

# CHAPTER 1 NATURE , OBJECTIVE & SCOPE OF AUDIT

## BASICS OF AUDIT

### • Definition & Objectives of Audit –

Audit is Independent examination of Financial Information of any entity , whether profit oriented or not & irrespective of it's size or legal form , when such examination is conducted with view of expressing an opinion there on.

### Objectives of Audit

To obtain **Reasonable Assurance** about whether financial statements as a whole **are free from material misstatement &**

To **report** on Financial Statements & **Communicate** as required by SA's

**Auditor should keep in mind following points to ensure financial statements are not misleading (Entries & financial statements)**

- Accounts have been drawn with reference to entries from Books of Accounts
- Entries are adequately supported by sufficient & appropriate audit evidence
- None of the entries have been omitted in process of compilation & nothing which is not in Books of account is included in Financial Statements
- Information Conveyed by Statements is clear & unambiguous
- Amounts in Financial Statements are properly classified , described & disclosed as per AS
- Statement of Accounts presents True & Fair picture of operational results & Assets & Liabilities

### Scope of Audit

Audit should cover all aspects of Enterprise relevant to financial statements being audited

To form an opinion on Financial Statements , auditor should be reasonably satisfied information contained in accounting records & other source data is reliable & sufficient for preparation of financial statements

Auditor assess reliability & sufficiency of accounting records & source data by

1. Making a study & evaluation of accounting systems & internal control
2. Carrying out tests , enquiries & other verification procedures

Auditor should also decide whether Information is properly disclosed in financial statements as per statutory requirements

Auditor determines Information is properly disclosed by

1. Comparing Financial Statements with Accounting records & other source data
2. Considering judgements that management has made in preparing financial statements

Auditor is not expected to perform duties which fall outside the scope of his competence

Constraints on the scope of audit should be set out in his report & a qualified or disclaimer of opinion should be expressed as appropriate

### Types of audit

#### Audit required under law

Companies as required by Companies Act 2013  
Banking Companies  
Electricity supply Companies  
Cooperative Societies  
Public & Charitable Trusts  
Corporations set up under Act of Parliament or State Legislature like LIC  
Specified Entities under various Section of Income Tax Act , 1961

#### Voluntary audit

Proprietary Entities  
Partnership Firms  
Hindu Undivided Families



# CHAPTER 1 NATURE , OBJECTIVE & SCOPE OF AUDIT

## BASICS OF AUDIT – PART 2

### Advantages of Audit of Financial Statements

- It safeguards **the financial interest of the person** who are not associated with management of entity , be it shareholders or partners
- It acts as a **moral check on employees** from committing defalcations or embezzlement
- Audited statement of accounts are helpful in **settling liability for taxes , negotiating loans & determining the purchase consideration for business**
- They are helpful in **settling trade disputes for higher wages or bonus as well as insurance claims**
- They are of help in **settlement of accounts** at time of **admission or death** of partner
- Audit ascertains whether **necessary books of accounts & allied records** have been kept , & any weakness in that regard
- Audit helps in **detection of wastages & losses** especially those that occur due to inadequate internal checks or internal controls
- Audit reviews **existence & operations of various controls & reports** inadequacies or **Weakness in them**
- Government may require audited & certified statements before it **gives financial assistance or issues license for particular trade**

### Aspects to be covered in audit

- Examination of System of Accounting & Internal Control whether it is **appropriate** for Business & helps in recording all transactions
- Reviewing system & procedures to find out whether they are **adequate & comprehensive & helps in detecting errors & fraud**
- Checking of **arithmetical accuracy** of books of accounts
- **Verification of authenticity & validity of transactions** by checking transactions entered with relevant supporting documents
- Comparison of **B/S & P & L A/c** or other statements with underlying records
- Verification of **title , existence & valuation of Assets**
- Verification of **liabilities stated in B/S**
- Ascertaining **proper distinction** is made between **capital & revenue items** and items of Income & Expenditure **are adjusted in accounts in accounting period**
- Checking the results shown by **P/L are true & fair**
- Whether audit is of **body corporate confirming statutory requirements** have been complied
- Reporting to appropriate body / person whether **statement of accounts show true & fair view of state of affairs & profit & loss of organisation**

### Inherent Limitations of Audit

**Nature of Financial Reporting** – Judgement by Management & many financial statements also involve subjective decisions which differs from different management perspective

**Nature of Audit Procedures** - Auditors job is to do audit & not do official investigation into alleged wrong doing. Fraud if done will always be carefully organized to conceal it

**Timeliness of Financial Statements & Balance between Benefit & Cost** – We want more information early to get more benefit , but it may involve more cost which we are not ready to incur and there is fixed deadline of financial statements . So maintaining balance between Benefit & cost is difficult and also completing audit in time

### Other Matters That Affect Limitation of Audit -

Fraud involving Senior Management or collusion  
Existence & completeness of related party relationships  
Non-compliance with laws & regulations  
Future events or conditions that may cause entity to cease continue as going concern



# CHAPTER 1 NATURE , OBJECTIVE & SCOPE OF AUDIT

## ELEMENTS OF SYSTEM OF QUALITY CONTROL

**Firms system of Quality Control should include policies & procedures addressing each of the following elements :**

1. Leadership Responsibilities for Quality within the firm
2. Ethical Requirements
3. Acceptance & Continuance of Client Relationships & Specific Engagements
4. Human Resources
5. Engagement Performance
6. Monitoring

### **Leadership Responsibilities for Quality of Audit**

- Engagement partner is responsible for quality of each audit engagement to which he is assigned as partner
- Actions of Engagement Partner & members of Engagement Team in taking responsibility for over all quality on each audit engagement emphasize –
- Importance to **Audit Quality** of –
  1. Performing work that complies with professional standards & regulatory & legal requirements
  2. Complying with firm's quality control policies & procedures
  3. Issuing auditor's report appropriate as per circumstances
  4. Ability to raise concerns without fear of reprisals

The Fact that quality **is essential in performing audit engagements**

### **Ethical Requirements relating to an Audit of Financial Statements**

**Code of Ethics has given Fundamental Principles of Professional Ethics relevant to auditor conducting audit of financial statements (I-COP)**

Integrity

Confidentiality

Objectivity

Professional Competence & Due Care

Professional Behaviour

**Independence of Mind** – State of Mind that permits making an opinion without being affected by others , & act with integrity & exercise objectivity & professional scepticism

**Independence of Appearance** – Such Facts & Circumstances should not be that that third party can conclude that auditor's integrity , objectivity or professional scepticism has been compromised

Threats to Independence (SAIF)

Self Interest Threat

Self Review Threat

Advocacy Threats

Intimidation Threat

Familiarity Threat

**Safeguards to Independence**

When such threat exists , audit should not take the audit or put in place safeguards that eliminate them . If Auditor is unable to implement adequate safeguards , he must not accept the work

### **Acceptance & continuance of client relationships & audit engagements**

**SQC 1** requires that firm obtains information before accepting

Engagement

Information such as following assists Engagement Partner in deciding Acceptance & Continuance of Audit Engagement are Appropriate or not :

