ul style="list-style-type: none"> ▪ Inspection of documents ▪ Inquiries about, and observation of, internal controls ▪ Re-performance ▪ Testing of internal control operating on specific computerised applications
8.	WHAT IS AN AUTOMATED ENVIRONMENT?
8.1	Key features of an automated environment
	<ul style="list-style-type: none"> • Enables faster business operation • Accuracy in data processing and computation

	<ul style="list-style-type: none"> • Ability to process large volume of transactions
	<ul style="list-style-type: none"> • Integration amongst business operations
	<ul style="list-style-type: none"> • Better security and controls
	<ul style="list-style-type: none"> • Less prone to human errors
	<ul style="list-style-type: none"> • Provides latest information
	<ul style="list-style-type: none"> • Connectivity and networking capability
8.2	Understanding and documenting automated environment
	<ul style="list-style-type: none"> ▪ Information systems being used
	<ul style="list-style-type: none"> ▪ Their purpose
	<ul style="list-style-type: none"> ▪ Location of IT systems - local vs global
	<ul style="list-style-type: none"> ▪ Architecture
	<ul style="list-style-type: none"> ▪ Version
	<ul style="list-style-type: none"> ▪ Interfaces within systems
	<ul style="list-style-type: none"> ▪ In-house vs Packaged
	<ul style="list-style-type: none"> ▪ Outsourced activities
	<ul style="list-style-type: none"> ▪ Key persons
8.3	Risks arising from use of IT Systems
	<ul style="list-style-type: none"> ▪ Inaccurate processing of data
	<ul style="list-style-type: none"> ▪ Unauthorized access to data.
	<ul style="list-style-type: none"> ▪ Direct data changes (backend changes).
	<ul style="list-style-type: none"> ▪ Excessive access / Privileged access (super users).
	<ul style="list-style-type: none"> ▪ Lack of adequate segregation of duties.
	<ul style="list-style-type: none"> ▪ Unauthorized changes to systems or programs.
	<ul style="list-style-type: none"> ▪ Failure to make necessary changes to systems or programs.
	<ul style="list-style-type: none"> ▪ Loss of data.
8.4	Impact of IT related risks
	<ul style="list-style-type: none"> ◆ Impact on substantive checking
	<ul style="list-style-type: none"> ◆ Impact on controls
	<ul style="list-style-type: none"> ◆ Impact on reporting
8.5	Types of Controls in an automated environment
(A)	General IT controls
(B)	Application controls

(C)	<i>IT-dependent controls</i>
8.5 (A)	<i>General IT controls</i>
	<i>General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:</i>
	<ul style="list-style-type: none"> • <i>Data centre and network operations</i> • <i>Program change</i> • <i>Access security</i> • <i>Application system acquisition, development, and maintenance</i> • <i>General IT controls are known as “pervasive” controls or “indirect” controls.</i>
(a)	<i>Controls over Data centre and network operations</i>
	<i>Overall management of computer operation activities, preparing, scheduling and executing of batch jobs, monitoring, storage and retention of backups.</i>
	<i>Matters such as BCP (Business continuity plan) and DRP (Disaster recovery plan)</i>
(b)	<i>Program Change</i>
	<i>Change management process, recording, managing and tracking change requests, making and testing changes etc.</i>
(c)	<i>Access Security</i>
	<i>Security organization & management, security policies & procedures, application security, data security, operating system security, network security, physical security etc.</i>
(d)	<i>Application system acquisition, development, and maintenance</i>
	<i>Management of development activities, project initiation, analysis & design, construction, testing & quality assurance etc.</i>
8.5 (B)	<i>Application Control</i>
	<i>Application controls include both automated or manual controls that operate at a business process level. Examples of automated applications include edit checks and validation of input data, sequence number checks, user limit checks, reasonableness checks, mandatory data fields.</i>
8.5 (C)	<i>IT dependent Controls</i>
	<i>IT dependent controls are basically manual controls that make use of some form of data or information or report produced from IT systems and applications.</i>
8.6	<i>General IT Controls vs. Application Controls</i>

	<i>General IT Controls are needed to support the functioning of application controls</i>
8.7	<i>Testing methods in an automated environment</i>
	<i>Inquiry is the most efficient audit test but it also gives the least audit evidence.</i>
	<i>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.</i>
	<i>Applying inquiry in combination with inspection gives the most effective and efficient audit evidence.</i>
	<i>When testing in an automated environment, some of the more common methods are as follows:</i>
	<ul style="list-style-type: none"> ◆ <i>Obtain an understanding of how an automated transaction is processed.</i> ◆ <i>Observe how a user processes transactions under different scenarios.</i> ◆ <i>Inspect the configuration defined in an application.</i>
9.	<i>CHARACTERISTICS OF MANUAL AND AUTOMATED ELEMENTS OF INTERNAL CONTROL RELEVANT TO THE AUDITOR'S RISK ASSESSMENT</i>
(a)	<i>Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items.</i>
(b)	<i>Controls in IT systems consist of a combination of automated controls and manual controls.</i>
9.1	<i>Manual elements vs automated elements in entity's internal control</i>
	<i>Manual elements in internal control may be more suitable.</i>
	<ul style="list-style-type: none"> ▪ <i>Large, unusual or non-recurring transactions.</i> ▪ <i>Circumstances where errors are difficult to define, anticipate or predict.</i> ▪ <i>In changing circumstances.</i> ▪ <i>In monitoring the effectiveness of automated controls.</i>
	<i>Manual control elements may be less suitable for the following circumstances:</i>
	<ul style="list-style-type: none"> ▪ <i>High volume or recurring transactions</i> ▪ <i>Control activities where the specific ways to perform the control</i>
10.	<i>AUDIT APPROACH IN AN AUTOMATED ENVIRONMENT</i>
1.	<i>Risk Assessment</i>

2.	<i>Understand and Evaluate</i>
3.	<i>Test for Operating Effectiveness</i>
4.	<i>Reporting</i>
11.	<i>DATA ANALYTICS FOR AUDIT</i>
	<i>Data analytics can be used in testing of electronic records and data residing in IT systems:</i>
	<ul style="list-style-type: none"> ▪ <i>Check completeness of data and population</i> ▪ <i>Selection of audit samples</i> ▪ <i>Re-computation of balances</i> ▪ <i>Reperformance of mathematical calculations</i> ▪ <i>Analysis of journal entries Fraud investigation.</i> ▪ <i>Evaluating impact of control deficiencies.</i>
12.	<i>DIGITAL AUDIT</i>
	<i>Auditors are making use of artificial intelligence, data analytics and other latest technologies to help understand business processes in a better way.</i>
13.	<i>INTERNAL FINANCIAL CONTROLS AS PER REGULATORY REQUIREMENTS</i>
	<i>Term Internal Financial Controls (IFC)</i>
	<ul style="list-style-type: none"> ▪ <i>Reliability of financial reporting</i> ▪ <i>Effectiveness and efficiency of operations</i> ▪ <i>Compliance with applicable laws and regulations</i> ▪ <i>Safeguarding of assets</i> ▪ <i>Prevention and detection of frauds</i>
14.	<i>DOCUMENTING THE RISKS</i>
	<i>The auditor shall document:</i>
(a)	<i>The discussion among the engagement team</i>
(b)	<i>Key elements of the understanding obtained regarding each of the aspects</i>
(c)	<i>The identified and assessed risks of material misstatement</i>
(d)	<i>The risks identified, and related controls</i>

15.	ASSESS AND REPORT AUDIT FINDINGS
	<ul style="list-style-type: none"> ▪ Are there any weaknesses in IT controls? ▪ What is the impact of these weaknesses on overall audit? ▪ Report deficiencies to management - Internal controls memo or Management letter. ▪ Communicate in writing any significant deficiencies to those Charged with governance.
16.	THE AUDITOR'S RESPONSES TO ASSESSED RISKS
	SA 330 The auditor's responses to assessed risks
(a)	The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.
(b)	The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.
	In designing the further audit procedures to be performed, the auditor shall:
(a)	Consider the reasons for the assessment given to the risk of material misstatement
(i)	The likelihood of material misstatement
(ii)	Whether the risk assessment takes into account the relevant controls
(b)	Obtain more persuasive audit evidence the higher the auditor's assessment of risk.
	The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:
(a)	includes an expectation that the controls are operating effectively or
(b)	Substantive procedures alone cannot provide sufficient appropriate audit evidence
16.1	Nature and Extent of Test of Controls
	In designing and performing test of controls, the auditor shall:
(a)	Perform other audit procedures in combination with inquiry
(i)	How the controls were applied at relevant times during the period under audit.
(ii)	The consistency with which they were applied.
(iii)	By whom or by what means they were applied.
(b)	Determine whether the controls to be tested depend upon other controls
	Matters the auditor may consider in determining the extent of test of controls
	<ul style="list-style-type: none"> ▪ The frequency of the performance of the control ▪ The length of time during the audit period that the auditor is relying

	<ul style="list-style-type: none"> ▪ <i>The expected rate of deviation from a control.</i> ▪ <i>The relevance and reliability of the audit evidence.</i> ▪ <i>The extent to which audit evidence is obtained from tests of other controls.</i>
16.2	Timing of Test of Controls
	<i>The auditor shall test controls for the particular time, or throughout the period.</i>
16.3	Using Audit Evidence Obtained in Previous Audits
	<i>The auditor shall consider the following:</i>
(a)	<i>The effectiveness of other elements of internal control</i>
(b)	<i>The risks arising from the characteristics of the control</i>
(c)	<i>The effectiveness of general IT-controls</i>
(d)	<i>The effectiveness of the control</i>
(e)	<i>Whether the lack of a change in a particular control</i>
(f)	<i>The risks of material misstatement and the extent of reliance on the control</i>
16.4	Evaluating the Operating Effectiveness of Controls
	<i>The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.</i>
16.5	Specific inquiries by auditor when deviations from controls are detected
(a)	<i>The test of controls that have been performed provide an appropriate basis</i>
(b)	<i>Additional test of controls are necessary or</i>
(c)	<i>The potential risks of misstatement need to be addressed using substantive procedures.</i>
	<i>This requirement reflects the facts that:</i>
(i)	<i>the auditor's assessment of risk is judgmental</i>
(ii)	<i>there are inherent limitations to internal control</i>
16.6	Tests of Details
	<i>Tests of details are further classified into tests of transactions i.e., vouching and tests of balances i.e., verification.</i>
16.7	Substantive analytical procedures
16.6.1	Nature and extent of Substantive procedures
	<ul style="list-style-type: none"> • <i>Performing only substantive analytical procedures.</i> • <i>Only tests of details are appropriate.</i> • <i>A combination of substantive analytical procedures and tests of details</i>

	<i>itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant.</i>
	<i>While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:</i>
	<ul style="list-style-type: none"> ▪ <i>When it is obtained from independent sources outside the entity.</i> ▪ <i>Generated internally is increased when the related controls.</i> ▪ <i>Audit evidence obtained directly by the auditor</i> ▪ <i>Audit evidence in documentary form</i> ▪ <i>Audit evidence obtained as original documents</i>
1.5	<i>Sufficient appropriate audit evidence</i>
1.5.1	<i>Sufficiency and Appropriateness are interrelated.</i>
	<i>Sufficiency is the measure of the quantity of audit evidence.</i>
	<i>Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability.</i>
1.5.2	<i>Obtaining Sufficient and appropriate Audit Evidence by the Auditor</i>
	<i>Audit evidence is necessary to support the auditor's opinion and report.</i>
	<i>Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions.</i>
1.5.3	<i>Further, auditor's judgement as to sufficiency may be affected by the factors such as:</i>
1.	<i>Materiality</i>
2.	<i>Risk of material misstatement</i>
3.	<i>Size & characteristics of a population</i>
1.6	<i>Source of audit evidence</i>
	<i>Some audit evidence is obtained by performing audit procedures to test the accounting records.</i>
	<i>More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually.</i>

1.7	<i>Audit procedures for obtaining audit evidence</i>
(a)	<i>Risk assessment procedures; and</i>
(b)	<i>Further audit procedures, which comprise:</i>
(i)	<i>Tests of controls</i>
(ii)	<i>Substantive procedures, including tests of details and substantive analytical procedures.</i>
1.7.1	<i>Audit procedures to obtain audit evidence can include:</i>
(i)	<i>Inspection</i>
	<i>Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.</i>
	<i>Some documents represent direct audit evidence of the existence of an asset.</i>
	<i>Inspection of such documents may not necessarily provide audit evidence about ownership or value.</i>
(ii)	<i>Observation</i>
	<i>Observation consists of looking at a process or procedure being performed by others.</i>
	<i>Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place.</i>
(iii)	<i>External Confirmation</i>
	<i>An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.</i>
(iv)	<i>Recalculation</i>
	<i>Recalculation consists of checking the mathematical accuracy of documents or records.</i>
(v)	<i>Reperformance</i>
	<i>Reperformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.</i>
(vi)	<i>Analytical Procedures</i>
	<i>Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.</i>
(vi)	<i>Inquiry</i>
	<i>Inquiry consists of seeking information of knowledgeable persons, both financial and</i>

non-financial, within the entity or outside the entity.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence.

Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level.

1.7.2 *The following points are also relevant in respect of audit procedures for auditor's consideration:*

The audit procedures inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry may be used as risk assessment procedures, tests of controls or substantive procedures.

1.7.3 *Nature and Timing of the Audit Procedures*

Affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time.

1.8 *Assertions*

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

1.8.1 *Assertions contained in the Financial Statements.*

(a) *Assertions about classes of transactions and events for the period under audit:*

- i. Occurrence ii. Completeness iii. Accuracy
- iv. Cut-off v. Classification

(b) *Assertions about account balances at the period end:*

- i. Existence ii. Rights and obligations
- iii. Completeness iv. Valuation and allocation

(c) *Assertions about presentation and disclosure:*

- i. Occurrence and rights and obligations ii. Completeness

iii.	Classification and understandability	iv. Accuracy and valuation
	The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered.	
	For example, where the Government is a major stakeholder, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.	
	Explicit assertions are made when otherwise the reader will be left with an incomplete picture; it may even be misleading.	
	Negative assertions are also encountered in the financial statements and the same may be expressed or implied.	
1.9	Audit Trail	
	An audit trail is a documented flow of a transaction. It is used to investigate how a source document was translated into an account entry and from there it was inserted into financial statement of an entity.	
	Audit trails (or audit logs) act as record-keepers that document evidence of certain events, procedures or operations, because their purpose is to reduce fraud, material errors, and unauthorized use.	
	However, audit trails involve costs.	
	Systems which have a feature of audit trail inspires confidence in auditors. Since audit trails also enhance data security, these can be used by auditor while performing audit procedures thus increasing reliability of audit evidence obtained.	
1.10	Information to Be Used as Audit Evidence	
1.10.1	When information to be used as audit evidence has been prepared using the work of a management's expert, the nature, timing and extent of audit procedures may be affected by such matters;	
	◆	The nature and complexity of the matter
	◆	The risks of material misstatement.
	◆	The availability of alternative sources.

	<ul style="list-style-type: none"> ◆ The nature, scope and objectives of the management's expert's work. ◆ Whether the management's expert is employed by the entity. ◆ The extent to which management can exercise control or influence. ◆ Whether the management's expert is subject to technical performance standards. ◆ The nature and extent of any controls within the entity over the management's expert's work. ◆ The auditor's knowledge and experience. ◆ The auditor's previous experience of the work of that expert.
1-10-2	<p><i>When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances:</i></p> <ul style="list-style-type: none"> (a) <i>Obtaining audit evidence about the accuracy and completeness of the information;</i> (b) <i>Evaluating whether the information is sufficiently precise and detailed.</i>
1-11	<p><i>Selecting Items for Testing to Obtain Audit Evidence</i></p> <p><i>The means available to the auditor for selecting items for testing are:</i></p> <ul style="list-style-type: none"> (a) <i>Selecting all items (100% examination);</i> (b) <i>Selecting specific items; and</i> (c) <i>Audit sampling</i>
1-11(a)	<p><i>Selecting All Items</i></p> <p><i>100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details.</i></p> <p><i>100% examination may be appropriate when,</i></p> <ul style="list-style-type: none"> • <i>The population constitutes a small number of large value items;</i> • <i>There is a significant risk.</i> • <i>The repetitive nature of a calculation or other process performed.</i>
1-11(b)	<p><i>Selecting Specific Items</i></p> <p><i>The auditor may decide to select specific items from a population.</i></p>

	<i>The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:</i>
♦	<i>High value or key items</i>
♦	<i>All items over a certain amount</i>
	<i>Nature of the entity or the nature of transactions.</i>
1-11(c)	Audit Sampling
1-12	Inconsistency in or Doubts over Reliability of Audit Evidence
	<i>If:</i>
(a)	<i>audit evidence obtained from one source is inconsistent with that obtained from another; or</i>
(b)	<i>the auditor has doubts over the reliability of information to be used as audit evidence, the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit.</i>
1-13	Relying on the work of a management's expert
(a)	<i>Evaluate the competence, capabilities and objectivity of that expert;</i>
(b)	<i>Obtain an understanding of the work of that expert; and</i>
(c)	<i>Evaluate the appropriateness of that expert's work as audit evidence</i>
2.	USING THE WORK OF INTERNAL AUDITORS(SA 610)
2.1	Definition of Internal Audit Function
	<i>A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.</i>
	<i>The objectives and scope of internal audit functions</i>
(1)	<i>Activities Relating to Governance</i>
(2)	<i>Activities Relating to Risk Management</i>
(3)	<i>Activities Relating to Internal Control</i>
	<i>Evaluation of internal control</i>

	<ul style="list-style-type: none"> • <i>Examination of financial and operating information</i> • <i>Review of operating activities</i> • <i>Review of compliance with laws and regulations</i>
2.2	<i>Ways in which the external auditor may make use of the function for purposes of the audit.</i>
(i)	<i>to obtain information that is relevant to the external auditor's assessments of the risks of material misstatement.</i>
(ii)	<i>May decide to use work that has been performed by the internal audit function.</i>
(iii)	<i>Internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.</i>
2.3	<i>Scope of SA 610</i>
(a)	<i>using the work of the internal audit function</i>
(b)	<i>using internal auditors to provide direct assistance.</i>
2.4	<i>External Auditor's Responsibility for the audit</i>
2.5	<i>Objectives of the external auditor, where the entity has an internal audit function</i>
(a)	<i>To determine whether the work of the internal audit function or direct assistance.</i>
(b)	<i>Determine whether that work is adequate for purposes of the audit; and</i>
(c)	<i>Provide direct assistance, to appropriately direct, supervise and review their work.</i>
2.6	<i>Evaluating the Internal Audit Function</i>
(A)	<i>Organizational status and relevant policies and procedures support the objectivity</i>
(B)	<i>The level of competence</i>
(C)	<i>A systematic and disciplined approach, including quality control.</i>
2.6A	<i>Objectivity and its evaluation</i>
	<i>Factors that may affect the external auditor's evaluation in relation to Objectivity include the following:</i>