- Integrity of Principal Owners , Key Management & those Charged with Governance
- Whether Engagement Team is Competent to perform audit & has necessary capabilities including time & resources
- Whether Firm & Engagement Team comply with relevant ethical requirements
- Significant matters that have arisen during current or previous audit engagement & their implications for continuing relationship

# CHAPTER 1 NATURE , OBJECTIVE & SCOPE OF AUDIT

## ELEMENTS OF SYSTEM OF QUALITY CONTROL – Part 2

### Engagement Performance

Firm should establish Policies & Procedures to ensure Engagements are performed in accordance with Professional Standards & legal & regulatory requirements & Engagement partner issues reports that are appropriate in circumstances

Through Policies & Procedures –

1. Firm seeks to establish consistency in quality of engagement performance
2. Consistency is accomplished through written or electronic manuals , software tools or other subject matter specific guidance
3. Matters include
  - How engagement teams are briefed on Engagement
  - Processes for complying applicable engagement standards
  - Engagement supervision , staff training & coaching

### Human Resources

Firm should establish Policies & Procedures to provide it with reasonable assurance that it has Personnel with Capabilities , Competence & Commitment to ethical Principles necessary to perform its engagements

#### **Policies & Procedures should Address Following Personnel Issues**

Recruitment  
Capabilities  
Competence  
Career Development  
Promotion  
Compensation  
Performance Evaluation  
Estimation of Personnel Needs

### Monitoring

Firm should establish Policies & Procedures designed to provide that system of quality control are relevant , adequate , operating effectively & complied with in practice.

#### **Purpose of Monitoring Compliance with Quality Control Policies & Procedures is to Provide Evaluation of :**

- Adherence to Professional Standards & regulatory & legal requirements
- Whether Quality Control System is designed & effectively implemented
- Whether firm's quality control policies & procedures have been appropriately applied , reports are issued as appropriate in circumstances



# CHAPTER 1 NATURE , OBJECTIVE & SCOPE OF AUDIT

## SA-210 Agreeing the Terms of Engagement

Auditor shall agree with terms of Audit Engagement with Management or those charged with Governance as appropriate. Audit Engagement Letter is sent by Auditor to his client

**The terms of Audit Engagement shall include –**

1. Objective & Scope of Audit of Financial Statements
2. Responsibilities of Auditor
3. Responsibilities of Management
4. Identification of Applicable Financial Reporting Framework for preparation of financial statements
5. Form & Content of Audit report to be issued by Auditor

**As per SA 210 “Agreeing the Terms of Audit Engagement” , Preconditions for an audit may be defined as “ Use by Management of an acceptable financial reporting framework in preparation of financial statements & agreement of management & those charged with governance to premise on which audit is conducted “**

In order to establish Preconditions for an audit are present , Auditor shall

- Determine whether Financial Reporting framework is acceptable &
- Obtain agreement of management that it acknowledges and understands its responsibility :
  1. For Preparation of financial statements as per relevant framework
  2. For Internal Control as Management considers necessary
  3. To Provide Auditor with All Information , Additional Information & Unrestricted access to persons for obtaining audit evidence

### **Limitation on Scope Prior to Audit Engagement Acceptance**

If Management or those charged with Governance put limitation on scope of auditor's work such that auditor feels he has to issue Disclaimer of Opinion Report Auditor shall not accept such limited Engagement unless required by law or regulation to do so

### **Acceptance of a change in engagement**

Auditor before completion of Engagement is requested to change the Engagement

If Auditor concludes that there is **Reasonable Justification to change the engagement** , he shall prepare New Engagement Letter & Issue report under revised terms and to avoid confusion would not reference to original engagement or work performed under original engagement If there is **No Reasonable Justification** , Auditor should not agree & should tell Management to continue the assignment

If not permitted by Management to continue He shall Withdraw from Audit Engagement where possible under law or regulation & report to parties such as owner , regulator or those charged with governance

### **Recurring Audits**

Auditor may not decide to sent new Engagement Letter for each period.

**However in following factors he has to prepare New Engagement Letter –**

- Any Indication that entity misunderstands objective & scope of Audit
- Any revised or special terms of audit engagement
- A recent change of Senior Management
- A Significant Change in Ownership
- A Significant Change in Nature or Size of Entity's Business
- Change in legal or regulatory requirements
- Change in Financial reporting framework
- Change in other Reporting Requirement



# CHAPTER 2 AUDIT STRATEGY , PLANNING & PROGRAMME

## AUDIT STRATEGY

### Establishment of Over-all Audit Strategy

- **Determination Of Characteristics of Audit** – Identify the characteristics of engagement that define its scope
- **Team Efforts** – Consider factors in auditors judgement are significant in Directing the Engagement Team's effort
- **Reporting Objectives** – Ascertain the reporting objectives to plan timing of audit & nature of communication required
- **Nature , Timing & Extent of Resources** – Determine nature , timing & extent of resources required to perform the Engagement
- **Preliminary Work** – Consider results of preliminary engagement activities & where Applicable knowledge gained on other assignments

### Audit Planning : A Continous Process

Planning includes certain activities to be done before performance of Further Audit Procedures & include matters such as :

1. Analytical Procedures to be applied as risk assessment procedures
2. Performance of other risk assessment procedures
3. Obtain General understanding of legal & regulatory framework applicable to entity and how entity is complying with that framework
4. Determination of materiality
5. Involvement of experts

### Over-all Audit Strategy & Plan is Auditor's Responsibility

Auditor may discuss elements of planning with management to facilitate the conduct & management of audit engagement Although these discussions often occur , overall strategy & plan remain auditor's responsibility

When discussing matters with management , care is required not to compromise effectiveness of audit

### Direction , Supervision & Review of Engagement Team Members Depends on : (CARS)

Capabilities & Competence of Individual team members performing work

Area of the audit

Assessed risk of material misstatements

Size & Complexity of entity

### Audit Strategy Assists Auditor in / Benefits of Audit Strategy

- Employment of Qualitative Resources
- Allotment of Quantity of Resources
- Timing of Deployment of Resources
- Management of Resources
- 

### Documentation of Audit Plan

Auditor shall document :

**Over-all Audit Strategy**– Over all Audit Strategy includes record of key decisions considered necessary to properly plan the audit & communicate significant matters to engagement team

**Audit Plan** – Audit Plan is record of planned Nature , Timing & Extent of Risk assessment procedures & further assessment procedures

**Changes made to Audit Strategy & Audit Plan** – Changes in Plan & Strategy will also make changes in Nature , Timing & Extent of Audit Procedures



# CHAPTER 2 AUDIT STRATEGY , PLANNING & PROGRAMME

## AUDIT PLANNING

### **Any Audit Plan should Cover :**

1. Knowledge of the client accounting system , policies & internal control procedures
2. Establishing the expected degree of reliance to be placed on Internal Controls
3. Determining nature , timing & extent of audit procedures to be performed
4. Coordinating the work to be performed

Planning is not a discrete phase of audit , rather continual & iterative process that begins shortly after completion of previous engagement & continues till completing of current audit engagement

### **Benefits of Planning in Audit of Financial Statement**

1. Proper Organisation & Management of Audit Engagement
2. Attention to Important Areas
3. Timely Resolution of Potential Problems
4. Proper Selection of Engagement Team
5. Direction & Supervision of Engagement Team
6. Easy Coordination

### **Knowledge of Client's Business**

Auditor shall obtain understanding of following Relevant industry , regulatory & other external factors including applicable financial reporting framework

Nature of Entity including operations , ownership & governance structures , types of investments , way entity is financed

Entity's selection & application of accounting policies & reasons for changes thereto

Entity objectives & strategies and those related business risks that may result in risk of material misstatements

Measurement & review of financial performance

### **Contents of Audit Plan**

Nature , Timing & Extent of Risk Assessment Procedures

Nature , Timing & Extent of Further Audit Procedures

Other Planned Audit Procedures as per SA's

There can be change in Audit Strategy & Audit Plan , this may result in changes in Nature , Timing & Extent of Further Audit Procedures based on consideration of assessed risks



# CHAPTER 2 AUDIT STRATEGY , PLANNING & PROGRAMME

## AUDIT PROGRAMME

### Audit Programme

It is series of Verification Procedures to be applied to financial statements of company to obtaining sufficient evidence to enable auditor to express an informed opinion on such statements

Business vary in size , nature & composition , work which is suitable to one business may not be suitable to other Hence one Audit Programme applicable to all business under all circumstances is not practicable

### Advantages of Audit Programme

- It gives Assistants clear set of instruction of work to be done
- In case of major audits , it gives Total Perspective of work to be performed
- In case of Written Programme , there is no danger of ignoring certain Books & Records
- Selection of Assistants for Jobs on basis of capability becomes easier when work is divided / segregated
- Signature by assistants on programme accept responsibility of work and work can be traced back
- Principal can control progress of various audits by audit programme
- Serves as a Guide for audits to be carried out in succeeding years
- Serves as a Evidence in event of charge of Negligence against Auditor

### Constructing Audit Programme –

#### FOLLOWING POINTS TO BE KEPT IN MIND

- Stay within the Scope & Limitations of Assignment
- Consider all the Possibilities of Error
- Determine Evidence reasonably available & identify best evidence for deriving satisfaction
- Apply those steps & procedures which are useful in Verification Purpose in specific situation
- Coordinate the procedures to be applied to related items

### Developing the Audit Programme

- **Written Audit Programme** – It will include procedures that are needed to implement audit plan
- **Audit Objective & Instruction to Assistants** – Audit Objective of each areas & set of instruction to assistants
- **Reliance on Internal Controls** –For Determining Nature , Timing & Extent of Auditing Procedures
- **Timing of Performance of Audit Procedures** – Auditor is flexible in performing audit procedures except in some cases
- **Audit Planning** – Starts after conclusion of previous years audit & should be modified as audit progresses

### Disadvantages of Audit Programme (MARI)

1. Work can become **mechanical** & some steps can be carried out without understanding objective of whole audit scheme
2. Inefficient **Assistants** take shelter behind program
3. Programme can tend to be **rigid & inflexible** following rules , business is changed , but still old programme is carried on.
4. Hard & Fast Audit Programme may kill **initiative of efficient assistants**

#### Open Mind while Developing Programme

**Standard Programme** – Having regard to Nature , Size & Composition of business & Internal Controls , we should frame a programme with minimum essential work

**Alterations** – As experience is gained by carrying out the work , program may be altered to take care of situations that were earlier left out



# CHAPTER 2 Audit Strategy , Planning & Programme

## SA-320 Materiality in Planning & Performing the Audit

**SA 320** requires auditor should consider Materiality & its relationship with audit risk while performing audit

When planning audit , auditor should select audit procedures that can reduce audit risk to acceptably low level

Auditor's assessment of materiality and audit risk may be different at time of planning as against at time of evaluating results of audit procedures

### **Determining Materiality & Performance Materiality while Planning the Audit**

**Materiality** – While Establishing Audit Strategy , auditor shall determine materiality for financial statements as a whole . If in specific circumstances , there is one or more particular class of transactions , account balance or disclosures for which misstatement of lesser amounts than materiality could reasonably be expected to influence economic decision of users taken on the basis of the financial statements , auditor may determine materiality levels to be applied to those class of transactions, account balance or disclosures

**Performance Materiality** – Means amount set by auditor at less than materiality for the financial statements as a whole to reduce probability that aggregate of uncorrected & undetected misstatement exceeds materiality of Financial Statements as whole

### **Use of Benchmark in Determining Materiality for Financial Statements as Whole**

1. Elements of Financial Statements (Turnover , Profit before Tax , Gross Profit , Total Assets , Total Equity)
2. Items where user's focus on Financial Statements
3. Nature of Entity , lifecycle , industry & economic environment in which it operates
4. Entity's Ownership Structure & way it is financed
5. Volatility

**Amount even less than materiality could influence economic decision of users on financial statements when :**

1. Whether law , regulation or applicable financial reporting framework affects users expectations regarding measurement or disclosure of certain items
2. Key disclosures in relation to industry in which entity operates
3. Whether attention is focused on particular aspect of entity's business that is separately disclosed in financial statements

### **Revision of Materiality as Audit Progresses**

Materiality for financial statements as a whole may need to be revised as result of change in circumstances that occurred during audit , new information or change in auditor's understanding of entity & operations as a result of performing further audit procedures

If the auditor concludes that a lower materiality for the financial statements as a whole than that initially determined is appropriate , auditor shall determine whether it is necessary to revise performance materiality & whether nature , timing & extent of further audit procedures remain appropriate



# CHAPTER 3 AUDIT DOCUMENTATION & AUDIT EVIDENCE

## SA 230 AUDIT DOCUMENTATION

### AUDIT DOCUMENTATION

- It refers to record of audit procedures performed , relevant audit evidence obtained & conclusions the auditor reached
- It is also called as working papers or work papers

### COMPLETION MEMORANDUM / AUDIT DOCUMENTATION SUMMARY

Auditor may consider to keep part of Audit Documentation as a summary that describes – Significant matters identified during audit & How they are addressed

#### Benefits

It helps in effective & efficient review & inspection of audit documentation  
Assist Auditor's consideration of significant matters  
Helps to see if any SA is not followed which will prevent auditor from achieving it's objectives

### COMPLETION MEMORANDUM / AUDIT DOCUMENTATION SUMMARY

SQC 1 provides that Audit Documentation is property of the auditor  
He may at his discretion make portions or extracts from audit documentation available to client if it does not affect independence of auditor or undermine the validity of work performed by him

- **Purpose of Audit Documentation**
- Assisting Engagement Team to Plan & Perform the Audit
- Assisting members of Engagement Team to direct & supervise auditor work & to discharge their review responsibilities
- Enable team to be accountable for its work
- Retaining record of matters of continuing significance to future audits
- Enabling conduct of quality control inspections & reviews
- Enabling conduct of External Inspection in accordance with legal or regulatory requirements