1.	<i>The ability of the function to be free from bias, conflict of interest or undue influence.</i>
2.	<i>Oversee employment decisions.</i>
3.	<i>Any constraints or restrictions placed on the internal audit function.</i>
2.6 B	<i>Competence and its evaluation</i>
	<i>Factors that may affect the external auditor's determination in relation to competence include the following:</i>
1.	<i>Internal audit function is adequately and appropriately resourced.</i>
2.	<i>Policies for hiring, training and assigning internal auditors.</i>
3.	<i>Adequate technical training and proficiency.</i>
4.	<i>Knowledge relating to the entity's financial reporting.</i>
2.6 C	<i>Application of a Systematic and Disciplined Approach</i>
	<i>Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following:</i>
1.	<i>The existence, adequacy and use of documented internal audit procedures or guidance</i>
2.	<i>Whether the internal audit function has appropriate quality control policies.</i>
2.7	<i>Circumstances When Work of the Internal Audit Function Cannot Be Used</i>
(a)	<i>Policies and procedures do not adequately support the objectivity.</i>
(b)	<i>The function lacks sufficient competence.</i>
(c)	<i>The function does not apply a systematic and disciplined approach.</i>
2.8	<i>Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used</i>
1.	<i>Testing of the operating effectiveness of controls.</i>
2.	<i>Substantive procedures involving limited judgment.</i>
3.	<i>Observations of inventory counts.</i>
4.	<i>Tracing transactions through the information system.</i>
5.	<i>Testing of compliance with regulatory requirements.</i>

2.9	<i>Circumstances in which the external auditor shall plan to use less of the work of the Internal audit function and perform more of the work directly</i>
(a)	<i>The more judgment is involved in:</i>
(i)	<i>Planning and performing</i>
(ii)	<i>Evaluating the audit evidence gathered;</i>
(b)	<i>The higher the assessed risk of material misstatement</i>
(c)	<i>The less the internal audit function's organizational status.</i>
(d)	<i>The lower the level of competence of the internal audit function.</i>
2.10	<i>Using the Work of the Internal Audit Function</i>
(A)	<i>discuss the planned use of its work with the function.</i>
(B)	<i>read the reports of the internal audit function</i>
(C)	<i>perform sufficient audit procedures on the body of work of the internal audit function.</i>
	<i>Discussion and Coordination with the Internal Audit Function</i>
1.	<i>The timing of such work.</i>
2.	<i>The nature of the work performed.</i>
3.	<i>The extent of audit coverage.</i>
4.	<i>Materiality for the financial statements.</i>
5.	<i>Proposed methods of item selection and sample sizes.</i>
6.	<i>Documentation of the work performed.</i>
7.	<i>Review and reporting procedures.</i>
2.11	<i>Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance</i>
	<i>The external auditor shall not use an internal auditor to provide direct assistance if:</i>
(a)	<i>There are significant threats to the objectivity of the internal auditor; or</i>
(b)	<i>The internal auditor lacks sufficient competence to perform the proposed work.</i>
	<i>The external auditor shall not use internal auditors to provide direct assistance to perform procedures that:</i>
(a)	<i>Involve making significant judgments in the audit;</i>
(b)	<i>Relate to higher assessed risks of material misstatement</i>

	(c) <i>Relate to work with which the internal auditors have been involved</i>
	(d) <i>Relate to decisions the external auditor makes in accordance with this SA.</i>
	<i>Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall:</i>
	(a) <i>Obtain written agreement from an authorized representative of the entity</i>
	(b) <i>Obtain written agreement from the internal auditors that they will keep confidential.</i>
2.12.	<i>Distinction between Internal Financial Control and Internal Control over financial reporting</i>
	<i>The term Internal Financial Controls (IFC) refers to the policies and procedures put in place by companies for ensuring reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws and regulations, safeguarding of assets and prevention and detection of frauds.</i>
	<i>On the other hand, Internal controls over financial reporting is required where auditors are required to express an opinion on the effectiveness of an entity's internal controls over financial reporting, such opinion is in addition to and distinct from the opinion expressed by the auditor on the financial statements.</i>
3.	<i>AUDIT SAMPLING (SA 530)</i>
3.1	<i>Sampling: An Audit Procedure</i>
3.2	<i>Meaning of Audit Sampling</i>
	<i>'Audit sampling' refers to the application of audit procedures to less than 100% of items within a population relevant under the audit, such that all sampling units (i.e all the items in the population) have a equal chance of selection.</i>
3.3	<i>Population</i>
	<i>Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.</i>
3.3.1	<i>Characteristics of Population</i>
1.	<i>Appropriateness: Appropriate means population from which the samples are drawn</i>

shall be relevant.

2. **Completeness:** The population needs to include all relevant items.

3. **Reliable:** Sufficiently complete and accurate.

3.4 Sampling Unit

The individual items that make up the population are known as sampling units. Audit procedures are applied on these units and the conclusions drawn from them are projected on the population.

Sample must be representative

Whatever may be the approach non-statistical or statistical sampling, the sample must be representative.

◆ **SAMPLING PROCESS** is performed on

1. Tests of controls

2. Tests of details

3.5 Approaches to Sampling (Types of Sampling)

Audit sampling can be applied using either

A) non-statistical or

B) statistical sampling approaches.

Statistical sampling is an approach to sampling that has the random selection of the sample units; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

A sampling approach that does not have the above features is considered as **non-statistical sampling**.

3.5 A Statistical Sampling-More Scientific

1. Audit testing done through this approach is more scientific.

2. Statistical sampling has reasonably wide application

3. There is no personal bias

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

3.5 B Non-Statistical Sampling

Composition are determined on the basis of the *personal experience and knowledge* of the auditor.

This approach has been in common application for many years, the auditor on the basis of his personal experience will determine the size of the sample.

An attempt would be made to avoid establishing a pattern of selection year after year.

The non-statistical sampling is criticized on the grounds that it is neither objective nor scientific.

3.6 Sampling Vs Traditional method of Auditing

Auditors realised that they can derive good satisfaction by undertaking a much lesser checking by adoption of this technique in the auditing process.

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

The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

- (i) Size of the organisation under audit.
- (ii) State of the internal control.
- (iii) Adequacy and reliability of books and records.
- (iv) Tolerable error range.
- (v) Degree of the desired confidence.

3.7 Appropriateness of Sampling Approaches

The advantages of statistical sampling may be summarized as follows-

- (1) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
- (2) The sample selection is more objective.
- (3) The method provides a means of estimating the minimum sample size.
- (4) It provides a means for deriving a "calculated risk"

(5)	<i>It may provide a better description of a large mass of data</i>
(6)	<i>It is widely accepted way of sampling as it is more scientific,</i>
3.8	<i>Sampling Process</i>
1.	<i>SAMPLE DESIGN</i>
2.	<i>SAMPLE SIZE</i>
3.	<i>SAMPLE SELECTION</i>
4.	<i>AUDIT PROCEDURES</i>
5.	<i>NATURE AND CAUSE OF DEVIATION AND</i>
6.	<i>PROJECTING</i>
7.	<i>EVALUATING RESULTS OF AUDIT</i>
3.9	<i>Sample Design, Size and Selection of Items for Testing</i>
3.9.1	<i>Sample Design</i>
	<i>When designing an audit sample,</i>
i)	<i>The auditor's consideration includes the specific purpose to be achieved.</i>
ii)	<i>Consideration of the nature of the audit evidence sought and possible deviation.</i>
iii)	<i>In fulfilling the requirement of SA 500 "Audit Evidence".</i>
3.9.1 A	<i>Stratification and Value-Weighted Selection</i>
	<i>Stratification: Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic.</i>
	<i>When performing tests of details, the population is often stratified by monetary value.</i>
	<i>The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum.</i>
	<i>In order to draw an opinion on the overall population, the auditor needs to combine the results of all the stratum to check for possible deviation or risk of material misstatement.</i>
	<i>Value-Weighted Selection: When performing tests of details, it may be efficient to identify the sampling unit as the individual monetary units that make up the population.</i>
	<i>One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.</i>

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

3.9.2 Sample Size

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

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

- (i) the greater the reliance the auditor places on the operating effectiveness of controls sample size will increase.*
- (ii) Increase in the tolerable rate of deviation. Larger will be the sample size.*
- (iii) Increase in the expected rate of deviation of the population larger the sample size.*
- (iv) An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size.*
- (v) There will be negligible effect on sample size due to increase in the number of sampling units in the population.*

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

- (i) The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be.*
- (ii) The more the auditor is relying on other substantive procedures the smaller the sample size can be.*
- (iii) An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population will increase the sample size.*
- (iv) An increase in tolerable misstatement will decrease the sample size.*
- (v) The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size.*
- (vi) When stratification of the population is appropriate then sample size will decrease.*
- (vii) There will be negligible effect on sample size due to number of sampling units in.*

3-9-3	Selection of Items for Testing
	<i>The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.</i>
3-9-3 A	Sample Selection Methods
(1)	<i>Random Sampling: Random selection ensures that all items in the population or within each stratum have a known chance of selection.</i>
(i)	<i>Simple Random Sampling: Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum). It is suitable for a homogeneous population having a similar range.</i>
(ii)	<i>Stratified Sampling: This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences.</i>
(2)	<i>Interval Sampling or Systematic Sampling: Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval. Although the starting point may be determined haphazardly.</i>
(3)	<i>Monetary Unit Sampling: It is a type of value-weighted selection.</i>
(4)	<i>Haphazard sampling: Haphazard selection, in which the auditor selects the sample without following a structured technique. Haphazard sampling has no structured approach, does not involve judgement and does not even use the random number tables.</i>
(5)	<i>Block Sampling: This method involves selection of a block(s) of contiguous items from within the population.</i>
3-10	Performing Audit Procedures
(i)	<i>The auditor shall perform audit procedures, appropriate to the purpose.</i>
(ii)	<i>If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item.</i>

- (iii) *If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation.*
- (iv) *An example of when it is necessary to perform the procedure on a replacement item is when a cancelled cheque is selected while testing for evidence of payment authorization.*
- (v) *An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost.*
- (vi) *An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.*
- (vii) *Another example for replacement of a sample could be, if all transactions of computerized sales are being checked.*

3-11 Nature and Cause of Deviations and Misstatements

- (i) *In analyzing the deviations and misstatements identified, the auditor may observe that many have a common feature.*
 - (ii) *The auditor may decide to identify all items in the population that possess the common feature.*
 - (iii) *The auditor shall investigate the nature and causes of any deviations.*
 - (iv) *Auditor considers a misstatement or deviation discovered in a sample to be an anomaly.*
 - (v) *The auditor shall obtain this degree of certainty.*
- Anomaly may be defined as a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.*

3-12 Projecting Misstatements

- (i) *To obtain a broad view of the scale of misstatement.*
- (ii) *Anomaly, it may be excluded when projecting misstatements to the population.*
- (iii) *For tests of details, the auditor shall project misstatements whereas for tests of controls, no explicit projection of deviations is necessary.*

3-13 Evaluating Results of Audit Sampling

	<i>The auditor shall evaluate-</i>
(a)	<i>The results of the sample; and</i>
(b)	<i>Whether the use of audit sampling has provided a reasonable basis.</i>
	Few Important terms to make the understanding better
	Stratification
	Tolerable misstatement - <i>A monetary amount set by the auditor</i>
	Tolerable rate of deviation - <i>A rate of deviation from prescribed internal control.</i>
4.	AUDIT EVIDENCE-SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS (SA 501)
4.1	Meaning of Audit Evidence- Specific Considerations for Selected Items
	SA 501- "Audit Evidence- Specific Considerations for Selected Items"
4.2	Objective of the Auditor in respect of Specific Considerations for Selected Items
(A)	<i>Existence and condition of inventory;</i>
(B)	<i>Completeness of litigation and claims involving the entity; and</i>
(C)	<i>Presentation and disclosure of segment information.</i>
4.3	Inventory
	When inventory is material to the financial statements.
(1)	Attendance at physical inventory counting.
(i)	<i>Evaluate management's instructions and procedures.</i>
(ii)	<i>Observe the performance of management's count procedures;</i>
(iii)	<i>Inspect the inventory; and</i>
(iv)	<i>Perform test counts.</i>
(2)	Performing audit procedures over the entity's final inventory records.
4.4	Attendance at Physical Inventory Counting
(a)	<i>Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;</i>
(b)	<i>Observing compliance with management's instructions</i>
(c)	<i>Obtaining audit evidence as to the reliability of management's count procedures.</i>

4.5	<i>Matters Relevant in Planning Attendance at Physical Inventory Counting</i>
<i>(a)</i>	<i>Nature of inventory.</i>
<i>(b)</i>	<i>Stages of completion of work in progress.</i>
<i>(c)</i>	<i>The risks of material misstatement related to inventory.</i>
<i>(d)</i>	<i>The nature of the internal control related to inventory.</i>
<i>(e)</i>	<i>Whether adequate procedures are expected to be established.</i>
<i>(f)</i>	<i>The timing of physical inventory counting.</i>
<i>(g)</i>	<i>Whether the entity maintains a perpetual inventory system.</i>
<i>(h)</i>	<i>The locations at which inventory is held</i>
<i>(i)</i>	<i>Whether the assistance of an auditor's expert is needed.</i>
4.6	<i>Physical Inventory Counting Conducted other than at the Date of the Financial Statements</i>
	<i>The auditor shall, in addition to the procedures required above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.</i>
4.7	<i>If the auditor unable to Attend Physical Inventory Counting due to Unforeseen Circumstances</i>
	<i>The auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.</i>
4.8	<i>Attendance at Physical Inventory Counting becomes impractical</i>
	<i>The auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory.</i>
	<i>If it is not possible to do so SA 705.</i>
	<i>In some cases, attendance at physical inventory counting may be impracticable.</i>
	<i>The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure.</i>

In some cases where attendance is impracticable, alternative audit procedures:

In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. SA 705 requires the auditor to modify the opinion.

4-9 *When inventory under the custody and control of a third party- What will the auditor do?*

(a) Request confirmation from the third party.

(b) Perform inspection or other audit procedures appropriate.

For Example

- Inspecting documentation*
- Requesting confirmation*
- Attending, or arranging for another auditor to attend.*
- Obtaining another auditor's report.*

4-10 *Litigation and Claims*

(a) Inquiry of management

(b) Reviewing minutes of meetings

(c) Reviewing legal expense accounts.

4-11 *If the Auditor Assesses a Risk of Material Misstatement regarding Litigation or Claims - Communication with the Entity's External Legal Counsel*

The auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

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

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

If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, the auditor may seek direct

communication through a letter of specific inquiry. A letter of specific inquiry includes:

- (a) A list of litigation and claims;
- (b) Management's assessment of the outcome
- (c) A request that the entity's external legal counsel confirm the reasonableness.

The auditor also may judge it necessary to meet with the entity's external legal counsel.

- i) The auditor determines that the matter is a significant risk.
- ii) The matter is complex.
- iii) There is disagreement between management and the entity's external legal counsel.

Further if:

- (a) Management refuses to give the auditor permission and
- (b) the auditor is unable to obtain sufficient appropriate audit evidence the auditor shall modify the opinion.

4.12 Segment Information

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

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

- (a) Obtaining an understanding of the methods used by management.
 - (i) Evaluating whether such methods are likely to result in disclosure
 - (ii) Where appropriate, testing the application of such methods; and
- (b) Performing analytical procedures.

4.14 Auditor's responsibility regarding the presentation and disclosure of segment information

The auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a stand alone basis.

4.15	Understanding of the Methods Used by Management
	Whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:
1.	Sales, transfers and charges between segments
2.	Comparisons with budgets and other expected results.
3.	The allocation of assets and costs among segments.
4.	Consistency with prior periods.
5.	EXTERNAL CONFIRMATIONS (SA 505);
5.1	Introduction
	SA 500 indicates that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.
5.2	Scope of this SA
	Use of external confirmation procedures to obtain audit evidence.
5.3	Definition of External Confirmation:
	External confirmation may be defined as an audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.
5.4	Definitions of other terms:
◆	Positive confirmation request - A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees.
◆	Negative confirmation request - Respond directly to the auditor only if the confirming party disagrees with the information.
◆	Non-response - A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.
◆	Exception - Difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

5.5	External Confirmation Procedures adopted by the Auditor to Obtain Audit Evidence
(a)	Determining the information to be confirmed or requested;
(b)	Selecting the appropriate confirming party;
(c)	Designing the confirmation requests
(d)	Sending the requests, including follow-up requests
(a)	Determining the Information to be Confirmed or Requested
	Are performed to confirm or request information regarding account balances and their elements.
(b)	Selecting the Appropriate Confirming Party
	Responses to confirmation requests provide more relevant and reliable audit evidence.
(c)	Designing Confirmation Requests
1.	Design of a confirmation request
	May directly affect the confirmation response rate, and the reliability.
2.	Factors to be considered by auditor when designing confirmation requests
(i)	The assertions being addressed.
(ii)	Specific identified risks of material misstatement.
(iii)	The layout and presentation.
(iv)	Prior experience
(v)	The method of communication
(vi)	Management's authorisation
(vii)	The ability of the intended confirming party to confirm.
3.	Positive confirmation request
	Confirming party to reply to the auditor in all cases. A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence. Positive confirmation requests that do not state the amount (or other information) on the confirmation request.
4.	Determination of properly addressed requests
	Testing the validity of some or all of the addresses.
(d)	Follow-Up on Confirmation Requests
	May send an additional confirmation request.

5.6	Management's refusal to allow the auditor to send a confirmation request-steps taken by the Auditor
(a)	Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
(b)	Evaluate the implications of management's refusal.
(c)	Perform alternative audit procedures.
	If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable , or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, SA 260, SA 705.
5.6 (a)	Reasonableness of Management's Refusal
	A common reason advanced is the existence of a legal dispute or ongoing negotiation. The auditor is required to seek audit evidence as to the validity and reasonableness.
5.6.(b)	Implications for the Assessment of Risks of Material Misstatement
	If management's request to not confirm is unreasonable, this may indicate a fraud risk factor that requires evaluation in accordance with SA 240.
5.6.(c)	Alternative Audit Procedures
	Examples of alternative audit procedures the auditor may perform include:
◆	For accounts receivable balances - examining specific subsequent cash receipts.
◆	For accounts payable balances - examining subsequent cash disbursements.
5.7	Negative Confirmations
	Negative confirmations provide less persuasive audit evidence than positive confirmations.
	Accordingly, the auditor shall not use negative confirmation requests unless all of the following are present:
(a)	The auditor has assessed the risk of material misstatement as low.
(b)	The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;
(c)	A very low exception rate is expected; and
(d)	The auditor is not aware of circumstances or conditions.

5.8	Evaluating the Evidence Obtained
	<i>The auditor may categorise such results as follows:</i>
(a)	<i>A response by the appropriate confirming party indicating agreement.</i>
(b)	<i>A response deemed unreliable;</i>
(c)	<i>A non-response; or</i>
(d)	<i>A response indicating an exception.</i>
6.	INITIAL AUDIT ENGAGEMENTS - OPENING BALANCES (SA 510)
6.1	Scope of this SA
	<i>Opening balances when conducting an initial audit engagement.</i>
6.2	Definitions
1.	Initial audit engagement refers to an engagement in which either:
(i)	<i>The financial statements for the prior period were not audited; or</i>
(ii)	<i>The financial statements for the prior period were audited by a predecessor auditor.</i>
2.	Opening balances means those account balances that exist at the beginning of the period.
3.	Predecessor auditor - The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.
6.3	Objective of Auditor with respect to Opening Balances-
(a)	<i>Opening balances contain misstatements that materially affect the current period's financial statements; and</i>
(b)	<i>Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements.</i>
6.4	Obtaining sufficient appropriate Audit evidence about opening balances by the Auditor
	The auditor shall obtain sufficient appropriate audit evidence
(a)	<i>Determining whether the prior period's closing balances have been correctly brought forward to the current period</i>
(b)	<i>Determining whether the opening balances reflect the application of appropriate accounting policies; and</i>

(c)	Performing one or more of the following:
(i)	Where the prior year financial statements were audited, perusing the copies of the audited financial statements;
(ii)	Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances;
(iii)	Performing specific audit procedures to obtain evidence regarding the opening balances. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance.
6.5	Procedures adopted by the Auditor to Obtain Audit Evidence regarding opening balances:
6.5.1	Nature and extent of Audit Procedures Depend on such matters as:
	<ul style="list-style-type: none"> ◆ The accounting policies ◆ The nature of the account balances, classes of transactions and disclosures. ◆ The significance of the opening balances. ◆ Whether the prior period's financial statements were audited.
6.5.2	If the prior period's financial statements were audited by a predecessor auditor The current auditor can place reliance except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.
6.5.3	For current assets and liabilities For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures.
6.5.4	For non- current assets and liabilities <ul style="list-style-type: none"> ◆ such as property plant and equipment, investments and long-term debt, some audit evidence may be obtained by examining the accounting records and other information ◆ In certain cases, the auditor may be able to obtain some audit evidence regarding

opening balances through confirmation with third parties.