### Form, Content & Extent of Audit Documentation

Size & Complexity of Audit

Identified risk of material misstatements

Nature of Audit Procedures to be performed

Significance of Audit Evidence obtained

Nature & Extent of Exception Identified

Need to Document a conclusion or basis for a conclusion not readily determinable from documentation of work performed

Audit Methodology & Tools used

### Assembly of Final Audit File

Audit File is defined as one or more folders or other storage media in physical or electronic form containing records that comprise audit documentation for specific engagement

Auditor shall assemble audit documentation in audit file on timely basis after Auditor's report

SQC 1 gives us time limit of max 60 days after the date of auditor's report

Completion of Final Audit File is administrative process and does not involve performance of new audit procedure or drawing of new conclusions

Changes can be made in Audit File if they are administrative in nature

#### Retention Period

After assembly of final audit file is completed , auditor shall not delete or discard audit documentation of any nature before end of 7 years



# CHAPTER 3 AUDIT DOCUMENTATION & AUDIT EVIDENCE

## SA 500 AUDIT EVIDENCE

### Audit Evidence

Auditing is a logical process, auditor is called upon to assess the actualities of situation & review the statements & give true & fair view on accounts of the company

An Opinion given on reckless & negligent examination & evaluation may expose the auditor to legal action with consequential loss of professional standing & prestige

It is Information used by auditor in arriving at the conclusions on which auditor's opinion is based

It includes –

- Information contained in accounting records
- Other Information that authenticates Accounting records & also supports auditor's rationale behind true & fair presentation of financial statements

### Types of Audit Evidence

#### Depending upon Nature

- Visual
- Oral
- Documentary

#### Depending Upon Source

- Internal
- External

Auditor should obtain reasonable assurance, to obtain that he shall obtain **Sufficient Appropriate Audit evidence** to reduce audit risk to an acceptably low level & after that make opinion on Financial Statements

SA 500 Audit Evidence states we should obtain Sufficiency & Appropriateness evidence.

Sufficiency is **quantum of evidence (quantity)**  
Appropriateness relates to **relevance & reliability (quality)**

**Auditor's judgement as to sufficiency may be affected by factors such as : (MSR)**

1. **Materiality** – More Material, More Evidence & Vice-versa
2. **Risk of Material Misstatement** – More risk of material misstatements more checking & vice-versa
3. **Size & Characteristics of the Population** – If size is bigger & heterogeneous, we need more checking & vice-versa

**Appropriateness of Audit Evidence** – It is measure of quality, **relevance & reliability** & influenced by source & by its nature & is dependent on individual circumstances under which it is obtained

**Relevance deals with logical connection with or bearing upon the purpose of audit procedure** and where **appropriate assertion** under consideration. Relevance also may be affected by **direction of testing**

### Reliability of Audit Evidence

- Reliability is increased when it is obtained from **Independent Sources outside the entity**
- If Internal Controls are **effective**, then Internal evidence is more reliable than external
- Audit evidence **directly obtained by Auditor** is more reliable than obtained indirectly
- Audit Evidence in **Documentary form or written form is more reliable than evidence obtained orally**
- Audit Evidence provided **by original documents is more reliable than xerox, fax or documents in electronic form**



# CHAPTER 3 AUDIT DOCUMENTATION & AUDIT EVIDENCE

## AUDIT PROCEDURES TO OBTAIN AUDIT EVIDENCE

### AUDIT PROCEDURES TO OBTAIN AUDIT EVIDENCE

Audit Procedures to draw reasonable conclusion on which to base auditor's opinion is obtained by performing :

- Risk Assessment Procedures &
- Further Audit Procedures contains :
  1. Test of Controls as required by SA's &
  2. Substantive Procedures including test of details & substantive analytical procedures

#### Risk Assessment Procedures

Audit Procedures performed to obtain Understanding of entity & its environment , including the entity's internal control to identify & assess the risk of material misstatement due to fraud or error at the financial statements & assertion levels

#### Nature & Timing of Audit Procedures

Affected by availability of information only in electronic form or only at certain points or period of time

### Further Audit Procedures

Test of Controls an audit procedure designed to evaluate the operating effectiveness of controls

#### Nature of Test of Controls –

Perform audit procedures in combination with inquiry to obtain audit evidence about operating effectiveness of the controls including –

1. How Controls were applied
2. By Whom they were applied
3. Consistency within which they were applied

Determine whether controls to be tested are dependent on other controls , if so we need need to test effective operation of those indirect controls

#### Determining Extent of Test of Controls includes :

1. Frequency of Performance of the control by Entity during the Period
2. Length of time during audit period auditor is relying on operating effectiveness of control
3. Expected rate of Deviation from Control
4. Relevance & Reliability of audit evidence to be obtained regarding operating effectiveness of controls

#### Timing of Test of Controls

- Auditor shall test controls for particular time or through out the period for which auditor tends to rely on those controls

### Using Audit Evidence Obtained in Previous Audits

**Whether it is appropriate to use Audit Evidence obtained in Previous Period regarding Operating Effectiveness of Internal Control depends on –**

1. Effectiveness of the Control & its application by the Entity
2. Effectiveness of other elements of Internal Control
3. Effectiveness of General IT Controls
4. Risks arising from characteristics of the control including whether it is manual or automated
5. Risk of Material misstatement & extent of reliance on the control
6. Risk arising due to lack of change in a particular control due to changing circumstances



# CHAPTER 3 AUDIT DOCUMENTATION & AUDIT EVIDENCE

## DESIGNING & PERFORMING SUBSTANTIVE PROCEDURES

### Combination of Methods/Techniques to Perform Audit Procedures & Obtain Evidence (AE-RIO)

1. **Analytical Procedures** – It consists of evaluation of financial information made by study of relationships among financial & non-financial data . It this we will check relationships with other relevant information or deviate significantly from predicted amounts
2. **External Confirmation** – Represents audit evidence obtained by auditor as a direct written response to auditor from third party in paper form or electronic or other medium.
3. **Recalculation** – It consists of checking mathematical accuracy of documents or records . It may be done manually or electronically
4. **Re-Performance** – Involves auditor's independent execution of procedures or controls where were originally performed as part of entity's internal control
5. **Inquiry** – It consists of seeking information from knowledgeable persons within or outside the entity . Used extensively in audit . It may range from formal written inquiries to oral inquiries. It is used to support audit evidence previously possessed
6. **Inspection** – It involves examining records or documents whether internal or external in paper or electronic form or other media or physical examination of Assets
7. **Observation** – It consists of looking at a process or procedure being performed by others , but it is limited to point in time at which observation takes place

### Designing & Performing Substantive Procedures

Auditor's assessment of risk is Judgemental & so may not identify all risks of material misstatement &

There are inherent limitations to internal control including management override

Depending Upon Circumstances auditor may determine that –

1. Performing only substantive analytical procedures will be sufficient to reduce risk to an acceptably lower level
2. Only Test of Details are appropriate
3. Combination of Both

Substantive Analytical Procedures are more applicable to large volumes of transactions that tend to be predictable over time