6.6 Consistency of Accounting Policies relating to opening balances

If the auditor concludes that:

- ◆ *Accounting policies are not consistently applied.*
- ◆ *a change in accounting policies is not properly accounted*

The auditor shall express a qualified opinion or an adverse opinion as appropriate in accordance with SA 705.

6.7 Reporting by the auditor with regard to opening balances

- ◆ *If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.*
- ◆ *If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, qualified opinion or an adverse opinion, as appropriate, in accordance with SA 705.*

7. RELATED PARTIES (SA 550)

7.1 Scope of this SA

Auditor's responsibilities regarding related party relationships and transactions.

7.2 Definition of Related Party

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

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

7.3 Meaning of control and significant influence in reference to related party

(a) Power to govern the financial and operating policies.

(b) Significant influence is the power to participate in the financial and operating policy.

The existence of the following relationships may indicate the presence of control or significant influence:

(i) Direct or indirect equity holdings or other financial interests.

(ii) The entity's holdings of direct or indirect equity or other financial interests.

(iii) Being part of those charged with governance or key management

(iv) Being a close family member of any person referred to in subparagraph (iii).

(v) Having a significant business relationship with any person referred to in subparagraph (iii).

7.4 Meaning of Related Parties with Dominant Influence

Ability to exert control or significant influence, may be in a position to exert dominant influence.

7.5 Meaning of Special-Purpose Entities as Related Parties

Entity may in substance control.

7.6 Nature of Related Party Relationships and Transactions

Many related party transactions are in the normal course of business.

However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement.

For example

(A) Related parties may operate through an extensive and complex range of relationships

(B) Information systems may be ineffective.

(C) Related party transactions may not be conducted under normal market terms

7.7	<i>Understanding the Entity's Related Party Relationships & Transactions</i>
	<i>The auditor shall inquire of management regarding:</i>
(a)	<i>The identity of the entity's related parties, including changes</i>
(b)	<i>The nature of the relationships between the entity and these related parties;</i>
(c)	<i>Whether the entity entered into any transactions with these related parties</i>
	<i>The auditor shall inquire of management to obtain an understanding of the controls, if any, that management has established to -</i>
(a)	<i>Identify, account for, and disclose related party relationships and transactions</i>
(b)	<i>Authorise and approve significant transactions and arrangements with related parties;</i>
(c)	<i>Authorise and approve significant transactions and arrangements outside the normal course of business.</i>
7.8	<i>Considerations specific to smaller entities by the auditor</i>
	<i>Control activities in smaller entities are likely to be less formal and smaller entities may have no documented processes for dealing with related party relationships and transactions.</i>
7.9	<i>How can an auditor verify the existence of related party relationships and transactions?</i>
	<i>The auditor should maintain alertness for related party information while reviewing records and documents.</i>
1.	<i>Entity income tax returns.</i>
2.	<i>Information supplied by the entity to regulatory authorities.</i>
3.	<i>Shareholder registers</i>
4.	<i>Statements of conflicts of interest from management.</i>
5.	<i>Records of the entity's investments.</i>
6.	<i>Contracts and agreements with key management.</i>
7.	<i>Significant contracts and agreements.</i>
8.	<i>Specific invoices and correspondence.</i>
9.	<i>Life insurance policies.</i>

8.	ANALYTICAL PROCEDURES (SA 520)
8.1	Meaning of Analytical Procedures
	<i>“Analytical procedures” means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.</i>
	<i>Examples of Analytical Procedures having consideration of comparisons of the entity’s financial information are:</i>
	<ul style="list-style-type: none"> ◆ <i>Comparable information for prior periods.</i> ◆ <i>Anticipated results of the entity.</i> ◆ <i>Similar industry information.</i> ◆ <i>Among elements of financial information that would be expected to conform to a predictable pattern.</i> ◆ <i>Between financial information and relevant non-financial information.</i>
8.2	Scope of SA 520
	<i>The objectives of the auditor are:</i>
	(a) <i>To obtain relevant and reliable audit evidence.</i>
	(b) <i>To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion.</i>
8.3	Purpose and timing of Analytical Procedures
8.3A	Purpose of Analytical Procedures
	<i>Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.</i>
8.3 B	Timing of Analytical Procedures
	<ul style="list-style-type: none"> • <i>Planning Phase</i> • <i>Testing Phase</i> • <i>Completion Phase</i>
8.3 C	Analytical Procedures in Planning the Audit
	<i>In identifying areas of potential risk</i>

8.4	Substantive Analytical Procedures
	<i>The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures.</i>
8.5	Factors to be considered for Substantive Audit Procedures
(i)	<i>Availability of Data</i>
(ii)	<i>Disaggregation</i>
(iii)	<i>Account Type</i>
(iv)	<i>Source</i>
(v)	<i>Predictability</i>
(vi)	<i>Nature of Assertion</i>
(vi)	<i>Inherent Risk or "What Can Go Wrong"</i>
8.6	Techniques available as Substantive Analytical Procedures
(i)	<i>Trend analysis - Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances.</i>
(ii)	<i>Ratio analysis - Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts.</i>
(iii)	<i>Reasonableness tests - This analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period.</i>
(iv)	<i>Structural modelling - A modelling tool constructs a statistical model.</i>
8.7	Analytical Procedures used as Substantive Tests
	<i>When designing and performing substantive analytical procedures.</i>
(i)	<i>Determine the suitability of particular substantive analytical procedures.</i>
(ii)	<i>Evaluate the reliability of data</i>
(iii)	<i>Develop an expectation of recorded amounts or ratios</i>
(iv)	<i>Determine the amount of any difference</i>
8.8	Suitability of particular analytical procedures for given assertions

1.	<i>More applicable to large volumes</i>
2.	<i>Is based on the expectation</i>
3.	<i>Depend upon the auditor's assessment of how effective it will be in detecting a misstatement.</i>
4.	<i>Even an unsophisticated predictive model may be effective.</i>
8-9	<i>The reliability of DATA</i>
(i)	<i>Source of the information available.</i>
(ii)	<i>Comparability of the information available.</i>
(iii)	<i>Nature and relevance of the information available.</i>
(iv)	<i>Controls over the preparation of the information.</i>
8-10	<i>Evaluation of whether the expectation is sufficiently precise</i>
	<i>Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement.</i>
(i)	<i>The accuracy with which the expected results of substantive analytical procedures</i>
(ii)	<i>The degree to which information can be disaggregated.</i>
(iii)	<i>The availability of the information, both financial and non-financial.</i>
8-11	<i>Amount of difference of recorded amounts from expected values that is acceptable</i>
	<i>The auditor's determination of the amount of difference from the expectation that can be accepted without further investigation.</i>
8-12	<i>Investigating results of Analytical Procedures</i>
(i)	<i>Inquiring of management and obtaining appropriate audit evidence.</i>
(ii)	<i>Performing other audit procedures as necessary in the circumstances.</i>
8-13	<i>Analytical procedures that assist when forming an overall conclusion</i>
	<i>Are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements.</i>

CHAPTER - 5

AUDIT OF ITEMS OF FINANCIAL STATEMENTS

1) INCOME STATEMENT CAPTIONS COMPRISING REVENUE AND EXPENSE

BALANCES:

i) Occurrence:

Transactions recognized in the financial statements have occurred and relate to the entity.

ii) Completeness:

All transactions that were supposed to be recorded have been recognized in the financial statements.

iii) Cut-off:

Whether all income and expenses are reported in the appropriate period. Cut-off is a separate assertion because the substantive procedures to verify it are typically different from those applied to the other components of completeness.

iv) Measurement:

Transactions have been recorded accurately at their appropriate amounts in the financial statements.

v) Presentation and Disclosure:

Transactions have been classified and presented fairly in the financial statements. Presentation and disclosure assertions are considered during the course of the audit by procedures to determine that disclosures are complete and accurate.

2) BALANCE SHEET CAPTIONS COMPRISING ASSETS, LIABILITIES AND EQUITY

BALANCES:

i) Existence: Assets, liabilities and equity balances exist as at the period end.

ii) Completeness: All assets, liabilities and equity balances that were supposed to be recorded have been recognized in the financial statements

iii) Cut-off: Whether all assets and liabilities are reported in the appropriate period.

iv) Valuation: Assets, liabilities and equity balances have been valued appropriately.

v) Rights & Obligations: Entity has the right to assets i.e.

(whether the entity has ownership and title to assets) and the liabilities recognized in the financial statements represent all the entity's obligations at a given date.

vi) **Presentation and Disclosure:** Whether particular items in the financial statements are properly classified, described and disclosed.

REFER MAIN BOOK CONTENT

CHAPTER - 6

AUDIT DOCUMENTATION

1.	AUDIT DOCUMENTATION
	<i>SA 230 on "Audit Documentation"</i>
1.1	Definition of Audit Documentation:
	<i>Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.</i>
1.2	Objective of the Auditor:
(a)	<i>A sufficient and appropriate record of the basis for the auditor's report; and</i>
(b)	<i>Evidence that the audit was planned and performed in accordance with SAs</i>
1.3	Nature of Audit Documentation
(a)	<i>evidence of the auditor's basis for a conclusion</i>
(b)	<i>evidence that the audit was planned and performed in accordance with SAs</i>
1.4	Purpose of Audit Documentation
1.	<i>Assisting the engagement team to plan and perform the audit.</i>
2.	<i>Assisting members of the engagement team to direct and supervise the audit work</i>
3.	<i>Enabling the engagement team to be accountable for its work.</i>
4.	<i>Retaining a record of matters of continuing significance to future audits.</i>
5.	<i>Enabling the conduct of quality control reviews</i>
6.	<i>Enabling the conduct of external inspections</i>
1.5	Form, Content and Extent of Audit Documentation
(a)	<i>The nature, timing and extent of the audit procedures performed.</i>
(b)	<i>The results of the audit procedures performed and the audit evidence obtained and</i>
(c)	<i>Significant matters arising during the audit and the conclusions reached</i>
♦	<i>Further in documenting the nature, timing and extent of audit procedures,</i>

(a)	<i>The identifying characteristics of the specific items or matters tested.</i>
(b)	<i>Who performed the audit work and the date such work was completed;</i>
(c)	<i>Who reviewed the audit work performed and the date and extent of such review.</i>
◆	<i>The auditor shall document discussions of significant matters with management</i>
◆	<i>If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter</i>
	<i>The form, content and extent of audit documentation depend on factors such as:</i>
1.	<i>The size and complexity of the entity.</i>
2.	<i>The nature of the audit procedures to be performed.</i>
3.	<i>The identified risks of material misstatement.</i>
4.	<i>The significance of the audit evidence obtained.</i>
5.	<i>The nature and extent of exceptions identified.</i>
6.	<i>The need to document a conclusion.</i>
7.	<i>The audit methodology and tools used.</i>
1.6	<i>Examples of Audit Documentation</i>
	<i>Audit Documentation Include:</i>
	<i>Audit programmes</i>
	<i>Analyses</i>
	<i>Issues memoranda</i>
	<i>Summaries of significant matters</i>
	<i>Letters of confirmation and representation</i>
	<i>Checklists</i>
	<i>Correspondence</i>
1.7	<i>Timely Preparation of Audit Documentation</i>
	<i>The auditor shall prepare audit documentation on a timely basis.</i>
1.8	<i>Audit File</i>

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

1-9 Assembly of the Final Audit File

- ◆ *SQC 1 “Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services”.*
- ◆ *Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.*

Examples of such changes include:

- *Deleting or discarding superseded documentation.*
- *Sorting, collating and cross-referencing working papers.*
- *Signing off on completion checklists*

1-10 Documentation of Significant Matters and Related Significant Professional Judgements

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

Matters that give rise to significant risks.

- *Results of audit procedures indicating (a) that the financial statements could be materially misstated, (b) a need to revise the auditor’s previous assessment.*
- *Circumstances that cause the auditor significant difficulty*
- *Findings that could result in a modification to the audit opinion*

1-11 Completion Memorandum or Audit Documentation Summary

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

Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits.

1-12 Ownership of Audit Documentation

- ◆ *Standard on Quality Control (SQC) 1*

CHAPTER - 7

COMPLETION AND REVIEW

1.	<i>SUBSEQUENT EVENTS</i>
1.1	<i>Subsequent events</i>
A.	<i>Events occurring between the date of the financial statements and the date of the auditor's report</i>
B.	<i>Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued</i>
C.	<i>Facts which become known to the auditor after the financial statements have been issued</i>
1.2	<i>Objectives of auditor in accordance with SA 560</i>
(a)	<i>Obtain sufficient appropriate audit evidence</i>
(b)	<i>Respond appropriately to facts</i>
1.3	<i>Audit procedures relating to events occurring between the date of the financial statements and the date of the auditor's report</i>
(a)	<i>Obtaining an understanding of any procedures management has established</i>
(b)	<i>Inquiring of management</i>
(c)	<i>Reading minutes if</i>
(d)	<i>Reading the entity's latest subsequent interim financial statements</i>
	<i>The auditor shall request management to provide a written representation.</i>
1.4	<i>Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued</i>
(a)	<i>Discuss the matter with management</i>
(b)	<i>Determine whether the financial statements need amendment and, if so,</i>
(c)	<i>Inquire how management intends to address the matter.</i>
	<i>If management amends the financial statements, the auditor shall:</i>

(a)	Carry out the audit procedures necessary in the circumstances.
(b)	Unless the circumstances in succeeding para apply
(i)	Extend the audit procedures, already referred, to the date of the new auditor's report and
(ii)	Provide a new auditor's report on the amended financial statements.
	When law, regulation or the financial reporting framework does not prohibit management from restricting the amendment
	In such cases, the auditor shall either:-
(a)	Amend the auditor's report to include an additional date or
(b)	Provide a new or amended auditor's report that
	In some entities, management may not be required by the applicable law, regulation or the financial reporting framework to issue amended financial statements
(a)	If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion as required by SA 705 or
(b)	If the auditor's report has already been provided to the entity, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, not to issue the financial statements to third parties before the necessary amendments.
1.5	Facts which become known to the auditor after the financial statements have been issued
(a)	Discuss the matter with management
(b)	Determine whether the financial statements need amendment and, if so,
(c)	Inquire how management intends to address the matter
	If the management amends the financial statements, the auditor shall:-
(a)	Carry out the audit procedures necessary in the circumstances on the amendment.
(b)	Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is

	<i>informed of the situation.</i>
(c)	<i>Unless such circumstances when law, regulation or the financial reporting framework does not prohibit management.</i>
(i)	<i>Extend the audit procedures</i>
(ii)	<i>Provide a new auditor's report on the amended financial statements.</i>
(d)	<i>When the circumstances are such that law, regulation or the financial reporting framework does not prohibit management amend the auditor's report, or provide a new auditor's report as already discussed.</i>
	<i>If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management.</i>
	<i>If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.</i>
2.	MEANING OF GOING CONCERN AND ITS SIGNIFICANCE
	<i>Going concern is one of the fundamental accounting assumptions.</i>
2.1	SA 570 Going Concern
	<i>SA 570 Going Concern deals with the auditor's responsibilities</i>
2.2	Responsibility for assessment of the entity's ability to continue as a going concern
	<i>The following factors are relevant to that judgment:-</i>
◆	<i>The degree of uncertainty associated with the outcome of an event or condition</i>
◆	<i>The size and complexity of the entity</i>
◆	<i>Any judgment about the future is based on information available</i>
2.3	Responsibilities of the auditor
	<i>Obtain sufficient appropriate audit evidence regarding and conclude on the appropriateness of management's use.</i>

2.4	Objectives of auditor in accordance with SA 570
(a)	To obtain sufficient appropriate audit evidence
(b)	To conclude based on the audit evidence obtained
(c)	To report in accordance with this SA
2.5	Risk assessment procedures and related activities
(a)	If such an assessment has been performed, the auditor shall discuss the assessment with management.
(b)	If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern.
	Examples of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern
	<u>Financial events or conditions</u>
◆	Net liability or net current liability position
◆	Fixed-term borrowings approaching maturity without realistic prospects
◆	Indications of withdrawal of financial support by creditors
◆	Negative operating cash flows
◆	Adverse key financial ratios
◆	Substantial operating losses
◆	Arrears or discontinuance of dividends
◆	Inability to pay creditors on due dates
◆	Inability to comply with the terms of loan agreements
◆	Change from credit to cash-on-delivery transactions with suppliers
◆	Inability to obtain financing for essential new product development
	<u>Operating events or conditions</u>
◆	Management intentions to liquidate the entity or to cease operations
◆	Loss of key management without replacement
◆	Loss of a major market
◆	Labour difficulties
◆	Shortages of important supplies

	◆ <i>Emergence of a highly successful competitor</i>
	<u>Other events or conditions</u>
	◆ <i>Non-compliance with capital or other statutory or regulatory requirements</i>
	◆ <i>Pending legal or regulatory proceedings</i>
	◆ <i>Changes in law or regulation or government policy</i>
	◆ <i>Uninsured or underinsured catastrophes when they occur</i>
2.6	<i>Evaluating management's assessment</i>
	<i>It is not the auditor's responsibility to rectify the lack of analysis by management.</i>
	<i>If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the date of the financial statements, the auditor shall request management to extend its assessment period to at least twelve months from that date.</i>
2.7	<i>Additional audit procedures when events or conditions are identified</i>
	(a) <i>Requesting management to make its assessment.</i>
	(b) <i>Evaluating management's plans for future actions</i>
	(c) <i>Where the entity has prepared a cash flow forecast, and analysis</i>
	(i) <i>Evaluating the reliability of the underlying data</i>
	(ii) <i>Determining whether there is adequate support for the assumptions.</i>
	(d) <i>Considering whether any additional facts or information.</i>
	(e) <i>Requesting written representations from management</i>
2.8	<i>Auditor's conclusions</i>
	<i>Appropriate disclosure of the nature and implications of the uncertainty is necessary.</i>
2.9	<i>Adequacy of disclosures when events or conditions have been identified and a material uncertainty exists</i>
	(a) <i>Adequately disclose the principal events or conditions</i>
	(b) <i>Disclose clearly that there is a material uncertainty</i>
2.10	<i>Adequacy of disclosures when events or conditions have been identified but no material</i>

uncertainty exists

The auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions.

2.11 Implications for the auditor's report

(I) *If use of Going concern basis of accounting is inappropriate - the auditor shall express an adverse opinion.*

(II) *If use of going concern basis of accounting is appropriate but a material uncertainty exists*

(A) Adequate Disclosure of a Material Uncertainty is made in the Financial Statements

The auditor shall express an unmodified opinion the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:-

(B) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements

The auditor shall:

(a) *Express a qualified opinion or adverse opinion,*

(b) *In the Basis for Qualified (Adverse) Opinion*

(III) Management unwilling to make or extend its assessment

A qualified opinion or a disclaimer of opinion

3. EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

3.1 SA 450 Evaluation of Misstatements Identified during the Audit

Auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements.