Nature of risk & assertion is relevant to design of Test of Details

Substantive Procedures need to be increased when results from Test of Controls are Unsatisfactory

In Designing Test of Details extent is testing is ordinarily thought of in terms of sample size

### Assertions

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

#### PC MOVE RIGHT

1. **Presentation** – Properly disclosed , classified & described as per framework
2. **Completeness** – No Unrecorded Assets , Liabilities or transaction
3. **Measurement** – Transaction recorded in proper amount & period
4. **Occurrence** – Transaction or Event took Place
5. **Valuation** – Asset or Liability is recorded at appropriate carrying value
6. **Existence** – Asset or Liability Exists at a given date
7. **Rights & Obligation** – Asset is right & Liability is obligation at a given date



# CHAPTER 3 AUDIT DOCUMENTATION & AUDIT EVIDENCE

## Audit Evidence—Specific Considerations For Selected Items (SA 501)

**Objective of Auditor is to obtain Sufficient & Appropriate Audit Evidence about –**

- **Existence & Condition of Inventory**
- **Completeness of litigation & claims involving the Entity**
- **Presentation & Disclosure of Segment Information**

### **Existence & Condition of Inventory**

When Inventory is **material to financial statements**, auditor shall obtain sufficient appropriate audit evidence regarding existence & condition of Inventory by –

**Attendance at Physical Inventory Counting –**

1. Evaluate **Management Instruction & Procedures** for **recording and controlling physical inventory** counting
2. Observe **the Performance of management's count procedures**
3. **Inspect the Inventory &**
4. **Perform Test Counts**

Perform audit procedures over the entity's final inventory records to determine whether they actually reflect actual inventory count results

### **Matters Relevant in Planning Attendance at Physical Inventory Counting**

- Locations at which inventory is held including materiality of Inventory
- Whether Adequate Procedures & instruction are expected to be issued for physical Inventory Counting
- Nature of Inventory
- Stages of Completion of Work in Progress
- Nature of Internal Control related to Inventory
- Risk of Material misstatement relevant to Inventory
- Timing of Physical Inventory Counting
- Whether Entity maintains Perpetual Inventory System
- Assistance of Auditor's Expert is needed

**Physical inventory counting conducted other than at date of financial statements**

Auditor shall perform audit procedures to obtain evidence about **whether changes in Inventory between count date & date of financial statement are properly recorded**

If Auditor is Unable to Attend Physical Counting due to Unforeseen Circumstances, **he shall do it on alternative date and perform audit procedures on other transactions**

### **Attendance at Physical Inventory Counting is Impracticable**

Auditor shall **perform alternative procedures** to obtain sufficient appropriate audit evidence regarding existence & condition of inventory

- If not possible, Auditor shall modify opinion as per SA 705

**When Inventory is with 3<sup>rd</sup> Party, and it is material,**

1. Auditor shall request confirmation from 3<sup>rd</sup> party about quantity & condition of inventory
2. Perform Inspection & other audit procedures as appropriate in circumstances



### Audit Evidence—Specific Considerations for Selected Items (SA 501) PART II

#### **Litigation & Claims**

Auditor shall perform audit procedures to identify Litigation & Claims involving the entity which may give rise to risk of material misstatement including :

1. Inquiry with Management & In House legal counsel
2. Reviewing minutes of meeting of those charged with governance and correspondence between entity & external legal counsel
3. Reviewing legal expense Accounts

#### **Auditor Assesses Risk of Material Misstatement Regarding litigation or claims – communicate with external legal counsel**

- If there is risk of material misstatement or audit procedures indicate other litigation or claim exists , auditor can directly communicate with external legal counsel through letter of enquiry
- If law or regulation or respective professional body prohibits external legal counsel from communication , auditor shall perform alternative audit procedures

#### **Auditor can also Meet External Legal Counsel when –**

1. Auditor determines that matter is a significant risk
  2. The matter is complex
  3. There is disagreement between management & entity's external legal counsel
- Such Meetings require management's permission and are held with representative of management in attendance



# CHAPTER 3 AUDIT DOCUMENTATION & AUDIT EVIDENCE

## External Confirmations SA-505

External Evidence is **Audit Evidence obtained as direct written response to auditor from third party** in paper form or by electronic or other medium

- **Positive Confirmation Request** – A request that confirming party agrees or disagrees with the information asked by auditor or providing requested information
- **Negative Confirmation Request** – A request that confirming party respond directly to auditor only if it disagrees with the information provided in the request
- **Non Response** – A failure of confirming party to respond or fully respond to positive confirmation request or confirmation request returned undelivered
- **Exception** – A response that indicates difference between information contained in entity's records and information provided by the confirming party. Exceptions need to be assessed

### External Confirmation Procedures –

Auditor shall maintain control over external confirmation requests including

- Determine information to be requested or confirmed
- Select the appropriate confirming party
- Designing the confirmation requests , including requests are properly addressed & contain return information for responses to be sent to auditor
- Sending the requests including follow-up requests

### Determining the Information to be Confirmed or Requested

External Confirmation Procedures frequently are performed to confirm information regarding Account Balance & their elements.

They may also be used to confirm terms of agreement , contracts or transactions between entity and other parties or confirm agreements if any

### Designing Confirmation Requests –

#### Factors to be kept in mind which directly affect confirmation rate

- Managements Authorization or encouragement to confirming parties to respond to auditor
- Specified risk of material misstatement including Fraud Risks
- Assertions being addressed
- Prior Experience on Audit or similar engagements
- Layout & Presentation of Confirmation Request
- Method of Communication (Paper or electronic form)
- Ability of Intended confirming party to confirm requested Information

### Management's refusal to allow auditor to send confirmation request

- Inquire **management's reasons** for refusal & seek audit evidence as to validity & reasonableness
- Evaluate **implication of management's refusal on auditor's relevant risk of material misstatement** & Nature , Timing & Extent of Other Audit Procedures &
- Perform **Alternative Procedures** designed to obtain relevant & reliable audit evidence



## Initial Audit Engagement (SA-510)

**It is Engagement in which either –**

- Financial Statements for **prior period were not audited or**
- Financial Statements for **prior period were audited by Another Auditor**

**Objective of Auditor with respect to Opening Balances – Initial Audit Engagement**

- Opening **Balances contain misstatements that materially affect current period's** financial statements &
- **Appropriate Accounting** policies reflected in opening balances have been **consistently applied in current period's financial statements** or changes thereto are properly accounted , presented & disclosed

**Audit Procedures Regarding Opening Balances**

- Auditor shall **read the most recent financial statements if any & predecessor audit report** if any , for information relevant to Opening Balances including disclosures
1. Determine whether **Prior Period closing balances have been correctly brought forward as Opening Balances** or when appropriate any adjustments have been disclosed as prior period items in current year's statement of profit & loss
  2. Determine whether opening balances reflect the application of appropriate accounting policies
  3. Perform one or more of the following :
    - Where **prior year financial statements were audited , take copy of those financial statements** including other relevant documents
    - Evaluate whether **audit procedures performed in current period provide evidence regarding opening balances or**
    - **Perform Specific audit procedures** to obtain evidence regarding opening balances