3.2 Objectives of auditor in accordance with SA 450

(a) *The effect of identified misstatements on the audit and*

(b) *The effect of uncorrected misstatements*

3.3 Accumulation of misstatements identified during the audit

3.4 Consideration of identified misstatements as the audit progresses

	<i>The auditor shall determine whether the overall audit strategy and audit plan need to be revised if:</i>
(a)	<i>The nature of identified misstatements when aggregated with misstatements accumulated during the audit, could be material or</i>
(b)	<i>The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320.</i>
3.5	<i>Communication and correction of misstatements</i>
	<i>The auditor shall communicate on a timely basis all misstatements with the appropriate level of management, unless prohibited by law or regulation.</i>
	<i>If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons.</i>
3.6	<i>Evaluating the effect of uncorrected misstatements</i>
	<i>The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:-</i>
(a)	<i>The size and nature of the misstatements, and</i>
(b)	<i>The effect of uncorrected misstatements related to prior periods</i>
3.7	<i>Communication with those charged with governance</i>
3.8	<i>Written Representation from management regarding effects of uncorrected statements</i>
	<i>A summary of such items shall be included in or attached to the written representation.</i>
3.9	<i>Documentation regarding misstatements identified during audit</i>
	<i>The audit documentation shall include:-</i>
(a)	<i>The amount below which misstatements would be regarded as clearly trivial;</i>
(b)	<i>All misstatements accumulated</i>
(c)	<i>The auditor's conclusion as to whether uncorrected misstatements are material</i>

4.	WRITTEN REPRESENTATIONS
4.1	Written representations as audit evidence
	<i>Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfilment of management's responsibilities, or about specific assertions.</i>
4.2	SA 580- Written Representations
	<i>Deals with the auditor's responsibility to obtain written representations</i>
4.3	Objectives of auditor in accordance with SA 580
(a)	<i>To obtain written representations</i>
(b)	<i>To support other audit evidence</i>
(c)	<i>To respond appropriately</i>
4.4	From whom written representations are requested by auditor?
	<i>The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.</i>
4.5	Written representations about management's responsibilities
(I)	<i>Preparation of the financial statements</i>
(II)	<i>Information provided and completeness of transactions</i>
	<i>The auditor shall request management to provide a written representation that: -</i>
(a)	<i>It has provided the auditor with all relevant information and access as agreed.</i>
(b)	<i>All transactions have been recorded and are reflected in the financial statements.</i>
4.6	Why written representations about management responsibilities are necessary?
	<i>This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed.</i>

4-7	Description of management's responsibilities in the written representations
4-8	Other Written representations They may include representations about the following:- <ul style="list-style-type: none"> ◆ Whether the selection and application of accounting policies are appropriate; and ◆ Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognized, measured, presented or disclosed <ul style="list-style-type: none"> ▪ Plans or intentions that may affect the carrying value of assets ▪ Liabilities, both actual and contingent; ▪ Title to, or control over, assets ▪ Aspects of laws, regulations and contractual agreements
4-9	Additional Written representations about information provided to the auditor
4-10	Written representations about specific assertions When obtaining evidence about, or evaluating, judgments and intentions, the auditor may consider one or more of the following: <ul style="list-style-type: none"> ◆ The entity's past history in carrying out its stated intentions. ◆ The entity's reasons for choosing a particular course of action. ◆ The entity's ability to pursue a specific course of action. ◆ The existence or lack of any other information
4-11	Date of and Period (s) covered by Written Representations Shall be as near as practicable to, <i>but not after</i> , the date of the auditor's report on the financial statements.
4-12	Form of Written representations The written representations shall be in the form of a representation letter addressed to the auditor.
4-13	Doubt as to the reliability of written representations

If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705.

4-14 Requested Written representations not provided

- (a) Discuss the matter with management;
- (b) Re-evaluate the integrity of management
- (c) Take appropriate actions

4-15 Disclaimer of opinion in case of non-reliability of Written Representations about management's responsibilities or failure to provide such Written Representations

The auditor shall disclaim an opinion

- (a) The auditor concludes that there is sufficient doubt about the integrity of management.
- (b) Management does not provide the written representations relating to fulfilling its responsibilities.

5. SIGNIFICANCE OF COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

An effective two-way communication is important in assisting:-

- (a) Constructive working relationship
- (b) Information relevant to the audit.
- (c) Fulfilling their responsibility

5-1 Who are "Those charged with governance"?

The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity.

5-2 Scope of SA 260- Communication with Those Charged with Governance

Auditor's responsibility to communicate with those charged with governance.

5-3 Objectives of auditor in accordance with SA 260

(a)	To communicate clearly with those charged with governance
(b)	To obtain from those charged with governance information relevant to the audit;
(c)	To provide those charged with governance with timely observations
(d)	To promote effective two-way communication.
5.4	Determining appropriate persons with whom to communicate
5.5	Matters to be communicated by auditor
(a)	The auditor's responsibilities in relation to the financial statement audit
♦	The auditor is responsible for forming and expressing an opinion
♦	The audit of the financial statements does not relieve management
(b)	Planned scope and timing of the audit
(c)	Significant findings from the audit
(a)	The auditor's views about significant qualitative aspects of the entity's accounting practices including accounting policies, accounting estimates.
(b)	Significant difficulties, if any, encountered during the audit;
(c)	Unless all of those charged with governance are involved in managing the entity:-
(i)	Significant matters
(ii)	Written representations the auditor is requesting
(d)	Circumstances that affect the form and content of the auditor's report
(e)	Any other significant matters
5.6	Communication of auditor's independence in case of listed entities
	In the case of listed entities
(a)	A statement that the engagement team and others in the firm as appropriate have complied with relevant ethical requirements regarding independence
(b)	
(i)	All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence.
(ii)	The related safeguards
5.7	The Communication process

The auditor shall communicate with those charged with governance on a timely basis.

5.8 Adequacy of the communication process

If it has not, the auditor shall evaluate the effect.

5.9 Documentation

6. WHY COMMUNICATION OF SIGNIFICANT DEFICIENCIES IN INTERNAL CONTROL IS NECESSARY?

6.1 Scope of SA 265- Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

Auditor's responsibility to communicate appropriately

6.2 Objective of auditor in accordance with SA 265

Deficiencies in internal control that the auditor has identified during the audit.

6.3 Meaning of "Deficiency in internal control" and "significant deficiency in internal control"

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

(i) *A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements*

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

(b) Significant deficiency in internal control - Is of sufficient importance to merit the attention of those charged with governance.

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

- ◆ *The likelihood of the deficiencies leading to material misstatements*
- ◆ *The susceptibility to loss or fraud of the related asset or liability.*
- ◆ *The subjectivity and complexity of determining estimated amounts.*
- ◆ *The financial statement amounts exposed to the deficiencies.*
- ◆ *The volume of activity that has occurred or could in the account balance.*

♦	<i>The importance of the controls to the financial reporting process,</i>
(b - 1)	<i>Examples of indicators of significant deficiencies in internal control</i>
♦	<i>Evidence of ineffective aspects of the control environment, such as:-</i>
	▪ <i>Indications that significant transactions</i>
	▪ <i>Identification of management fraud</i>
	▪ <i>Management's failure to implement appropriate remedial action</i>
♦	<i>Absence of a risk assessment process</i>
♦	<i>Evidence of an ineffective entity risk assessment process</i>
♦	<i>Evidence of an ineffective response to identified significant risks</i>
♦	<i>Misstatements detected by the auditor's procedures</i>
♦	<i>Disclosure of a material misstatement due to error or fraud as prior period items.</i>
♦	<i>Evidence of management's inability to oversee the preparation</i>
6.4	<i>Determination of significant deficiencies in internal control</i>
6.5	<i>Communication of significant deficiencies in internal control to those charged with governance</i>
	<i>The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis:-</i>
(a)	<i>In writing, significant deficiencies in internal control</i>
(b)	<i>Other deficiencies in internal control</i>
	<i>The auditor shall include in the written communication of significant deficiencies in internal control:-</i>
(a)	<i>A description of the deficiencies</i>
(b)	<i>Sufficient information</i>
	<i>In particular, the auditor shall explain that: -</i>
(i)	<i>The purpose of the audit</i>
(ii)	<i>The audit included consideration of internal control relevant to the preparation of the financial statements.</i>
(iii)	<i>The matters being reported are limited to those deficiencies that the auditor has identified during the audit.</i>

CHAPTER - 8

AUDIT REPORT

1.	INTRODUCTION
	<i>The purpose of an audit is to enhance the degree of confidence of intended users of the financial statements.</i>
2.	FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS
	<i>SA 700 (Revised)- "Forming an Opinion and Reporting on Financial Statements".</i>
2.1	Objective of the Auditor
	<i>The objectives of the auditor as per SA 700 (Revised) are:</i>
	<i>◆ To form an opinion on the financial statements</i>
	<i>◆ To express clearly that opinion through a written report</i>
2.2	To Form Opinion - Auditor to Obtain Reasonable Assurance
	<i>That conclusion shall take into account:</i>
(a)	<i>Whether sufficient appropriate audit evidence has been obtained;</i>
(b)	<i>Whether uncorrected misstatements are material, individually or in aggregate;</i>
(c)	<i>The evaluations</i>
2.3	Evaluations by the Auditor
	<i>The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.</i>
	<i>This evaluation shall include consideration of the qualitative aspects.</i>
2.3.1	Qualitative Aspects of the Entity's Accounting Practices
1.	<i>Management makes a number of judgements.</i>
2.	<i>SA 260 (Revised) contains a discussion of the qualitative aspects.</i>
3.	<i>Indicators of a lack of neutrality include the following:</i>
(i)	<i>The selective correction of misstatements brought to management's attention</i>
(ii)	<i>Possible management bias in the making of accounting estimates.</i>

4.	<i>SA 540 addresses possible management bias in making accounting estimates.</i>
2.4	<i>Specific Evaluations by the Auditor</i>
(a)	<i>The financial statements adequately disclose the significant accounting policies</i>
(b)	<i>The accounting policies selected and applied are consistent</i>
(c)	<i>The accounting estimates made by management are reasonable;</i>
(d)	<i>The information presented in the financial statements is relevant, reliable, comparable, and understandable;</i>
(e)	<i>The financial statements provide adequate disclosures</i>
(f)	<i>The terminology used in the financial statements</i>
	<i>Evaluation by the auditor as to whether the financial statements achieve fair presentation which shall include consideration of:</i>
(a)	<i>The overall presentation, structure and content of the financial statements; and</i>
(b)	<i>Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.</i>
2.5	<i>Definitions</i>
(a)	<i>General purpose financial statements</i>
(b)	<i>General purpose framework - common financial information needs of a wide range of users.</i>
(c)	<i>Unmodified opinion</i>
3.	<i>FORM OF OPINION</i>
	<i>Unmodified Opinion</i>
	<i>Modified Opinion: If the auditor:</i>
(a)	<i>The financial statements as a whole are not free from material misstatement; or</i>
(b)	<i>is unable to obtain sufficient appropriate audit evidence</i>
4.	<i>AUDITOR'S REPORT</i>
	<i>The auditor's report shall be in writing.</i>

	<i>Basic Elements of an Audit Report are given below:</i>
1.	<i>Title</i>
2.	<i>Addressee</i>
3.	<i>Auditor's Opinion</i>
	<i>The Opinion section of the auditor's report shall also:</i>
◆	<i>Identify the entity whose financial statements have been audited;</i>
◆	<i>State that the financial statements have been audited;</i>
◆	<i>Identify the title of each statement comprising the financial statements;</i>
◆	<i>Refer to the notes, including the summary of significant accounting policies; and</i>
◆	<i>Specify the date of, or period covered by, each financial statement comprising the financial statements.</i>
	<i>Unmodified Opinion:</i>
	<i>The phrases "present fairly, in all material respects," and "give a true and fair view" are regarded as being equivalent</i>
	<i>When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as "with the foregoing explanation" or "subject to" in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.</i>
4.	<i>Basis for Opinion</i>
1.	<i>States that the audit was conducted in accordance with Standards on Auditing;</i>
2.	<i>Refers to the section that describes the auditor's responsibilities.</i>
3.	<i>Includes a statement that the auditor is independent of the entity</i>
4.	<i>The audit evidence the auditor has obtained is sufficient and appropriate.</i>
5.	<i>Going Concern:</i>
6.	<i>Key Audit Matters</i>
7.	<i>Responsibilities for the Financial Statements:</i>
(a)	<i>Preparing the financial statements and for such internal control as management determines is necessary.</i>
(b)	<i>Assessing the entity's ability to continue as a going concern.</i>
8.	<i>Auditor's Responsibilities for the Audit of the Financial Statements:</i>
1.	<i>This section of the auditor's report shall state:</i>
(a)	<i>That the objectives of the auditor are to:</i>

(i)	Obtain reasonable assurance
(ii)	Issue an auditor's report
(b)	That reasonable assurance is a high level of assurance, but is not a guarantee
(c)	That misstatements can arise from fraud or error, and either
(i)	Describe that they are considered material
(ii)	Provide a definition or description of materiality
II.	The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further:
	Auditor's responsibility section to further
(a)	the auditor exercises professional judgement and maintains professional skepticism.
(b)	Describe an audit by stating that the auditor's responsibilities are:
◆	To identify and assess the risks of material misstatement
◆	To obtain an understanding of internal control.
◆	To evaluate the appropriateness of accounting policies.
◆	To conclude on the appropriateness of management's use of the going concern basis.
◆	Overall presentation, structure and content of the financial statements.
(c)	When SA 600 applies, further describe the auditor's responsibilities
III.	The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall:
(a)	the planned scope and timing of the audit and significant audit findings
(b)	For audits of financial statements of listed entities, that the auditor has complied with relevant ethical requirements regarding independence
(c)	For audits of financial statements of listed entities key audit matters are communicated in accordance with SA 701,
9.	Location of the description of the auditor's responsibilities for the audit of the financial statements:
◆	Within the body of the auditor's report
◆	Within an appendix to the auditor's report
◆	A website of an appropriate authority
10.	Other Reporting Responsibilities
11.	Signature of the Auditor

12.	<i>Place of Signature</i>
13.	<i>Date of the Auditor's Report</i>
	<i>UDIN</i>
	<i>Chartered Accountants having full-time Certificate of Practice can register on UDIN Portal and generate UDIN by registering the certificates attested/certified by them.</i>
	<i>Accordingly, an auditor is required to mention the UDIN with respect to each audit report being signed by him, along with his membership number while signing an audit report.</i>
5.	<i>AUDITOR'S REPORT PRESCRIBED BY LAW OR REGULATION</i>
(a)	<i>A title.</i>
(b)	<i>An addressee</i>
(c)	<i>An Opinion section</i>
(d)	<i>An identification of the entity's financial statements that have been audited.</i>
(e)	<i>A statement that the auditor is independent.</i>
(f)	<i>Going concern as per SA 570 (Revised).</i>
(g)	<i>Basis for Qualified (or Adverse) Opinion section</i>
(h)	<i>Information required by SA 701</i>
(i)	<i>A description of management's responsibilities</i>
(j)	<i>A reference to Standards on Auditing</i>
(k)	<i>The auditor's signature.</i>
(l)	<i>The Place of signature.</i>
(m)	<i>The date of the auditor's report.</i>
6.	<i>MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT</i>
	<i>Standard on Auditing (SA) 705 "Modifications to the Opinion in the Independent Auditor's Report".</i>
6.1	<i>Circumstances When a Modification to the Auditor's Opinion Is Required</i>
◆	<i>The financial statements as a whole are not free from material misstatement; or</i>
◆	<i>The auditor is unable to obtain sufficient appropriate audit evidence.</i>

6.2	Objective of the Auditor- To Express Clearly an Appropriately Modified Opinion
6.3	Types of Modified Opinions:
1.	A qualified opinion
2.	An adverse opinion
3.	A disclaimer of opinion
6.3.1.	Qualified Opinion
	The auditor shall express a qualified opinion when:
(a)	Concludes that misstatements, individually or in the aggregate, are material, but not pervasive or
(b)	The auditor is unable to obtain sufficient appropriate audit evidence auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.
6.3.2.	Adverse Opinion
	Obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
6.3.2.1	Definition of Pervasive
(i)	Are not confined to specific elements, accounts or items of the financial statements;
(ii)	If so confined, represent or could represent a substantial proportion
(iii)	In relation to disclosures, are fundamental to users' understanding
6.3.3.	Disclaimer of Opinion: The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.
6.4	Which type of opinion is appropriate?
(a)	The nature of the matter giving rise to the modification
(b)	The auditor's judgement about the pervasiveness of the effects or possible effects
6.5	Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management- Imposed Limitation after the Auditor Has Accepted the Engagement
1)	the auditor shall request that management remove the limitation.