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

If Auditor concludes that **misstatements exist in current period's financial statements** , the auditor shall communicate the misstatements **with appropriate level of management & those charged with governance in accordance with SA 450**

**CONSISTENCY OF ACCOUNTING POLICIES RELATING TO OPENING BALANCES**

- Accounting Policies **reflected in Opening Balances have been consistently applied &** whether changes in accounting policies are properly accounted , presented and disclosed in the financial statements

**Conclusion**

- If Auditor is **unable to obtain Sufficient appropriate audit evidence** regarding Opening Balances , he shall issue Qualified or Disclaimer of Opinion report as per SA 705
- If Auditor **concludes Opening Balances have a material misstatements** , effect of which is not properly accounted , disclosed or presented , auditor shall express Qualified or Adverse Opinion as per SA 705



# CHAPTER 3 AUDIT DOCUMENTATION & AUDIT EVIDENCE

## RELATED PARTY (SA 550)

Related Party as defined in **applicable financial reporting framework** or Where Applicable framework establishes **minimal or no requirement** :

1. **A Person or Entity that has control or significant Influence** through Intermediaries over the reporting Entity
2. **Reporting Entity has control or significant influence over another entity** through Intermediaries
3. Another Entity that is under **common control with reporting entity** through having –
  - **Common Controlling Ownership**
  - Owners who are **close family members** or
  - **Common Key Management**

Note - However entities those are under **common control by state or national government are not related** unless they engage in significant transactions

### Responsibilities of Auditor –

Related Party Relationships & Transactions

- There are specific accounting & disclosure requirements for **related party relationships , transactions & balances** to enable users of the financial statements to understand their nature & effects on the financial statements
- Auditor has to **Perform Audit Procedures to identify , assess & respond to risk of material misstatement** arising from failure to account for related party transactions
- Auditor needs to obtain an understanding of entity's related party relationships & transactions to conclude , those relationships and transactions :
  1. **Achieve true & fair presentation or**
  2. **Are not misleading (for compliance framework)**

Auditor still may not detect Related Party Relationships , transactions & balances , risk is higher because :

1. Management may be unaware of existence of all related party relationships
  2. Related Party Relationships may present greater opportunity for collusion , concealment or manipulation by management.
- Planning & Performing audit with **professional skepticism is very important provided potential for undisclosed related party relationships & transactions**
  - This SA is designed to assist auditor in **Identifying & Assessing risk of material misstatement associated with related party relationships , transactions & balances & in designing audit procedures to respond to the assessed risks**



# CHAPTER 3 AUDIT DOCUMENTATION & AUDIT EVIDENCE

## SUBSEQUENT EVENTS (SA 560)

Events occurring **after the Balance Sheet date & before date of auditor's report** and facts that become known to auditor after date of auditor's report

### Objectives

1. Obtain **Sufficient Appropriate Evidence** that **events occurring after B/S Date & before date of auditor's report require adjustment or disclosure in financial statements** are appropriately reflected in those financial statements
2. Respond **appropriately to facts that become known to auditor after the date of auditor's report**, had he known before would have caused him to amend the auditor's report

### Audit Procedures Regarding Events Occurring After B/S Date & Before Date of Auditor's Report

1. Obtain an **understanding of any procedures management** has established to ensure that subsequent events are identified
2. Inquiring of **management & where appropriate TCWG**, as to whether any subsequent events have occurred which affect financial statements
3. Reading **minutes of meetings of owners & TCWG that have been held after Date of Financial Statements** & inquiring about matters discussed for which minutes are not available
4. Read the **entity's latest subsequent interim financial statements**, if any. If auditor knows there is adjusting event, he shall see whether adjustments are appropriately made in the financial statements or disclosures as required

### Auditor's Obligations Regarding Subsequent Events

1. **Facts which become known to Auditor after date of auditor's report but before the date when Financial Statements are issued to Members or**
  2. **After Financial Statements are Issued to Members**
    - Auditor has no obligation to perform any audit procedures. However if Auditor feels had he known this before, it would have amended his report. He shall –
1. Discuss **matter with Management & where appropriate TCWG**
  2. Determine **whether financial statements need amendments &**
  3. Inquire How **Management intends to address the matter in Financial Statements**



# CHAPTER 10 AUDIT EVIDENCE & AUDIT DOCUMENTATION

## Auditor & Going Concern Assumption (SA-570)

### Auditor's Responsibility Regarding Going Concern

- Auditor has to obtain **Sufficient Appropriate Audit Evidence regarding & conclude on management's going concern assumption** & see if material uncertainty exists as regards to Going Concern
- However there can be **inherent limitations on auditor's ability to detect material misstatements** for future events or conditions
- Auditor **cannot predict future events or conditions**, so absence of any reference to a material uncertainty about going concern **cannot guarantee entity's ability to continue as going concern**

### Additional Audit Procedures when events or conditions are identified

Auditor shall perform following procedures :

1. **Where Management has not yet performed assessment**, request management to make assessment on entity's ability to continue as going concern
2. Evaluate **Management's plans for future actions** in relation to Going Concern assessment
3. Where entity has **prepared a cash flow forecast & analysis of the forecast** is a significant factor
4. Consider whether **any additional facts or information have become available** since date on which management has made its assessment
5. Requesting **written representation from management** regarding future plans & feasibility of these plans

### Events or Conditions that may cast Significant Doubt on Auditor's Ability to Continue as Going Concern :

#### Financial

- Net liability or net current liability position
- Negative operating cashflows indicated by historical or prospective financial statements
- Fixed term borrowings approaching maturity without realistic prospects of renewal or repayment or excessive dependent on short term borrowings
- Indications of withdrawal of financial support by creditors
- Adverse key financial ratios

#### Operating Indicators

- Management intentions to liquidate the entity or cease operations
- Loss of key management without replacement
- Loss of major market, key customer, franchise, license or principal supplier
- Labour difficulties
- Shortages of important supplies
- Emergence of highly successful competitor

#### Other indicators

- Non-compliance with capital or other statutory or regulatory requirements such as solvency or liquidity requirements for financial institutions
- Pending legal cases, if successful will result in claims entity can't satisfy
- Changes in law or regulation or government policy expected to adversely affect the entity
- Uninsured or underinsured catastrophes when they occur



# CHAPTER 3 AUDIT DOCUMENTATION & AUDIT EVIDENCE

## Written Representations from Management (SA 580)

- Written **statement provided by Management to auditor to confirm certain matters or support Audit Evidence**
- Audit Evidence is all the Information obtained by the auditor for arriving at conclusion on which audit report is based
- Written representation are audit evidence requested from those **responsible for preparation & presentation of financial statements**
- Written Representations **do not provide sufficient appropriate audit evidence on their own** about any of the matters
- Written Representation **does not affect Nature or Extent of other Audit Evidence** auditor has to obtain about fulfilment of management responsibilities or specific assertions