2)	<i>If management refuses to remove the limitation referred above, the auditor shall communicate the matter to those charged with governance.</i>
3)	<i>If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:</i>
(a)	<i>Could be material but not pervasive, the auditor shall qualify the opinion; or</i>
(b)	<i>Could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:</i>
(i)	<i>Withdraw from the audit</i>
(ii)	<i>Disclaim an opinion on the financial statements.</i>
4)	<i>If the auditor withdraws as contemplated by point (b)(i) above, before withdrawing, the auditor shall communicate to those charged with governance.</i>
6.6	<i>Form and Content of the Auditor's Report When the Opinion is Modified</i>
	<i>Auditor's Opinion</i>
	<i>When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section.</i>
(1)	<i>Qualified Opinion</i>
	<i>The auditor shall state that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion section.</i>
(2)	<i>Adverse Opinion</i>
	<i>The auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion section,</i>
(3)	<i>Disclaimer of Opinion</i>
	<i>The auditor shall:</i>
(a)	<i>State that the auditor does not express an opinion</i>
(b)	<i>The auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements;</i>
(c)	<i>State that the auditor was engaged to audit the financial statements.</i>
6.7	<i>Basis for Opinion</i>

◆	<i>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</i>
◆	<i>Within this section, include a description of the matter giving rise to the modification.</i>
◆	<i>If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements a description and quantification of the financial effects.</i>
◆	<i>If it is not practicable to quantify the financial effects, the auditor shall so state in this section.</i>
◆	<i>If there is a material misstatement of the financial statements that relates to narrative disclosures, explanation of how the disclosures are misstated.</i>
◆	<i>If there is a material misstatement of the financial statements non-disclosure of information required to be disclosed, the auditor shall:</i>
(a)	<i>Discuss the non-disclosure</i>
(b)	<i>Describe in the Basis for Opinion</i>
(c)	<i>Unless prohibited by law or regulation, include the omitted disclosures.</i>
◆	<i>If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.</i>
◆	<i>When the auditor disclaims an opinion on the financial statements, the auditor’s report shall not include the following elements required by SA 700 (Revised).</i>
(a)	<i>A reference to the section of the auditor’s report where the auditor’s responsibilities.</i>
(b)	<i>A statement about whether the audit evidence obtained is sufficient and appropriate.</i>
6-8	<i>Description of Auditor’s Responsibilities for the Audit of the Financial Statements When the Auditor Disclaims an Opinion on the Financial Statements</i>
(a)	<i>A statement that the auditor’s responsibility is to conduct an audit of the entity’s financial statements in accordance with Standards on Auditing.</i>
(b)	<i>A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate.</i>
(c)	<i>The statement about auditor independence and other ethical responsibilities.</i>

6-9	Considerations When the Auditor Disclaims an Opinion on the Financial Statements <i>The auditor's report shall not include a Key Audit Matters section.</i>
6-10	Communication with Those Charged with Governance
7.	EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT
7.1	Objective of the Auditor as per SA 706 <i>As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report".</i>
(a)	<i>It is fundamental to users' understanding</i>
(b)	<i>Is relevant to users' understanding</i>
7.2	Emphasis of Matter Paragraphs in the Auditor's Report <i>The auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:</i>
(a)	<i>The auditor would not be required to modify the opinion in accordance with SA 705.</i>
(b)	<i>When SA 701 applies, the matter has not been determined to be a key audit matter.</i>
7.2.1	Separate section for Emphasis of Matter paragraph
(a)	<i>Include the paragraph within a separate section.</i>
(b)	<i>Include in the paragraph a clear reference to the matter being emphasized.</i>
(c)	<i>Indicate that the auditor's opinion is not modified in respect of the matter emphasized.</i> Some examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph:
◆	<i>An uncertainty relating to the future outcome</i>
◆	<i>A significant subsequent event</i>
◆	<i>Early application</i>
◆	<i>A major catastrophe</i>
7.3	An Emphasis of Matter paragraph is not a substitute for:

(a)	<i>A modified opinion in accordance with SA 705</i>
(b)	<i>Disclosures in the financial statements</i>
(c)	<i>Reporting in accordance with SA 570</i>
7.4	<i>Other Matter Paragraphs in the Auditor's Report</i>
	<i>The auditor shall include an Other Matter paragraph in the auditor's report, provided:</i>
(a)	<i>This is not prohibited by law or regulation; and</i>
(b)	<i>When SA 701 applies, the matter has not been determined to be a key audit matter.</i>
7.4.1	<i>Separate section for Other Matter paragraph</i>
	<i>A separate section with the heading "Other Matter," or other appropriate heading.</i>
7.5	<i>Communication with Those Charged with Governance</i>
8.	<i>COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT (SA 701)</i>
8.1	<i>Purpose of Communicating Key Audit Matters</i>
	<i>Communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency.</i>
8.2	<i>Objectives of the Auditor regarding Key Audit Matters</i>
	<i>Determine key audit matters and, having formed an opinion on the financial statements.</i>
8.3	<i>Determining Key Audit Matters</i>
	<i>The auditor shall take into account the following:</i>
◆	<i>Areas of higher assessed risk of material misstatement, or significant risks.</i>
◆	<i>Significant auditor judgements relating to areas in the financial statements.</i>
◆	<i>The effect on the audit of significant events or transactions.</i>
8.4	<i>Communicating Key Audit Matters</i>

	<i>The introductory language in this section of the auditor's report shall state that:</i>
(a)	<i>Were of most significance in the audit of the financial statements.</i>
(b)	<i>The auditor does not provide a separate opinion on these matters.</i>
8.5	<i>Communicating Key Audit Matters- not a substitute for disclosure in the Financial Statements etc.</i>
(a)	<i>A substitute for disclosures in the financial statements</i>
(b)	<i>A substitute for the auditor expressing a modified opinion</i>
(c)	<i>A substitute for reporting in accordance with SA 570</i>
(d)	<i>A separate opinion on individual matters.</i>
8.6	<i>Communication with Those Charged with Governance</i>
9.	<i>STANDARD ON AUDITING - 710, "COMPARATIVE INFORMATION CORRESPONDING FIGURES AND COMPARATIVE FINANCIAL STATEMENTS"</i>
9.1	<i>The essential audit reporting differences between the approaches are:</i>
(a)	<i>For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas</i>
(b)	<i>For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.</i>
9.2	<i>Audit Procedures regarding comparative information</i>
(a)	<i>The comparative information agrees with the amounts and other disclosures presented in the prior period; and</i>
(b)	<i>The accounting policies reflected in the comparative information are consistent.</i>
◆	<i>If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances.</i>
◆	<i>As required by SA 580, the auditor shall request written representations.</i>
9.3	<i>Audit Reporting regarding Corresponding Figures</i>

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

- 1.** *If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements.*
- 2.** *If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion.*
- 3.** ***Prior Period Financial Statements Not Audited-***
Prior Period Financial Statements Audited by a Predecessor Auditor
The auditor shall state in an Other Matter paragraph in the auditor's report:
 - (a) That the financial statements of the prior period were audited by the predecessor auditor*
 - (b) The type of opinion expressed by the predecessor auditor.*
 - (c) The date of that report.*

9.4 Comparative Financial Statements

- 1.** *When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph.*
- 2.** ***Prior Period Financial Statements Audited by a Predecessor Auditor***
The auditor shall state in an Other Matter paragraph:
 - (a) That the financial statements of the prior period were audited by a predecessor.*
 - (b) The type of opinion expressed by the predecessor auditor.*
 - (c) The date of that report, unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.*
- 3.** ***Prior Period Financial Statements Not Audited***

10.	AUDIT OF BRANCH OFFICE ACCOUNTS
	<ul style="list-style-type: none"> • <i>Principal auditor</i> • <i>Other auditor</i> • <i>Component</i>
	<i>SA 600, "Using the Work of another Auditor". When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:</i>
(a)	<i>advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts.</i>
(b)	<i>advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.</i>
	<i>The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.</i>
11.	JOINT AUDIT
	<i>In specific terms the advantages that flow may be the following:</i>
(i)	<i>Sharing of expertise.</i>
(ii)	<i>Advantage of mutual consultation.</i>
(iii)	<i>Lower workload.</i>
(iv)	<i>Better quality of performance.</i>
(v)	<i>Improved service to the client.</i>
(vi)	<i>Lower staff development costs.</i>
(vii)	<i>Lower costs to carry out the work.</i>
	<i>The general disadvantages may be the following:</i>
(i)	<i>The fees being shared.</i>
(ii)	<i>Psychological problem</i>
(iii)	<i>General superiority complex of some auditors.</i>

- (iv) *Problems of co-ordination of the work.*
- (v) *Areas of work of common concern being neglected.*
- (vi) *Uncertainty about the liability for the work done.*

Standard on Auditing (SA) 299 (Revised), "Joint Audit of Financial Statements".
This Standard deals with the special considerations in carrying out audit by joint auditors. It requires that-

- (i) *each of the joint auditors should be involved in planning the audit.*
 - (ii) *the joint auditors should jointly establish an overall audit strategy.*
 - (iii) *joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:*
 - (a) *identify division of audit areas and common audit areas;*
 - (b) *ascertain the reporting objectives of the engagement;*
 - (c) *consider and communicate among all joint auditors*
 - (d) *consider the results of preliminary engagement activities*
 - (e) *ascertain the nature, timing and extent of resources.*
 - (iv) *each of the joint auditors should consider and assess the risks of material misstatement.*
 - (v) *the joint auditors should discuss and document the nature, timing, and the extent of the audit procedures.*
 - (vi) *the joint auditors should obtain common engagement letter and common management representation letter.*
 - (vii) *the work allocation document.*
- Each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. On the other hand, all the joint auditors shall be jointly and severally responsible for:*
- (i) *the audit work which is not divided among the joint auditors*
 - (ii) *decisions taken by all the joint auditors*
 - (iii) *matters which are brought to the notice of the joint auditors by any one of them.*
 - (iv) *examining that the financial statements of the entity comply with the requirements.*
 - (v) *presentation and disclosure of the financial statements;*

(vi) *ensuring that the audit report complies with the requirements.*

In case a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgment by other joint auditors, the said joint auditor shall communicate the same to all the other joint auditors in writing prior to the completion of the audit.

*It may be noted that the joint auditors are required to issue **common audit report.***

*However, where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a **separate audit report.** In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to each other's audit report(s).*

12. DUTIES OF AUDITORS

Sections 143 of the Companies Act, 2013

1. Duty of Auditor to Inquire on certain matters: *It is the duty of auditor to inquire into the following matters-*

- (a) Loans and advances made by the company on the basis of security*
- (b) Transactions of the company which are represented merely by book entries*
- (c) Company not being an investment company or a banking company, whether securities have been sold at a price less than that at which they were purchased.*
- (d) Loans and advances made by the company have been shown as deposits;*
- (e) Personal expenses have been charged to revenue account;*
- (f) Books and documents of the company that any shares have been allotted for cash.*

2. Duty to Sign the Audit Report: *Section 145 of the Companies Act, 2013*

3. Duty to comply with Auditing Standards: *Sub-section (9) of section 143*

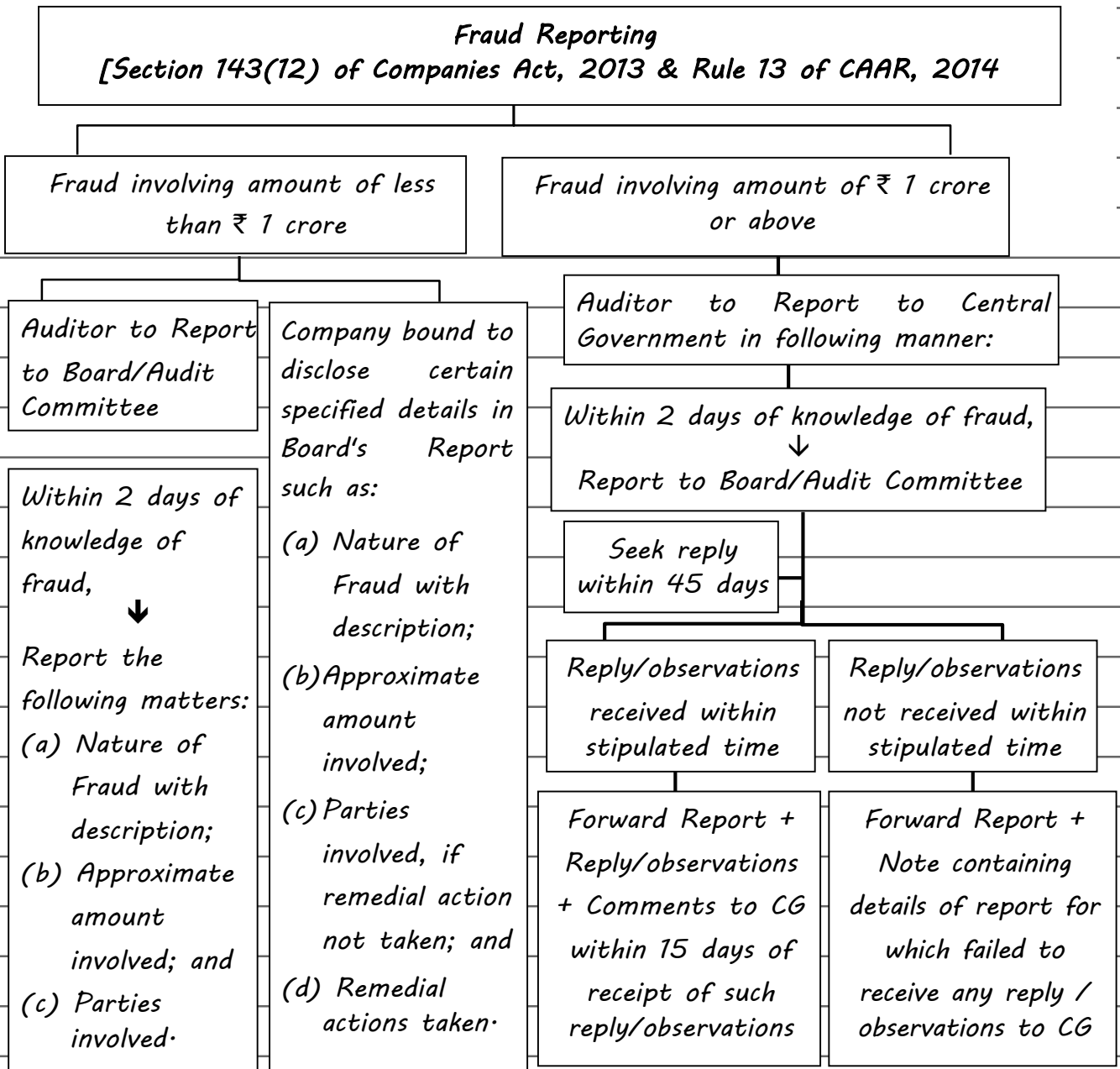
4. Duty to audit report: *As per sub-section (3) of section 143, the auditor's report shall also state-*

- (a) whether he has sought and obtained all the information and explanations.*
- (b) whether, in his opinion, proper books of account as required by law have been kept.*

(c)	<i>whether the report on the accounts of any branch office.</i>
(d)	<i>whether the company's balance sheet and profit and loss account dealt.</i>
(e)	<i>whether, in his opinion, the financial statements comply with the accounting standards;</i>
(f)	<i>the observations or comments of the auditors on financial transactions have any adverse effect on the functioning of the company;</i>
(g)	<i>whether any director is disqualified sub-section (2) of the section 164;</i>
(h)	<i>any qualification, reservation or adverse remark.</i>
(i)	<i>whether the company has adequate internal financial controls.</i>
	<i>(Note: Clause (i) of Sub-Section (3) of Section 143 shall not apply to a private company: - (i) which is a one person company or a small company; or (ii) which has turnover less than rupees fifty crores as per latest audited financial statement and which has aggregate borrowings from banks or financial institutions or anybody corporate at any point of time during the financial year less than rupees twenty five crore)</i>
(j)	<i>such other matters</i>
(1)	<i>whether the company has disclosed the impact, if any, of pending litigations</i>
(2)	<i>material foreseeable losses, if any, on long term contracts including derivative contracts;</i>
(3)	<i>delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.</i>
(4)	
(i)	<i>no funds have been advanced or loaned or invested by the company to or in any other person(s) or entity(ies), including foreign entities with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company.</i>
(ii)	<i>no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified.</i>
(iii)	<i>believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.</i>
(5)	<i>compliance with section 123 of the Companies Act, 2013.</i>

(6) the company has used such accounting software for maintaining its books of account

5. Duty to report on frauds:



6. Duty to report on any other matter specified by Central Government.

7. Duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor are discussed separately.

8. Duty to state the reason for qualification or negative report

12.1 Reporting Under CARO, 2000

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

☞ *Applicability of the Order: The CARO, 2020 is an additional reporting requirement Order. The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013.*

☞ *However, the Order specifically exempts the following class of companies-*

i) *A banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;*

ii) *An insurance company as defined under the Insurance Act, 1938;*

iii) *A company licensed to operate under section 8 of the Companies Act;*

iv) *A One Person Company*

v) *A small company*

vi) *A private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than Rs. 1 crore as on the balance sheet date and which does not have total borrowings exceeding Rs. 1 crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding Rs. 10 crore during the financial year as per the financial statements.*

It may be noted that the Order shall not be applicable to the auditor's report on consolidated financial statements.

❖ Matters to be included in the Auditor's Report:

☞ *Paragraph 3 of the Order requires the auditor to include a statement in the auditor's report on the following matters, namely -*

(i) (a) *Whether the company is maintaining proper records showing full particulars.*

(b) *Whether these Property, Plant and Equipment have been physically verified.*

(c) *Whether the title deeds of all the immovable properties.*

(d) *Whether the company has revalued its Property, Plant and Equipment.*

(e) *Whether any proceedings have been initiated or are pending against the company.*

(ii) (a) *Whether physical verification of inventory has been conducted.*

	<i>(b) Whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees.</i>
<i>(iii)</i>	<i>Whether during the year the company has made investments in, provided any guarantee or security or granted any loans or advances.</i>
	<i>(a) (i) To subsidiaries, joint ventures and associates;</i>
	<i>(ii) To parties other than subsidiaries, joint ventures and associates;</i>
	<i>(b) The terms and conditions of the grant of all loans and advances.</i>
	<i>(c) Schedule of repayment of principal and payment of interest.</i>
	<i>(d) State the total amount overdue for more than ninety days.</i>
	<i>(e) Renewed or extended or fresh loans granted.</i>
	<i>(f) Aggregate amount of loans granted to Promoters, related parties.</i>
<i>(iv)</i>	<i>In respect of loans, investments, guarantees, and security, whether provisions of sections 185 and 186 of the Companies Act have been complied with</i>
<i>(v)</i>	<i>In respect of deposits accepted by the company or amounts which are deemed to be deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76.</i>
<i>(vi)</i>	<i>Whether maintenance of cost records has been specified by the Central Government</i>
<i>(vii)</i>	<i>(a) whether the company is regular in depositing undisputed statutory dues</i>
	<i>(b) Where statutory dues referred to in sub-clause (a) have not been deposited on account of any dispute.</i>
<i>(viii)</i>	<i>Whether any transactions not recorded in the books of account have been surrendered or disclosed as income</i>
<i>(ix)</i>	<i>(a) Whether the company has defaulted in repayment of loans or other borrowings</i>
	<i>(b) Whether the company is a declared wilful defaulter by any bank</i>
	<i>(c) Whether term loans were applied for the purpose</i>
	<i>(d) Whether funds raised on short-term basis</i>
<i>(x)</i>	<i>(a) Whether the company has taken any funds from any entity or person</i>
	<i>(b) Whether the company has raised loans during the year on the pledge of securities.</i>
<i>(xi)</i>	<i>(a) Whether any fraud by the company or any fraud on the company</i>
	<i>(b) Whether any report under sub-section (12) of section 143</i>
	<i>(c) Whether the auditor has considered whistle - blower complaints,</i>

(xii) (a) Whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability.

(b) Whether the Nidhi Company is maintaining ten per cent unencumbered term deposits

(xiii) Whether all transactions with the related parties are in compliance

(xiv) (a) Whether the company has an internal audit system

(b) Whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor

(xv) Whether the company has entered into any non - cash transactions

(xvi) (a) Whether the company is required to be registered under section 45 - 1A

(b) Whether the company has conducted any Non - Banking Financial

(c) Whether the company is a Core Investment Company (CIC)

(d) Whether the Group has more than one CIC as part of the Group

(xvii) Whether the company has incurred cash losses in the financial year

(xviii) Whether there has been any resignation of the statutory auditors

(xix) The auditor's knowledge of the Board of Directors and management plans

(xx) (a) Whether, in respect of other than ongoing projects, the company has transferred unspent amount to a Fund specified in Schedule VI

(b) Whether any amount remaining unspent under subsection (5) of Section 135.

(xxi) Whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports.

CHAPTER - 9

SPECIAL FEATURES OF AUDIT OF DIFFERENT TYPES OF ENTITIES

1. GOVERNMENT AUDIT

1.1 Introduction

Government auditing is

- ◆ the objective, systematic, professional and independent examination
- ◆ of financial, administrative and other operations
- ◆ of a public entity

OBJECTIVES:-

- (a) Accounting for Public Funds:
- (b) Appraisal of Government policies
- (c) Base for Corrective actions

Administrative accountability

1.2 Legal Framework and Comptroller & Auditor General

1. APPOINTMENT & REMOVAL

The Constitution guarantees the independence of the C&AG of India by prescribing that he shall be appointed by the President of India and shall not be removed from office except on the ground of proven mis-behaviour or incapacity. He can be removed only when each House of Parliament decides to do so by a majority of not less than 2/3rd of the members of the House present and voting.

2. TENURE

Fixed tenure of the office prescribing that he shall be paid a salary which is equal to the salary of the Judge of the Supreme Court.

3. VARIOUS CONSTITUTIONAL PROVISIONS

- i. Article 149 states that the C&AG shall perform such duties and exercise such powers.

ii.	<i>Article 150 accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG.</i>
iii.	<i>Article 151 reports of the C&AG Union/State shall be submitted to the President/Governor who shall cause them to be laid before House of Parliament/State Legislature.</i>
1.3	<i>Comptroller and Auditor General's – Duties and Powers</i>
	<i>Duties of the C & AG:</i>
(i)	<i>Compile and submit Accounts of Union and States</i>
(ii)	<i>General Provisions Relating to Audit</i>
(a)	<i>to audit and report on all expenditure from the Consolidated Fund of India.</i>
(b)	<i>to audit and report all transactions of the Union and of the States.</i>
(c)	<i>to audit and report on all trading, manufacturing and profit and loss accounts.</i>
(iii)	<i>Audit of Receipts and Expenditure</i>
	<i>Meaning of Substantially financed :- Where the grant or loan to a body or authority in a financial year is not less than ₹ 25 lakhs and the amount of such grant or loan is not less than 75% of the total expenditure of that body or authority.</i>
(iv)	<i>Audit of Grants or Loans</i>
(v)	<i>Audit of Receipts of Union or States</i>
(vi)	<i>Audit of Accounts of Stores and Inventory</i>
(vii)	<i>Audit of Government Companies and Corporations</i>
	<i>Powers of C & AG</i>
(a)	<i>To inspect any office of accounts</i>
(b)	<i>To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions.</i>
(c)	<i>To put such questions or make such observations.</i>
(d)	<i>The C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions.</i>
1.4	<i>Expenditure Audit</i>

(1)	Audit against Rules & Orders
	<i>These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:</i>
(i)	<i>Rules and orders regulating the powers to incur and sanction expenditure.</i>
(ii)	<i>Rules and orders dealing with the mode of presentation of claims against government.</i>
(iii)	<i>Rules and orders regulating the conditions of service, pay and allowances.</i>
	<i>But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:</i>
(a)	<i>they are not inconsistent with any provisions of the Constitution.</i>
(b)	<i>they are consistent with the essential requirements of audit.</i>
(c)	<i>they do not come in conflict with the orders.</i>
(d)	<i>in case they have not been separately approved by competent authority.</i>
(2)	Audit of sanctions - <i>The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority.</i>
(3)	Audit against provision of funds - <i>That the amount of such expenditure does not exceed the appropriation made.</i>
(4)	Propriety audit - <i>Audit against propriety seeks to ensure that expenditure conforms to these principles:</i>
(a)	<i>The expenditure should not be prima facie more than the occasion demands.</i>
(b)	<i>No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.</i>
(c)	<i>Public moneys should not be utilised for the benefit of a particular person or section of the community unless:</i>
(i)	<i>the amount of expenditure involved is insignificant; or</i>
(ii)	<i>a claim for the amount could be enforced in a Court of law; or</i>
(iii)	<i>the expenditure is in pursuance of a recognised policy or custom; and</i>
(iv)	<i>the amount of allowances, such as travelling allowances.</i>
(5)	Performance audit - <i>The scope of audit has been extended to cover efficiency, economy and effectiveness audit or performance audit.</i>
1.5	Audit of Receipts

	<i>Correctly assessed, realised and credited to government account.</i>
(ii)	<i>Adequate regulations and procedures have been framed.</i>
(iii)	<i>Regulations and procedures are actually being carried out;</i>
(iv)	<i>Adequate checks are imposed</i>
(v)	<i>review of systems and procedures.</i>
(vi)	<i>The extent and quantum of audit required to be done under each category of audit are determined by the C&AG.</i>
1.6	<i>Audit of Stores and Inventories</i>
	<i>Audit is conducted:-</i>
◆	<i>to ascertain whether the Regulations governing purchase, receipt and issue.</i>
◆	<i>to bring to the notice of the government any deficiencies.</i>
◆	<i>to verify that the purchases are properly sanctioned.</i>
◆	<i>to ensure that the prices paid are reasonable.</i>
◆	<i>to check the accounts of receipts, issues and balances regarding accuracy, correctness and reasonableness of balances.</i>
1.7	<i>Audit of Commercial Accounts</i>
	<i>Generally classified under three categories—</i>
(a)	<i>departmental enterprises (b) statutory bodies, corporations (c) government companies</i>
	<i>Role of C & AG is prescribed under sub section (5), (6) and (7) of section 143</i>
(1)	<i>Power to appoint Government Company Auditor</i>
(2)	<i>Power to conduct Supplementary Audit & comment thereupon:- Within 60 days from the date of receipt of the audit report have a right to</i>
(a)	<i>conduct a supplementary audit under section 143(6)(a)</i>
(b)	<i>comment upon or supplement such audit report under section 143(6)(b)</i>
(3)	<i>Test Audit: Cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor- General's Act, 1971, shall apply to the report of such test audit.</i>
2.	<i>AUDIT OF LOCAL BODIES</i>

2.1	Background
(1)	<i>A Municipality can be defined as a unit of local self-government in an urban area.</i>
(2)	<i>Municipal government in India covers five distinct types of urban local authorities-</i>
◆	<i>the municipal corporations,</i>
◆	<i>the municipal councils,</i>
◆	<i>the notified area committees,</i>
◆	<i>the town area committees and</i>
◆	<i>the cantonment committees.</i>
(3)	<i>Municipal authorities are endowed with specific local functions covering</i>
(a)	<i>regulatory,</i>
(b)	<i>maintenance and</i>
(c)	<i>development activities</i>
(4)	<i>Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads:</i>
(a)	<i>general administration and revenue collection,</i>
(b)	<i>public health,</i>
(c)	<i>public safety,</i>
(d)	<i>education,</i>
(e)	<i>public works, and</i>
(f)	<i>others such as interest payments, etc.</i>
(5)	<i>Property taxes and octroi are the major sources of revenue of the municipal authorities;</i>
(6)	<i>Local bodies may receive different types of grants</i>
(a)	<i>General purpose grants</i>
(b)	<i>Specific purpose grants</i>
(c)	<i>Statutory and compensatory grants</i>
2.2	Financial Administration
(a)	<i>Budgetary Procedure</i>
(b)	<i>Expenditure Control</i>
(c)	<i>Accounting System</i>
2.3	Objective of Audit of Local Bodies
	<i>The important objectives of audit are:</i>
(a)	<i>reporting on the fairness of the content and presentation of financial statements;</i>

- (b) reporting upon the strengths and weaknesses of systems of financial control;
- (c) reporting on the adherence to legal and/or administrative requirements;
- (d) reporting upon whether value is being fully received on money spent; and
- (e) detection and prevention of error, fraud and misuse of resources.

2.4 Audit Programme for Local Bodies

- (i) **APPOINTMENT:-** The Local Fund Audit Wing of the State Govt.
- (ii) **AUDITOR'S CONCERNS:-** Should report on the objectives.
- (iii) **RULES & REGULATIONS:-** Conforms to the relevant provisions.
- (iv) **AUTHORISATIONS**
- (v) **PROVISIONING**
- (vi) **PERFORMANCE**

3. AUDIT OF NON - GOVERNMENTAL ORGANISATION (NGO'S)

3.1 Background

- 1. NGOs can be defined as non-profit making organisations.
- 2. Religious organisations, voluntary health and welfare agencies, **charitable organisations**.
- (3) Non-Governmental Organisations are generally incorporated as societies under the **Societies Registration Act, 1860** or as a trust under the **India Trust Act, 1882**, NGOs can also be incorporated as a company under section 8 of the **Companies Act, 2013**.

3.2 Sources and Applications of Funds

- (1) Grants and donations, fund raising programmes, advertisements, fees subscriptions, gifts, sale of produce or publications, etc.
- (a) Promoter's contribution are in the nature of capital receipts.
- (b) Voluntary contributions made with a specific direction.
- (c) Revolving Fund
- (d) Acquisition of specific fixed assets
- (e) Contributions in kind.
- (2) The areas of application of funds for an NGO include Establishment Costs, Office and

Administrative Expenses, Maintenance Expenses, Programme / Project Expenses, Charity, Donations and Contributions given, etc.

3.3 Provisions Relating to Audit

While planning the audit, the auditor may concentrate on the following:

- (i) Knowledge of the NGO's work,*
- (ii) Updating knowledge of relevant statutes*
- (iii) Reviewing the legal form of the Organisation*
- (iv) Reviewing the NGO's Organisation chart*
- (v) Examination of minutes of the Board/Managing Committee*
- (vi) Study the accounting system*
- (vii) Setting of materiality levels*
- (viii) The nature and timing of reports*
- (ix) The involvement of experts*
- (x) Review the previous year's Audit Report.*

The audit programme should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted.

- | | |
|--|---------------------------------------|
| <i>(i) Corpus Fund</i> | <i>(ii) Reserves</i> |
| <i>(iii) Ear-marked Funds</i> | <i>(iv) Project / Agency Balances</i> |
| <i>(v) Loans</i> | <i>(vi) Fixed Assets</i> |
| <i>(vii) Investments</i> | <i>(viii) Cash in Hand</i> |
| <i>(ix) Bank Balance</i> | <i>(x) Inventory</i> |
| <i>(xi) Programme and Project Expenses</i> | <i>(xii) Establishment Expenses</i> |

The receipt of income of NGO may be checked on the following lines:

- (i) Contributions and Grants for projects and programmes*
- (ii) Receipts from fund raising programmes*
- (iii) Membership Fees*
- (iv) Subscriptions*
- (v) Interest and Dividends*

4.	AUDIT OF SOLE TRADER
	<i>A sole trader is under no legal obligation to have his accounts audited. However, many such individuals get their financial statement audited due to regulatory requirements, such as inventory brokers or on a specific instructions of the bank for approval of loans, etc.</i>
5.	AUDIT OF FIRM
	<i>Appointment of Auditors: By the partners.</i>
	<i>Matters to be considered before starting audit:</i>
1.	<i>The name and style</i>
2.	<i>The duration of the partnership</i>
3.	<i>The amount of capital</i>
4.	<i>The period at the end</i>
5.	<i>The provisions as regards maintenance of books of account.</i>
6.	<i>Borrowing capacity</i>
7.	<i>The rate at which interest will be allowed</i>
8.	<i>Whether any salaries are payable</i>
9.	<i>Duties of the partners</i>
10.	<i>Who shall operate the bank account</i>
11.	<i>Limitations and restrictions</i>
	<i>Advantages of Audit of a Partnership Firm</i>
(1)	<i>Disputes</i>
(2)	<i>Dissolution</i>
(3)	<i>Reliable</i>
(4)	<i>Admission</i>
(5)	<i>Control</i>
	<i>Matters which should be specially considered in the audit of accounts of a partnership:</i>
(i)	<i>Letter of Appointment</i>
(ii)	<i>Partnership Documents</i>
(iii)	<i>Objects of Partnership</i>
(iv)	<i>Books of Account</i>
(v)	<i>Mutual Interest</i>
(vi)	<i>Provision for Taxes</i>
(vii)	<i>Division of Profits</i>
5.1	Basics of Limited Liability Partnerships (LLP) Audit

LLP is governed by Limited Liability Partnership Act, 2008.

It defines a Small Limited Liability Partnership to denote any LLP:

- a) the Contribution of which, does not exceed twenty-five lakh rupees
- b) the Turnover does not exceed forty lakh rupees

Whether LLP is required to maintain Books of Accounts:- LLP's are required to maintain books of accounts which shall contain

1. Particulars of all sums of money received and expended
2. A record of the assets and liabilities of the LLP
3. Statements of costs of goods purchased, inventories, work-in-progress
4. Any other particulars which the partners may decide

Audit of the Accounts of an LLP:- Whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty five lakh rupees, is not required to get its accounts audited.

Advantages / Purpose / Need of Audit

1. Detection of Errors
2. Disputes
3. Reliability
4. Better Compliance and Management
5. Reconstitution

Returns to be maintained and filed by an LLP

- ◆ Annual return in Form 11 with ROC within 60 days of closer of financial year.
- ◆ Statement of Account and Solvency in Form 8 which shall be filed within a period of thirty days from the end of six months the financial year.

Appointment of Auditor

1. At any time for the first financial year but before the end of first financial year,
2. At least thirty days prior to the end of each financial year.
3. To fill the casual vacancy in the office of auditor.
4. To fill the casual vacancy caused by removal of auditor.

The partners may appoint the auditors if the designated partners have failed to appoint them.

Auditor's Duty Regarding Audit of LLP

- | | |
|----------------------|-----------------|
| 1. Engagement Letter | 2. Minutes Book |
| 3. LLP Agreement | 4. Reporting |

6. AUDIT OF CHARITABLE INSTITUTION

(1) General

- (i) Studying the constitution
- (ii) Verifying whether the institution is being managed.
- (iii) Examining the system of internal check
- (iv) Verifying in detail the income and confirming that the amounts received.
- (v) Examine the Trust Deed

(2) Subscriptions and donations

- (i) Annual or life membership
- (ii) Whether official receipts

(3) Legacies - Verifying the amounts received

(4) Grants -

- (i) Vouching the amount
- (ii) Obtaining a certificate

(5) Investments Income

- (i) Vouching the amounts
- (ii) Checking the calculations
- (iii) Comparing the amounts of dividend

(6) Rent

- (i) Examining the rent roll
- (ii) Vouching the rent

(7) Special function, etc.

(8) Income Tax Refunds

(9)	Expenditure
(i)	Vouching payment of grants
(ii)	Verifying the schedules
(iii)	Verifying the cash and bank payments.
(iv)	Ascertaining that any funds contributed for a special purpose.
7.	AUDIT OF EDUCATIONAL INSTITUTIONS (SCHOOL, COLLEGE OR UNIVERSITY)
	The special steps involved in their audit are the following-
(A)	General:-
1.	Examine the Trust Deed
2.	Read through the minutes of the meetings.
(B)	Fee from Students:-
1.	Check names entered in the Students Fee Register.
2.	Check fees received.
3.	Total up the various columns of the Fees Register.
4.	Check admission fees
5.	See that free studentship
6.	Confirm that fines for late payment
7.	Confirm that hostel dues were recovered
(C)	Other Receipts/Grants & Donations:-
1.	Verify rental income
2.	Vouch income
3.	Verify any Government or local authority grant
(D)	Expenditure:-
1.	Verify that the Provident Fund money
2.	Vouch donations
3.	Vouch, all capital expenditure
4.	Vouch, in the usual manner, all establishment expenses.
5.	See that increase in the salaries

(E) Assets & Liabilities:-

1. Report any old heavy arrears.
2. Confirm that caution money.
3. See that the investments representing endowment funds.
4. Ascertain that the system ordering inspection on receipt.
5. Verify the inventories of furniture, stationery, clothing.

(F) Compliances:-

1. Confirm that the refund of taxes deducted from the income from investment.
2. Finally, verify the annual statements of account.

8. AUDIT OF HOSPITAL

The special steps involved in such an audit are stated below-

- | | | |
|---------------------------------------|---|---------------|
| 1. Register of Patients | 2. Collection of Cash | |
| 3. Income from Investments, Rent etc. | 4. Legacies and Donations | |
| 5. Reconciliation of Subscriptions | 6. Authorisation and Sanctions | |
| 7. Grants and TDS | 8. Budgets | |
| 9. Internal Check | 10. Depreciation | 11. Registers |
| 12. Inventories | 13. Management Representation and Certificate | |

9. AUDIT OF CLUB

The special steps involved in such an audit are stated below-

- | | |
|-------------------------------|---------------------------|
| (1) Entrance Fee | (2) Subscriptions |
| (3) Arrears of Subscriptions | (4) Arithmetical accuracy |
| (5) Irrecoverable Member Dues | (6) Pricing |
| (7) Member Accounts | (8) Purchases |
| (9) Margins earned | (10) Inventories |
| (11) Investments | (12) Management Powers |

10. AUDIT OF CINEMA

The special steps involved in its audit are stated below-

(1)	Verify the internal control mechanism-
(a)	that entrance
(b)	that they are serially numbered
(c)	that the number of tickets issued for each show
(d)	that for advance booking a separate series
(e)	that the inventory of tickets
(2)	Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.
(3)	Verify that a record is kept of the ' free passes '.
(4)	Reconcile the amount of Tax collected.
(5)	Vouch the entries in the Cash Book .
(6)	Verify the charges collected for advertisement .
(7)	Vouch the expenditure
(8)	Confirm that depreciation on machinery and furniture.
(9)	Vouch payments on account of film hire with bills of distributors .
(10)	Examine unadjusted balance out of advance paid to the distributors .
11.	AUDIT OF HIRE PURCHASE AND LEASING COMPANIES
(A)	HIRE - PURCHASE:-
(1)	A Hire-purchase agreement means an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement.
(2)	While checking the hire- purchase transaction, the auditor may examine the following:
(i)	Hire purchase agreement is in writing and is signed.
(ii)	Hire purchase agreement specifies clearly-
(a)	Price of the goods
(b)	Cash price of the goods
(c)	Date on which the agreement
(d)	Number of instalments
(e)	Goods to which the agreement relates
(iii)	Ensure that instalment payments are being received regularly

(B)	LEASES:-
(1)	<i>In a lease agreement, a party (called 'lessee') acquires the right to use an asset for an agreed period of time in consideration of payment of rent to another party (called 'lessor').</i>
(2)	<i>A normal finance lease transaction usually goes through the following modality:</i>
I.	<i>The lessee will select the equipment, and satisfy himself</i>
II.	<i>The lessee approaches a lessor.</i>
III.	<i>The lease agreement is broadly negotiated.</i>
IV.	<i>The manufacturer delivers the equipment.</i>
V.	<i>The lease agreement giving detailed terms of contract.</i>
VI.	<i>During the lease period, the lessee:</i>
	<ul style="list-style-type: none"> • <i>Will pay rentals regularly</i> • <i>Will keep the equipment in good repair</i> • <i>Will be entitled to any manufacturer's warranties.</i>
VII.	<i>At the end of the lease period, the equipment shall retreat to the lessor.</i>
(3)	Auditor's Procedures
(1)	<i>The object clause of leasing company</i>
(2)	<i>Ascertain the credit analysis of lessee.</i>
(3)	<i>The lease agreement should be examined and the following points may be noted:</i>
(i)	<i>the description of the lessor, the lessee, the equipment and the location.</i>
(ii)	<i>the amount of tenure of lease, dates of payment, late charges, deposits or advances.</i>
(iii)	<i>whether the equipment shall be returned to the lessor.</i>
(iv)	<i>whether the agreement prohibits the lessee from assigning the subletting.</i>
(4)	<i>Examine the lease proposal.</i>
(5)	<i>Ensure that the invoice is retained safely.</i>
(6)	<i>Examine the acceptance letter.</i>
(7)	<i>See the Board resolution.</i>
(8)	<i>See that the copies of the insurance policies have been obtained by the lessor.</i>
	<i>Finance Lease: An arrangement with the following attributes qualifies as a Finance Lease:</i>
	<i>Transfers ownership of the asset to the lessee at the end of the lease term;</i>

- ◆ The lessee has the option to purchase the asset at a price
- ◆ The lease term is for the major part of the economic life of the asset.
- ◆ The present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset;
- ◆ the leased assets are of such a specialized nature.

Operating Lease

An arrangement that does not transfer substantially all the risks and rewards incidental to ownership qualifies as an Operating Lease.

12. AUDIT OF HOTELS

The special considerations in a hotel audit can be summarised as follows:

(1) Internal Controls - Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined.

The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic record.

(2) Room Sales & Hall Bookings - The charge for room sales is normally posted to guest bills by the receptionist/ front office or in the case of large hotels by the night auditor.

(3) Inventories - The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories.

The extent of such tests could well be limited since the figures will have been prepared independently of the hotel.

(4) Fixed Assets - The auditor should see that costs of repairs and minor renovation and redecoration are treated as revenue expenditure, where as costs of major alterations and additions to the hotel building and facilities capitalised.

(5) Casual Labour - The hotel trade operates to very large extent on casual labour. The records maintained of such wage payments are frequently inadequate.

(6) Travel Agents & Shops-

(i) The auditor should ensure that money are recovered from the travel agents or booking agencies.