### OBJECTIVES OF AUDITOR REGARDING WRITTEN REPRESENTATION

- **To Obtain Written Representation** – Management has fulfilled its responsibility for preparation & has provided complete information to auditor
- **To Support Other Evidence** – Relevant to financial statements or specific assertions
- **To Respond Appropriately** – To written representations provided by management or if management does not provide written representations requested by auditor

### Management From Whom Written Representations Requested

Management may also ask others who have specialized knowledge relating to matters about which representations are requested

1. Actuary – Responsible for actuarially determined accounting measurement
2. Staff Engineers about environment liability Measurements
3. Internal Counsel about Provisions for Legal Claims

Management may include qualifying language to the best of knowledge & belief , it is allowed if made by those with appropriate responsibilities and knowledge of matters in representation



# CHAPTER 4 Risk Assessment & Internal Controls

## AUDIT RISK

### Audit Risk (IR \*CR \*DR) –

It is a risk that Auditor **gives inappropriate opinion** when the **financial statements are materially misstated**

It is risk that auditor may fail to express an appropriate opinion in an audit assignment

**Risk of Material Misstatement consists of 2 components : (IR \* CR)**

1. **Inherent Risk** – Possibility of an assertion about class of transaction , account balance or disclosures to a material misstatement either individually or when aggregated with other misstatement , **before consideration of any related controls**
2. **Control Risk** – Risk that there could be material misstatement in class of transaction , account balance or disclosures either individually or when aggregated with other misstatement **because failure of controls to prevent or detect & correct risk of material misstatement**
  - **Detection risk** - It is a risk that **audit procedures performed by the auditor will not detect a misstatement** that could be material either individually or when aggregated with other misstatements.
  - **RoMM & Detection risk are inversely related**

### Risk Assessment Procedures Include –

1. Inquiries with management & other within Entity
2. Analytical Procedures
3. Observation & Inspection

### Risk of Material Misstatement at 2 levels –

1. **Overall Financial Statement Level** – That **relate pervasively to financial statements as a whole** & potentially affect many assertions
2. **Assertion Level for class of transactions , account balances & disclosures** - These risks are assessed to **determine nature , timing & extent of further audit procedures** necessary to obtain sufficient appropriate audit evidence which enables auditor to express an opinion on financial statements at an acceptably low level of audit risk

### Auditor Assesses Control Risk as to Rely or not rely on controls

- Control environment's influence over Internal Control . A **favourable Environment allows greater reliability in internal controls** , However it does not guarantee effectiveness of specific controls
- We therefore **test operating effectiveness of controls over Significant Class of Transactions (SCOT's)** , when we plan a **controls reliance strategy**
- When there are **control deficiencies** , auditor **identifies & tests more than one control** for each relevant assertion
- If auditor determines they support **"rely on controls"** or if **compensating controls are effective** , still **"rely on controls"** is effective.
- When there is **only one control for that assertions** , he revises risk assessment to **"not rely on controls"**

### Identifying & Assessing Risk of Material Misstatement Auditor shall

- Obtain **Understanding of entity , its environment** including relevant controls that relate to risk
- Assess the identified risk & evaluate whether they related **pervasively to financial statements as a whole** & affect many assertions
- Relate to identified risks to **what can go wrong at assertion level** , taking account of **relevant controls** that auditor intends to test
- Consider **likelihood of misstatement** , including **possibility of multiple misstatement** & whether it can be material misstatement



# CHAPTER 3 RISK ASSESSMENT & INTERNAL CONTROL

## INTERNAL CONTROL

### Internal Controls

As per SA 315 Internal Control can be defined as

**“Process designed , implemented & maintained by those charged with governance , management & other personnel to provide reasonable assurance about achievement of entity’s objectives with regards to (CARE)**

- Compliance with applicable laws & regulations
- Safeguarding of Assets
- Reliability of Financial reporting
- Effectiveness & efficiency of operations

### Objectives of Internal Control

- Transactions are executed in accordance with **management’s general or specific authorization**
- All transactions are promptly recorded in the **correct amount in the appropriate accounts & in the accounting period**
- Assets are safeguarded from **unauthorized access , use or disposition &**
- **Recorded assets are compared with existing assets** at reasonable intervals & appropriate action is taken with regard to differences

### Study of Various Aspects of Internal Control

- ***General Nature & Characteristics of Internal Control***
- ***Controls Relevant to Audit***
- ***Nature & Extent of Understanding of Relevant Controls***
- ***Components of Internal Control***

### General Nature & Characteristics of Internal Control

#### Purpose of Internal Control

Internal controls are designed , implemented & maintained to achieve entity’s objective that relates to (CARE) :

- Compliance with laws & regulations
- Safeguarding of Assets
- Reliability of Financial Reporting
- Effectiveness & Efficiency of operations

### Limitations of Internal Control (JUDGEMENT IN LIC)

1. **Human Judgement in decision making** – Human Decision making can be faulty
2. **Judgements by management** – Nature & extent of controls it chooses to implement & nature & extent of risk it assumes
3. **Lack of Understanding the purpose of control** – Individual does not understand purpose of control
4. **Limitations in case of Small Entities** – SOD is not possible due to fewer employees , and owner manager is able to exercise oversight
5. **Internal Control can only provide reasonable assurance**
6. **Collusion among people** – Controls can be misused by collusion of 2 or more people or inappropriate management override of controls



# CHAPTER 4 RISK ASSESSMENT & INTERNAL CONTROL

## CONTROLS RELEVANT TO AUDIT

### Nature & Extent of Understanding of Relevant Controls

**Evaluating the Design** – Involves considering whether control individually or in combination can effectively prevent or detect & correct material misstatements

**Implementation** – Means controls exists & entity is using it. First we see design & only then implementation

**Risk Assessment Procedures** – Procedures performed to obtain audit evidence about Design & Implementation of relevant Controls include –

1. Inquiring with entity personnel
2. Observing application of specific controls
3. Inspecting documents & reports
4. Tracing Transactions through system relevant to financial reporting

**Obtaining understanding of entity's control** is not sufficient to test operating effectiveness of such controls, unless they are automated controls

### Components of Internal Control

1. *Control Environment*
2. *Risk Assessment*
3. *Information System Including Related Business Process*
4. *Control Activity*
5. *Monitoring of Controls*

### Controls Relevant to Audit –

**Factors to be kept in mind for finding controls relevant to audit**

- Size of the entity
- Nature of entity's business including its organisation & ownership characteristics
- Nature & Complexity of system
- Diversity & Complexity of entity operations
- Applicable legal & regulatory requirements
- Circumstance & applicable component of internal control
- Materiality
- Significance of related risk
- Whether control individually or in combination with other prevents, detects or corrects material misstatement

### Controls over Completeness & Accuracy of information

- **Controls over Completeness & Accuracy of Information** – It is relevant to audit if auditor intends to make use of information in designing & performing further audit procedures
- **Controls relating to Operations & Compliance Objectives** – It is relevant to audit if they relate to data auditor evaluates or uses in applying audit procedures

### Internal Controls over Safeguarding of Assets

- **Financial Reporting** – Auditor's consideration of such controls is limited to those relevant to reliability of financial reporting
- **Operating Objectives** – Safeguarding controls related to operating objectives are not relevant to financial statement audit