(ii) Commission, if any, paid to travel agents or booking agents should be checked.

13.	AUDIT OF CO-OPERATIVE SOCIETIES
13.1	Background
	<i>A Cooperative (also known as co-operative, co-op, or coop) is "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned enterprise".</i>
13.2	Audit as per Section 17 of the Co-Operative Societies Act, 1912
	<i>"Registrar" means a person appointed to perform the duties of a Registrar of Co-operative Societies under this Act.</i>
	<i>The following points should be kept in mind in connection with the audit of a co-operative society:</i>
1.	<i>Qualifications of Auditors - Apart from a chartered accountant some of the State Co-operative Acts have permitted persons holding a government diploma in co-operative accounts.</i>
2.	<i>Appointment of the Auditor - Appointed by the Registrar of Co-operative Societies.</i>
3.	<i>Books, Accounts and other records of Co-operative Societies</i>
	<i>For example, in Maharashtra, the co-operative societies are required to maintain books.</i>
(i)	<i>All sums of money received and expended by the society.</i>
(ii)	<i>All sales and purchases of goods by the society.</i>
(iii)	<i>Assets and liabilities of the society.</i>
	<i>In case of large scale co-operative organisation</i>
(a)	<i>Daily cash sales summary register.</i>
(b)	<i>A register of collection from debtors if credit sales are allowed.</i>
(c)	<i>A register of recovery of loans from salaries and directly by receipts.</i>
(d)	<i>Loan disbursement register in case of credit society.</i>
(e)	<i>Any other columnar subsidiaries.</i>
4.	<i>Restrictions on share holdings - Section 5 would exceed a maximum of twenty percent of the total number of shares or of the value of shareholding to ₹ 1,000/-</i>
5.	<i>Restrictions on loans - Section 29 shall not make a loan to any person other than a member.</i>

6.	<i>Restrictions on borrowings - Section 30 shall accept loans and deposits from persons who are not members subject to the restrictions and limits.</i>
7.	<i>Investment of funds - Section 32</i>
(a)	<i>In the Central or State Co-operative Bank.</i>
(b)	<i>In any of the securities specified in section 20</i>
(c)	<i>In the shares, securities, bonds or debentures of any other society</i>
(d)	<i>In any co-operative bank</i>
(e)	<i>In any other moneys permitted by the Central or State Government.</i>
8.	<i>Appropriation of profits - Section 33 a prescribed percentage of the profits should be transferred to Reserve Fund.</i>
9.	<i>Contributions to Charitable Purposes - Section 34 contribute an amount not exceeding 10% of the net profits.</i>
10.	<i>Investment of Reserve Fund outside the business or utilisation as working capital -</i>
(a)	<i>in the business of a society</i>
(b)	<i>may invest as per provisions of the Act</i>
(c)	<i>may be used for some public purposes</i>
11.	<i>Contribution to Education Fund - At the appropriate rate as per the class of the society.</i>
13.3	<i>Special Features of Co-Operative Audit</i>
1.	<i>Examination of overdue debts - Overdue debts for a period from 6 months to 5 years and more than 5 years will have to be classified.</i>
2.	<i>Overdue Interest - Overdue interest should be excluded</i>
3.	<i>Certification of Bad Debts - Only when they are certified as bad by the auditor.</i>
4.	<i>Valuation of Assets and Liabilities - The auditor will have to ascertain existence, ownership and valuation of assets.</i>

5.	<i>Adherence to Co-operative Principles</i>
6.	<i>Observations of the Provisions of the Act and Rules</i>
7.	<i>Verification of Members' Register and examination of their pass books</i>
8.	<i>Special report to the Registrar - Special report may become necessary:</i>
(i)	<i>Personal profiteering by members</i>
(ii)	<i>Detection of fraud relating to expenses, purchases, property</i>
(iii)	<i>Specific examples of mis-management.</i>
(iv)	<i>In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence.</i>
9.	<i>Audit classification of society - Criteria specified by the Registrar.</i>
10.	<i>Discussion of draft audit report with managing committee</i>
13.4	<i>Audit, Inquiry and Inspection of Multi-State Co-Operative Societies</i>
	<i>Applies to co-operative societies whose objects are not confined to one State.</i>
	<i>Books of Accounts</i>
a.	<i>all sum of money received and expended</i>
b.	<i>all sale and purchase of goods;</i>
c.	<i>the assets and liabilities;</i>
d.	<i>in the case of a Multi-State Co-operative society engaged in production, particulars relating to utilization of materials or labour.</i>
13.4.1	<i>Audit of Multi-State Co-operative Society-</i>
1.	<i>Qualification of Auditors - A person who is a Chartered Accountant.</i>
	<i>However the following persons are not eligible</i>
(a)	<i>A body corporate</i>
(b)	<i>An officer or employee of the Multi-State co-operative society.</i>
(c)	<i>A person who is a member or who is in the employment, of an officer or employee</i>
(d)	<i>A person who is indebted to the Multi-State co-operative society for an amount exceeding one thousand rupees.</i>

2.	Appointment of Auditors - Section 70 first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails in the general meeting may appoint the first auditor or auditors. The subsequent auditor at each annual general meeting.
3.	Power and duties of Auditors - Section 73 right of access at all times to the books accounts and vouchers such information and explanation. As per section 73(2), the auditor shall make following inquiries: (a) Whether loans and advances made security have been properly secured. (b) Transactions merely by book entries. (c) Personal expenses have been charged to revenue account (d) Any shares have been allotted for cash.
4.	Content of Auditor's Report - As per sub-section (3) & (4) of section 73 (a) Society's affairs as at the end of its financial year. (b) Profit or loss for its financial year. The auditor's report shall also state: (i) Obtained all the information and explanation. (ii) Proper books of account have been kept. (iii) Report on the accounts of any branch office audited by a person other than (iv) Balance sheet and profit and loss account dealt with by the report are in agreement.
5.	Power of Central Government to direct special audit in certain cases - Section 77 (a) Are not being managed in accordance with self-help and mutual deed and co-operative principles or prudent commercial practices. (b) Manner likely to cause serious injury or damage to the interests of the trade. (c) endanger its solvency.
1.	Central Government's Order:- Direct that a special audit of the accounts for such period or periods as may be specified.
2.	Appointment of the Auditor:- Chartered accountant or the society's auditor himself.
3.	Shareholding Restriction :- Only if that Government or the State Government either

	<i>by itself or both hold fifty-one percent or more.</i>
4.	Special Auditor's Powers, Duties & Report
5.	Action by the Central Government:- <i>May take such action on the report as it considers necessary.</i>
6.	Expenses pertaining to the Special Audit:- <i>Shall be determined by the Central Government and paid by the Multi-State Co-operative society.</i>
13.4.2	Inquiry by Central Registrar under Section 78
1.	When:- <i>The Central Registrar may, on a request from :-</i>
	<ul style="list-style-type: none"> • <i>a federal co-operative</i> • <i>a creditor or not less than one-third of the members of the board</i> • <i>not less than one-fifth of the total number of members</i>
2.	How:- <i>hold an inquiry or direct some person authorized by him.</i>
3.	Opportunity of being Heard:- <i>Fifteen days notice must be given</i>
4.	Powers given
(a)	<i>Free access to the books, accounts, documents, securities, cash and other properties.</i>
(b)	<i>Require the officers of the society to call a general meeting of the society.</i>
(c)	<i>He may summon any person who is reasonably believed by him to have any knowledge.</i>
5.	Follow up:- <i>Within a period of three months communicate the report of inquiry.</i>
13.4.3	Inspection of Multi-State Co-operative societies under Section 79
1.	When:- <i>The Central Registrar may, on a request from</i>
	<ul style="list-style-type: none"> • <i>federal co-operative to which a Multi- State Co-operative society is affiliated.</i> • <i>not less than one-third of the members of the board or</i> • <i>not less than one-fifth of the total number of members.</i>
2.	How:- <i>By general or special order in writing in this behalf inspect.</i>
3.	Opportunity of Being heard:- <i>Not less than fifteen days.</i>
4.	Powers available:-
(a)	<i>Access to all books, accounts, papers, vouchers, securities, stock and other property.</i>
(b)	<i>Shall furnish such information with regard to the working of the society.</i>

5. **Inspection Report:-** Within a period of three months from the date of completion of such inspection.

14. **AUDIT OF TRUSTS & SOCIETIES**

There are three basic legal forms of charitable entities under Indian law: trusts, societies, and section 8 companies.

BOOKS OF ACCOUNT

- (i) cash book;
- (ii) ledger;
- (iii) journal;
- (iv) copies of bills, whether machine numbered or otherwise serially numbered
- (v) original bills wherever issued to the person and receipts in respect of payments made
- (vi) any other book

FINANCIAL STATEMENTS:- Balance sheet and Income and expenditure statements.
Auditor's responsibility

The auditor should then verify the records for the purpose of its audit.

He should keep detailed notes about the evidence on which he has relied upon while conducting the audit and also maintain all his working papers.

Such working papers should include his notes on the following, amongst other matters:

- (a) work done while conducting the audit and by whom;
- (b) explanation and information.
- (c) decision on the various points taken;
- (d) the judicial pronouncements.
- (e) certificates issued by the client / management letters.

It is important that the audit working papers prepared and/or obtained by the auditor provide evidence that:

- (i) the opinion expressed by the auditor is based on the examination;

- (ii) *in arriving at his opinion, the auditor has given due cognizance to the information.*
- (iii) *the information and explanations obtained were full and complete.*
- (iv) *the auditor did not merely rely upon the information or explanations.*

TRUSTS

The auditor has to ascertain:-

- (a) *whether accounts are maintained*
- (b) *whether receipts and disbursements are properly and correctly shown.*
- (c) *whether the cash balance and vouchers in the custody of the manager.*
- (d) *whether all books, deeds, accounts, vouchers were produced before him;*
- (e) *whether a register of movable and immovable properties is maintained.*
- (f) *whether the manager or trustee or any other person required to appear before him;*
- (g) *Funds of the Trust were applied for any object or purpose other than the object;*
- (h) *the amounts of outstanding for more than one year;*
- (i) *whether any money of the public trust has been invested contrary.*
- (j) *all cases of irregular, illegal or improper expenditure.*
- (k) *whether the maximum and minimum number of the trustees.*

SOCIETIES

The auditor's considerations:-

- (a) *The auditor should ascertain governing legislation of society.*
- (b) *Object of society.*
- (c) *Ascertain whether society has obtained registration.*
- (d) *Ascertain whether it is also registered under relevant provisions.*
- (e) *Obtain an understanding of internal control.*
- (f) *Evaluate appropriateness of accounting policies.*
- (g) *In case some expenses incurred by society are reimbursed by donors.*
- (h) *Ascertain, if any inquiry has been held by Registrar.*
- (i) *Ascertain all cases of irregular, illegal or improper expenditure.*
- (j) *Ascertain whether such expenditure or waste was caused in consequence of breach of trust or misapplication*

CHAPTER - 10

AUDIT OF BANK

1. INTRODUCTION

1.1 Types of Banks

There are different types of banking institutions prevailing in India which are as follows:

<i>Commercial Banks</i>	<i>Regional Rural Banks</i>
<i>Co-operative Banks</i>	<i>Payment Banks</i>
<i>Development Banks (more commonly known as 'Term-Lending Institutions')</i>	<i>Small Finance Banks</i>

1.2 Reserve Bank of India: Regulating Body

The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country.

1.2.1 RBI is responsible for:-

- ◆ development and supervision of the constituents of the Indian financial system
- ◆ the monetary and credit policies keeping in with the need of the hour.
- ◆ regulating the activities of commercial and other banks

1.2.2 Important functions of RBI are:-

- ◆ issuance of currency;
- ◆ regulation of currency issue;
- ◆ acting as banker to the central and state governments;
- ◆ acting as banker to commercial and other types of banks.

Banking Operations - Conducted only at Branches

1.3 Regulatory Framework

<i>Banking Regulation Act, 1949.</i>	<i>State Bank of India Act, 1955.</i>
<i>Companies Act, 2013.</i>	
<i>Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.</i>	

Regional Rural Banks Act, 1976.

Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

Information Technology Act, 2000. Prevention of Money Laundering Act, 2002.

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

Credit Information Companies Regulation Act, 2005.

Payment and Settlement Systems Act, 2007.

1.4 Peculiarities involved:

- ◆ *Huge volumes and complexity of transactions;*
- ◆ *Wide geographical spread of banks' network;*
- ◆ *Large range of products and services offered;*
- ◆ *Extensive use of technology;*
- ◆ *Strict vigilance by the banking regulator etc.*

2. Types of Bank Audit Reports to be issued (generally):

Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:

- (a)** *Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting.*
- (b)** *Long Form Audit Report. (LFAR)*
- (c)** *Report on compliance with SLR requirements.*
- (d)** *Report on treasury operations.*
- (e)** *Report on income recognition, asset classification and provisioning.*
- (f)** *Report on whether any serious irregularity was noticed.*
- (g)** *Report on status of the compliance by the bank Ghosh Committee Jilani Committee.*
- (h)** *Report on instances of adverse credit-deposit ratio in the rural areas.*

2. BANK AUDIT APPROACH

1. Drawing an Audit Plan

2. Control Environment at the Bank

The following are certain common questions /steps, which have to be kept in mind:

◆ **Nature of Questions**

- Who
- Where
- What
- Why
- When
- How

3. Engagement Team Discussions

The engagement team discussion ordinarily includes a discussion of the following matters:

- (a) Errors that may be more likely to occur;
- (b) Errors which have been identified in prior years;
- (c) Method by which fraud might be perpetrated by bank personnel
- (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

Advantages of such a discussion:-

- ◆ Specific emphasis should be provided to the susceptibility.
- ◆ Delegate the work to the experienced engagement team members.
- ◆ Need to involve specialists.

4. INCOME RECOGNITION POLICY

The policy of income recognition should be objective and based on record of recovery.

5. FORM AND CONTENT OF FINANCIAL STATEMENTS

Sub-sections (1) and (2) of Section 29 of the Banking Regulations Act, 1949. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

6. AUDIT OF ACCOUNTS

Sub-section (1) of section 30 of the Banking Regulations Act, 1949 auditor of companies

7.	ELIGIBILITY, QUALIFICATIONS AND DISQUALIFICATIONS OF AUDITOR
	<i>Applicable as to a Company Auditor</i>
8.	APPOINTMENT OF AUDITOR
◆	<i>The auditor of a banking company is to be appointed at the annual general meeting.</i>
◆	<i>The auditor of a nationalised bank through its Board of Directors.</i>
	<i>(In either case, approval of the Reserve Bank of India is required)</i>
◆	<i>The auditors of regional rural banks are to be appointed by the bank concerned with the approval of the Central Government.</i>
9.	REMUNERATION OF AUDITOR
(a)	<i>Section 142 of the Companies Act, 2013.</i>
(b)	<i>The remuneration of auditors of nationalised banks and State Bank of India is to be fixed by the Reserve Bank of India in consultation with the Central Government.</i>
10.	POWERS OF AUDITOR
	<i>Same powers as those of a company's auditor.</i>
11.	AUDITOR'S REPORT
	<i>In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:</i>
(a)	<i>Financial statements present a true and fair view.</i>
(b)	<i>Transactions of the bank have been made within the powers of that bank;</i>
(c)	<i>Returns received from the offices and branches.</i>
(d)	<i>any other matter.</i>
	<i>The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical.</i>
11.1	Format of Report
	<i>Standards on Auditing.</i>

11.2	<i>Long Form Audit Report</i>
	<i>The Statutory Central Auditors are required to submit the LFAR to the banks latest by 30th June every year.</i>
11.3	<i>Reporting to RBI</i>
1.	<i>Audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator.</i>
2.	<i>SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements".</i>
3.	<i>SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".</i>
12.	<i>CONDUCTING AN AUDIT</i>
1.	<i>Initial consideration by the statutory auditor</i>
(i)	<i>Declaration of Indebtedness</i>
(ii)	<i>Internal Assignments in Banks by Statutory Auditors</i>
(iii)	<i>Planning</i>
(iv)	<i>Communication with Previous Auditor</i>
(v)	<i>Terms of Audit Engagements</i>
(vi)	<i>Initial Engagements</i>
(vii)	<i>Assessment of Engagement Risk</i>
(viii)	<i>Establish the Engagement Team</i>
(ix)	<i>Understanding the Bank and its Environment</i>
2.	<i>Identifying and Assessing the Risks of Material Misstatements</i>
3.	<i>Understanding the Bank and Its Environment including Internal Control</i>
4.	<i>Understanding the Bank's Accounting Process</i>
5.	<i>Understanding the Risk Management Process</i>
(a)	<i>Oversight and involvement in the control process by those charged with governance</i>
(b)	<i>Identification, measurement and monitoring of risks</i>
(c)	<i>Control activities</i>
(d)	<i>Monitoring activities</i>
(e)	<i>Reliable information systems</i>
6.	<i>Engagement Team Discussions</i>
7.	<i>Establish the Overall Audit Strategy</i>

8.	<i>Develop the Audit Plan</i>
9.	<i>Audit Planning Memorandum: The auditor should summarise the audit plan</i>
	<ul style="list-style-type: none"> ◆ <i>Describe the expected scope and extent of the audit procedures.</i> ◆ <i>Highlight all significant issues and risks identified during their planning.</i> ◆ <i>Provide evidence that they have planned the audit engagement appropriately.</i>
10.	<i>Determine Audit Materiality</i>
11.	<i>Consider Going Concern</i>
12.	<i>Assess the Risk of Fraud including Money Laundering</i>
13.	<i>Assess Specific Risks</i>
14.	<i>Risk Associated with Outsourcing of Activities</i>
15.	<i>Response to the Assessed Risks</i>
16.	<i>Stress Testing</i>
17.	<i>BASEL III framework: The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB).</i>
18.	<i>Reliance on / review of other reports</i>
13.	ADVANCES
	<i>In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis.</i>
	Types of Advances: Funded Loans & Non-Funded Loans
	<ul style="list-style-type: none"> ◆ <i><u>Funded</u> loans are those loans where there is an actual transfer of funds from the bank to the borrower.</i> ◆ <i>Non-funded facilities are those which do not involve such transfer.</i>
13.1	What do ADVANCES comprise:
	<ul style="list-style-type: none"> ◆ <i>Term loans</i> ◆ <i>Cash credits, Overdrafts, Demand Loans Bills Discounted</i> ◆ <i>Interest-bearing Staff Loans</i>
13.2	Legal requirements of Disclosure in the Balance Sheet:
A.	<i>(i) Bills purchased and discounted</i>

(ii) Cash credits, Overdrafts and loans repayable on demand

(iii) Term Loans

B. (i) Secured by tangible assets

(ii) Covered by Bank/Government guarantees

(iii) Unsecured

Classification of Advances

1. Sector Wise

- Priority
- Non Priority

2. Security Wise

- Secured
- Unsecured

3. Prudential Norms

- Standard
- NPAs

C. I. Advances in India:	C. II. Advances outside India:
(i) Priority sectors	(i) Due from Banks
(ii) Public sector	(ii) Due from Others:
(iii) Banks	(a) Bills Purchased and discounted
(iv) Others	(b) Syndicated loans
	(c) Others

13.3 Classification of Advances

13.3.1 Sector Wise

RBI issues common guidelines for lending to Priority Sector.

13.4 SECURITY WISE

Banks ask Security or Collateral while lending to assure that the Borrower will return.

Nature of Security

A. Primary security one against which credit has been extended by the bank.

B. Collateral security is an additional security.

13.5	Mode of Creation of Security
(i)	Mortgage
	<ul style="list-style-type: none"> Registered Mortgage can be affected by a registered instrument. Equitable mortgage effected by a mere delivery of title deeds.
(ii)	Pledge: A pledge thus involves bailment or delivery of goods.
(iii)	Hypothecation: Creation of an equitable charge.
(iv)	Assignment: Transfer of an existing or future debt, right or property.
(v)	Set-off: Set-off is a statutory right of a creditor to adjust.
(vi)	Lien: Lien is creation of a legal charge with consent of the owner.
13.6	Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances:
	Classification of Advances as per RBI Prudential Norms
1.	Standard Loans
(a)	Standard Regular
(b)	SMA - Special Mention Accounts
	<ul style="list-style-type: none"> SMA 0 (Accounts showing stress signals) SMA 1 (Overdue between 31 to 60 days) SMA 2 (Overdue between 61 to 90 days)
2.	NPA Loans
	<ul style="list-style-type: none"> Sub - Standard Doubtful [D1/D2/D3] Loss
(i)	Non-performing Assets
	A non-performing asset (NPA) is a loan or an advance where:-
	<ul style="list-style-type: none"> Remain overdue for a period of more than 90 days in respect of a term loan; the account remains 'out of order' in respect of an Overdraft/Cash Credit the bill remains overdue for a period of more than 90 days.
(ii)	Out of Order
	<ul style="list-style-type: none"> the outstanding balance remains continuously in excess of the sanctioned limit. There are no credits continuously for 90 days as on the date of Balance Sheet Credits are there but are not enough to cover the interest debited.

(iii) Overdue

Categories of Non-Performing Assets:	Provision required
<ul style="list-style-type: none">• Substandard Assets: Would be one, which has remained NPA for a period less than or equal to 12 months.	75%
<ul style="list-style-type: none">• Doubtful Assets: Would be one, which has remained in the substandard category for a period of 12 months. Sub-categories: Doubtful up to 1 Year (D1) Doubtful 1 to 3 Years (D2) Doubtful more than 3 Years (D3)	(Secured + Unsecured) 25% + 100% 40% + 100% 100% + 100%
<ul style="list-style-type: none">• Loss Assets: Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Note:-

1. Classification as NPA should be based on the record of recovery.
2. Asset classification would be borrower-wise and not facility-wise.

(iv) Accounts regularized near the Balance Sheet Date: Few credits are recorded before the balance sheet date should be handled with care.

(v) Government Guaranteed advances:-

- ◆ Central Govt. guaranteed Advances would be classified as Standard Assets, but regarded as NPA for Income Recognition.
- ◆ The situation would be different if the advance is guaranteed by State Government.

(vi) Advances under Consortium:

Consortium advances mean advancing loans to a borrower by two or more Banks jointly by forming a Consortium.

Consortium advances should be based on the record of recovery of the respective individual member banks.

13.7	Accounts where there is erosion in the value of security / frauds committed by borrowers
(i)	Security is less than 50 per cent of the value straight-away classified under <u>doubtful category</u> .
(ii)	Is less than 10 per cent of the outstanding straight-away classified as <u>loss asset</u> .
13.8	Advances Against Term Deposits, NSCs, KVPs/ IVPs, etc. Need not be treated as NPAs, provided <u>adequate margin</u> is available.
13.9	Agricultural Advances Affected by Natural Calamities Banks may decide on their own relief measures.
13.10	Advances to Staff Advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards.
13.11	Agricultural Advances
(1)	Agricultural Advances for “long duration” crops; and
(2)	Agricultural Advances for “short duration” crops.
	The “long duration” crops would be crops with crop season longer than one year and crops, which are not “long duration” crops would be treated as “short duration” crops.
	The following NPA norms would apply to agricultural advances
◆	Short duration crops if the instalment of principal or interest thereon remains overdue for two crop seasons; and
◆	Long duration crops if the instalment of principal or interest thereon remains overdue for one crop season.
14.	COMPUTATION OF DRAWING POWER
1.	Meaning:- Drawing power is the limit up to which a firm or company can withdraw from the working capital limit sanctioned.
2.	Different from Sanctioned Limit:- Drawing Power refers to the amount calculated based on primary security less margin as on a particular date.

3. **Considerations:-** The drawing power and the sanctioned limit.
4. **Bank's Duties:-** Covered by the adequacy of the current assets.
5. **Auditor's Concern:-** Stock statements, quarterly returns other statements submitted by the borrower.
6. **Computation of DP:-** As per the extant guidelines formulated by the Board of Directors.
7. **Stock Audit:-** Funded exposure of more than 5 crores.

Particulars of current assets				DP
(A)	Stocks			
	Stocks at realizable value		1000	
	Less: Unpaid stocks:			
	- Sundry creditors	300		
	- Acceptances/LCs etc.	<u>300</u>	<u>600</u>	
	Paid for stocks		400	
	Margin @ 25%		<u>100</u>	300
(B)	Debtors			
	Total Debtors		1000	
	Less: Ineligible debtors		<u>200</u>	
	Eligible debtors		800	
	Margin @ 40%		<u>320</u>	<u>480</u>
	Total DP			780

15. AUDIT OF ADVANCES

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

- Which are outstanding at the date of the balance sheet.
- Advances represent amount due to the bank.
- Supported by loan documents and other documents.
- There are no unrecorded advances.
- The stated basis of valuation of advances is appropriate.
- The advances are disclosed, classified and described.
- Appropriate provisions towards advances have been made.

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

- ◆ *examining the validity of the recorded amounts;*
- ◆ *examining loan documentation;*
- ◆ *reviewing the operation of the accounts;*
- ◆ *examining the existence, enforceability and valuation of the security;*
- ◆ *checking compliance with RBI norms.*
- ◆ *carrying out appropriate analytical procedures.*

Evaluation of Internal Controls over Advances:

- ◆ *The bank should make an advance only after satisfying itself as to the credit worthiness.*
- ◆ *All the necessary documents*
- ◆ *The compliance with the terms of sanction.*
- ◆ *Sufficient margin*
- ◆ *The ownership of the same should be transferred in the name of the bank.*
- ◆ *All securities requiring registration should be registered in the name of the bank.*
- ◆ *Contents of the packages should be test checked at the time of receipt.*
- ◆ *Drawing Power Register should be updated every month.*
- ◆ *The accounts should be kept within both the drawing power and the sanctioned limit.*
- ◆ *Irregular should be brought to the notice of the controlling authority regularly.*
- ◆ *Advance account should be reviewed at least once a year.*

16. AUDIT OF REVENUE ITEMS - PROFIT AND LOSS ACCOUNT LOSS ACCOUNT

Sub-section (1) of Section 29 of the Banking Regulation Act, 1949.

16.1 Income

The following items are included under this head:

<i>Interest Earned</i>	<i>Other Income</i>
<ul style="list-style-type: none"> • <i>Interest/ Discount on Advances</i> • <i>Interest Income on Investments:</i> • <i>Interest on Balances with RBI</i> • <i>Others</i> 	<ul style="list-style-type: none"> • <i>Commission, Exchange and Brokerage</i> (a) <i>Commission on bills for collection.</i> (b) <i>Remittances and transfers.</i> (c) <i>Letters of credit</i>

- (d) Loan processing
- (e) Bills for collection
- (f) Mobile banking fees.
- (g) Credit/Debit card fee
- (h) Rent from letting out of lockers
- (i) Rent from letting out of lockers
- (j) Commission on Government business.
- (k) other permitted agency business
- (l) Brokerage on securities.
- (m) Fee on insurance referral.
- (n) Mutual fund clients.
- (o) Service/transaction banking charges
 - Profit on Sale of Investments
 - Profit on sale of Land, Buildings
 - Income earned by way of dividends, etc.,
 - Miscellaneous income.

16.1.1 Audit Approach and Procedures

- ◆ Auditor's Concern
- ◆ RBI's Directions
- ◆ Materiality
- ◆ Revenue Certainty
- ◆ Revenue Uncertainty
- ◆ Advances against Securities
- ◆ Bills Purchased
- ◆ Bills for Collection
- ◆ Renegotiations

Reversal of Income:

- (a) If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed.
- (b) In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed.
- (c) In case of banks which have wrongly recognised income in the past should reverse.
- (d) The auditor should enquire.

On leased assets: Asset became non-performing and remaining unrealised, should be reversed.

On Take-out finance: If based on record of recovery, the account is classified by the lending bank as NPA, it should not recognize income unless realised from the borrower/taking-over institution.

OBJECTIVE OF TAKEOUT FINANCE

1. *To expand sources of Finance for infrastructure projects.*
2. *To address sectoral/group/entity exposure issues.*
3. *To boost the availability of longer tenor debt finance for projects.*

On Partial Recoveries in NPAs:

Banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner.

Memorandum Account: Banks may continue to record such accrued interest in a Memorandum account in their books for control purposes.

Income from Investments

- ◆ *Interest Income on Investments*
- ◆ *Profit on Sale of Investments*
- ◆ *Profit/Loss on Revaluation of Investments*

16.2 Expenses

Expenditure is to be shown under three broad heads:

- (1) *Interest expense* (2) *Operating expense* (3) *Provisions and contingencies.*

16.2.1 Audit Approach and Procedures

- ◆ *In carrying out an audit of interest expense, assessing the overall reasonableness of the amount of interest expense.*
- ◆ *The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter.*
- ◆ *The auditor should also compare the average rate of interest paid.*

◆ The auditor should, on a test check basis, verify the calculation of interest.

(a) Interest has been provided on all deposits.

(b) Interest rates are in accordance with the bank's internal regulations.

(c) Interest on savings accounts are in accordance with the rules framed.

(d) Interest on inter-branch balances.

For audit of Operating expenses, the auditor should:-

◆ study and evaluate the system of internal control.

◆ should examine whether there are any divergent trends.

◆ perform substantive analytical procedures

◆ verify expenses with reference to supporting documents.

For audit of Provisions and contingencies the auditor should:-

◆ ensure that the compliances for various regulatory requirements.

◆ obtain an understanding as to how the bank computes provision.

◆ obtain the detailed break up.

◆ obtain the tax provision.

◆ examine the other provisions.

16.3 Disclosure of the prior period items

Third Schedule to the Banking Regulation Act, 1949 does not specifically provide for disclosure.

CHAPTER - 11

ETHICS & TERMS OF AUDIT ENGAGEMENT

1. MEANING OF ETHICS - A STATE OF MIND

The term "Ethics" means moral principles which govern a person's behaviour or his conducting of an activity.

2. NEED FOR PROFESSIONAL ETHICS

A Chartered Accountant, either in practice or in service, has to abide by ethical behaviours. They are expected to follow the fundamental principles of professional ethics while performing their duties.

Any deviation from the ethical responsibilities brings the disciplinary mechanism into action against the Chartered Accountants which may result into fines, suspension of membership, removal from membership or other disciplinary actions.

3. PRINCIPLES BASED APPROACH VS RULES BASED APPROACH TO ETHICS

The essence of principles-based approach to ethics is that it requires compliance with spirit of ethics.

Rules-based approach to ethics strictly follows clearly established rules. It may lead to a narrow outlook and spirit of ethics may be overlooked while strictly adhering to rules. Further, rules-based approach is somewhat rigid.

4. FUNDAMENTAL PRINCIPLES OF PROFESSIONAL ETHICS

1. Integrity

2. Objectivity

3. Professional competence and due care

4. Confidentiality

5. Professional Behaviour

5. INDEPENDENCE OF AUDITORS

(a) Independence of mind: allowing an individual to act with integrity, and exercise

objectivity and professional skepticism;

- (b) **Independence in appearance:** A member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

6. THREATS TO INDEPENDENCE

Following five types of threats to independence of auditors are discussed below:-

1. Self-interest threats

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

2. Self-review threats

Self-review threats occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client.

3. Advocacy threats

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

4. Familiarity threats

Familiarity threats are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests.

5. Intimidation threats

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

7. SAFEGUARDS TO INDEPENDENCE

To address the issue, the following guiding principles are to be applied:-

- ◆ It is essential that auditors should always be and appears to be independent.
- ◆ An auditor must conscientiously consider whether it involves threats.
- ◆ The auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level.
- ◆ He must not accept the work.

8. PROFESSIONAL SKEPTICISM

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

Professional skepticism includes being alert to, for example:

- ◆ Audit evidence that contradicts other audit evidence obtained.
- ◆ Information that brings into question the reliability of documents.
- ◆ Conditions that may indicate possible fraud.
- ◆ Circumstances that suggest the need for audit procedures.

Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

- ◆ Overlooking unusual circumstances.
- ◆ Over generalising when drawing conclusions.
- ◆ Using inappropriate assumptions.

9. AGREEING THE TERMS OF AUDIT ENGAGEMENTS

SA 210 deals with the auditor's responsibilities

9A Preconditions for an audit

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

- (a) Determine whether the FRF is acceptable and
- (b) Obtain the agreement of management
 - (i) For the preparation of the financial statements
 - (ii) For such IC as management considers necessary
 - (iii) To provide the auditor with:
 - ◆ Access to all information
 - ◆ Additional information
 - ◆ Unrestricted access to persons within the entity

9B. Agreement on audit engagement terms

Such a letter includes:-

- (a) The objective and scope of the audit of the financial statements
- (b) The responsibilities of the auditor
- (c) The responsibilities of management

	(d) Identification of the applicable financial reporting framework
	(e) Reference to the expected form and content of any reports to be issued
10.	LIMITATION ON SCOPE PRIOR TO AUDIT ENGAGEMENT ACCEPTANCE
	The auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.
11.	ACCEPTANCE OF A CHANGE IN THE TERMS OF THE AUDIT ENGAGEMENT
11.1	Request from Entity to change the Terms of Audit Engagement-When Reasonable Justification Exists?
	Change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances.
11.2	What should auditor consider before agreeing to change the audit engagement to the engagement providing lower level of assurance?
	If the auditor concludes that there is reasonable justification to change the audit engagement to a review or a related service, the audit work performed to the date of change may be relevant to the changed engagement.
	In order to avoid confusing the reader, the report on the related service would not include reference to:
	(a) The original audit engagement or
	(b) Any procedures that may have been performed in the original audit engagement, except engagement to undertake agreed- upon procedures.
11.3	Recourse available to auditor in situation of non- agreement to a change in terms of engagement and lack of permission from management to continue original audit engagement
	(a) Withdraw from the audit engagement
	(b) Determine whether there is any obligation, either contractual or otherwise.
12.	TERMS OF ENGAGEMENT IN RECURRING AUDITS
	Following factors may make it appropriate to revise the terms of the audit

	<i>engagement.</i>
(i)	<i>Any indication that the entity misunderstands the objective and scope of the audit.</i>
(ii)	<i>Any revised or special terms of the audit engagement.</i>
(iii)	<i>A recent change of senior management.</i>
(iv)	<i>A significant change in ownership.</i>
(v)	<i>A significant change in nature or size of the entity's business.</i>
(vi)	<i>A change in legal or regulatory requirements.</i>
(vii)	<i>A change in the financial reporting framework adopted in the preparation of the financial statements.</i>
(viii)	<i>A change in other reporting requirements.</i>
13.	AUDIT QUALITY
	<i>SQC 1 and SA 220 both deal with quality control.</i>
14.	SQC 1 - "QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS AND REVIEWS OF HISTORICAL FINANCIAL INFORMATION, AND OTHER ASSURANCE AND RELATED SERVICES ENGAGEMENTS"
15.	ELEMENTS OF SYSTEM OF QUALITY CONTROL
(A)	<i>Leadership responsibilities for quality within the firm</i>
(B)	<i>Ethical requirements</i>
(C)	<i>Acceptance and continuance of client relationships and specific engagements</i>
(D)	<i>Human resources</i>
(E)	<i>Engagement performance</i>
(F)	<i>Monitoring</i>
15A.	Leadership responsibilities for quality within the firm
	<i>Such policies and procedures should require the firm's chief executive officer or the firm's managing partners to assume ultimate responsibility for the firm's system of quality control.</i>
15B.	Ethical requirements
	<i>Such policies and procedures should enable the firm to:-</i>
(a)	<i>Communicate its independence requirements to its personnel.</i>

	<i>(b) Identify and evaluate circumstances and relationships that create threats.</i>
	<i>(c) There should exist a mechanism in the firm by which engagement partners provide the firm with relevant information about client engagements.</i>
	<i>(d) At least annually, the firm should obtain written confirmation of compliance.</i>
15C.	Acceptance and Continuance of Client Relationships and Specific Engagements
	<i>Such an information should help firm to decide about: -</i>
	◆ <i>Integrity of Client</i>
	◆ <i>Competence (including capabilities, time and resources) to perform engagement.</i>
	◆ <i>Compliance with ethical requirements</i>
	<i>With regard to the integrity of a client, matters that the firm considers</i>
	◆ <i>The identity and business reputation</i>
	◆ <i>The nature of the client's operations</i>
	◆ <i>Information concerning the attitude of the client's principal owners</i>
	◆ <i>Aggressively concerned with maintaining the firm's fees as low as possible.</i>
	◆ <i>Indications of an inappropriate limitation in the scope of work.</i>
	◆ <i>Indications that the client might be involved in money laundering.</i>
	◆ <i>The reasons for the proposed appointment</i>
	<i>Policies and procedures on the continuance of the engagement.</i>
	<i>(a) The professional and legal responsibilities that apply to the circumstances.</i>
	<i>(b) The possibility of withdrawing from the engagement.</i>
15D.	Human resources
	<i>Recruitment, compensation, training, career development, performance evaluation etc.</i>
15E.	Engagement Performance
	<i>Consistency in quality of engagement performance briefing, complying, supervision and training, reviewing, appropriate documentation.</i>
	<i>Consultation should take place in difficult or contentious matters</i>
	<i>Significant judgments made in an engagement should be reviewed by an engagement quality control reviewer.</i>
	<i>Engagement quality control review is mandatory for all audits of financial statements of listed entities.</i>
	<i>There might be difference of opinion within engagement team, with those consulted</i>

	and between engagement partner and engagement quality control reviewer. The report should only be issued after resolution of such differences.
	The assembly of engagement files should be completed in not more than 60 days after date of auditor's report.
	Policies and procedures should be designed to maintain the confidentiality.
	Engagement documentation is the property of the firm.
	Retention period ordinarily is no shorter than seven years from the date of the auditor's report.
15F.	Monitoring
	Policies and procedures relating to the system of quality control are relevant.
16.	SA 220- "QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS"
16A.	Leadership responsibilities for quality on audits
(a)	The importance to audit quality of:-
(i)	Performing work that complies with professional standards;
(ii)	Complying with the firm's quality control policies and procedures;
(iii)	Issuing auditor's reports;
(iv)	The engagement team's ability to raise concerns without fear of reprisals.
(b)	The fact that quality is essential in performing audit engagements.
16B.	Relevant ethical requirements
◆	Identifying a threat to independence regarding the audit engagement.
◆	Reporting by engagement partner to the relevant persons within the firm.
16C.	Acceptance and Continuance of Client Relationships and audit Engagements
	Is on lines of SQC 1
16D.	Assignment of engagement teams
	Collectively have the appropriate competence and capabilities
16E.	Engagement Performance
	For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:
(a)	Determine that an engagement quality control reviewer has been appointed.
(b)	Discuss significant matters arising during the audit engagement.

(c) *Not date the auditor's report until the completion of the engagement quality control review.*

16F. Monitoring

The engagement partner should document following matters:

(a) *Issues identified with respect to compliance with relevant ethical requirements.*

(b) *Conclusions on compliance with independence requirements.*

(c) *Conclusions reached regarding the acceptance and continuance.*

(d) *The nature and scope of, and conclusions resulting from, consultations.*