### Controls Relating to Objectives that are not relevant to audit

- Controls relating to objectives that are not relevant to audit need not to be considered

### Statute May Require Auditor to report on Compliance with Certain Controls –

- If Statute tells Auditor to report on certain controls, the auditor's review of internal control may be broader and more detailed and such controls are relevant to audit



# CHAPTER 4 RISK ASSESSMENT & INTERNAL CONTROL

## COMPONENTS OF INTERNAL CONTROL PART 1

**Control Environment** - Control Environment sets the tone of the organisation , influencing the control consciousness of its people

**Elements of Control Environment** – Which helps us in understanding the Control Environment are :

1. **Participation by those Charged with Governance** – Their Independence from management , experience & stature , extent of their involvement & information they receive & appropriateness of their actions
2. **Management Philosophy & Operating Style** – Management's approach to taking & managing business risk , actions towards financial reporting , information processing & accounting functions & personnel
3. **Communication & Enforcement of Integrity & Ethical Values** – Will Influence design , administration & monitoring of controls
4. **Organisational Structure** – Framework within which activities are planned , executed , controlled & reviewed for achieving objectivities
5. **Assignment of Authority & Responsibility** – How operating activities are assigned , reporting relationships & authorization hierarchies are established
6. **Human Resource Policies & Practices** – Policies regarding recruitment , orientation , training , evaluation , counselling , promotion , compensation & remedial actions
7. **Commitment to Competence** – Management's consideration of competence levels for particular jobs and how those levels translate into requisite skills & knowledge

### Entity's Risk Assessment Process

Auditor Shall obtain an understanding of whether entity has process for –

1. Identifying Business risks relevant to financial reporting objectives
2. Estimating Significance of the risks
3. Assessing likelihood of their occurrence
4. Deciding about actions to address those risks

### Information system including related business process relevant to financial reporting

*Auditor Shall obtain understanding of IS including related business process relevant to financial reporting including following areas :*

- How Information System **capture events & conditions** that are significant to financial statements
- **Classes of transactions** in entity's operations that are **significant** to financial statements
- Procedures by which those transactions are **initiated , recorded , processed ,corrected as necessary** , transferred to general ledger
- **Related records , supporting Information & specific accounts** in financial statements that are used to record such transactions
- **Financial reporting process** used to prepare financial statements
- Controls **surrounding journal entries**

### Points to be considered by auditor regarding communication of financial roles & responsibilities

1. **Understanding of Roles & Responsibility** – Communication by entity of roles & responsibilities pertaining to internal control over financial reporting
2. **Policy Manuals & Financial Reporting Manuals** – Communication may take in the form of manuals
3. **Understanding regarding Relation of Activities** – Understanding by employees how their work is related with other & means of reporting exceptions to higher level
4. **Open Communication Channels** – Help to ensure exceptions are reported & acted upon
5. **Less Structured & Easier for Smaller Entities** – It is easier and less structured in small entity due to fewer levels of responsibility & management's greater visibility & availability



## Components of Internal Control Part 2

### Control Activities

- Auditor shall obtain an understanding of control activities relevant to audit
- Control Activities are policies & procedures that help ensure that management directives are carried out .
- Whether IT or manual systems have various objectives and are applied at organisational & functional level

### Control Activities that are relevant to Audit are :

- That relate to significant risks & for which substantive procedures alone do not provide sufficient appropriate evidence
- Those that are considered to be relevant in the judgment of the auditor

### Auditor should consider following points in deciding significant risks

- Whether risk is a risk of fraud
- Whether risk involves significant transaction with related party
- Whether risk involves significant transactions that are outside the normal course of business for the entity or that appear to be unusual
- Complexity of transactions
- Degree of subjectivity in measurement of financial information related to the risk
- Whether risk is related to significant economic , accounting or other development like changes in regulatory requirement

### Identifying Significant Risks

#### Following are always Significant Risks –

1. Risk of material misstatement due to fraud
2. Significant transactions with related parties that are outside normal course of business for entity
3. Risk of Material Misstatement – Greater for significant non-routine transactions
4. Risk of Material Misstatement – Greater for significant Judgemental matters

### Monitoring of controls

Auditor shall obtain an understanding of major activities entity uses to monitor internal controls over financial reporting

1. **Monitoring of Controls Defined** – It is process to assess effectiveness of internal control performance over time
2. **Helps in Assessing of Controls on Timely Basis** – Assessing effectiveness of controls on timely basis and taking necessary remedial actions
3. **Management accomplishes through ongoing activities , separate evaluation** – On going activities are built into normal recurring activities of an entity and include regular management & supervisory activities
4. **Management Monitoring includes** – Information from communication from external parties such as customer complaints that indicate areas of improvements
5. **In Case of Small Entities** – Management's monitoring of control is often accomplished by management's or owner-manger's close involvement in operations. This will identify significant variances from expectations , leading to remedial action to control



# CHAPTER 4 RISK ASSESSMENT & INTERNAL CONTROL

## Evaluation of Internal Control by Auditor

Auditor needs reasonable assurance that accounting system is adequate and all accounting information which should be recorded has in fact been recorded

### **Benefits of Evaluation of Internal Control to the Auditor**

- Whether adequate internal control system is in use & operating as planned
- What would be appropriate audit techniques & procedures in given circumstances
- What are areas where control is weak or excessive
- Extent & depth of examination he needs to carry out in different areas of accounting
- Whether controls adequately safeguard the assets
- Whether effective internal auditing department is operating
- Whether worthwhile suggestions can be given to improve control system
- Whether errors & frauds are likely to be located in ordinary in course of business
- Whether administrative control has a bearing on his work
- How far management is discharging its function as far as correct recording of transactions is concerned
- How reliable reports , records & certificates to management can be

### **Formulate Audit Program After Understanding of Internal Controls**

After understanding controls , we need to review & evaluate internal controls , auditor can use any of the following to help him to review & evaluate Internal Controls

1. Narrative Record
2. Flow chart
3. Check List
4. Questionnaire

### **Narrative record**

- It is Complete & Exhaustive description of system as found in operation by auditor
- Actual Testing & Operation are necessary before such a record can be developed
- Good in cases when no formal control system is in operation
- More suited to small business

### **Flowchart**

- It is graphic presentation of each part of company's system of internal control
- It is most concise way of recording auditor's review of system
- It gives bird's eye view of system & flow of transactions and integration & in documentation can be easily spotted and improvements can be suggested
- It is also necessary for auditor to study the significant features of business carried on by concern

### **Check List**

- It is series of questions or instructions which member of auditing staff must follow or answer
- When he completes it he writes answers in Yes No or Not Applicable
- It is on Job Requirement & instruction are framed having regard to desirable elements of control

### **INTERNAL CONTROL QUESTIONNAIRE**

- It is comprehensive series of questions concerning internal control
- It is most widely used form for collecting information about existence , operation & efficiency of internal control in organisation
- It is issued to client and client gets it filled by executives & employees
- All inconsistencies are discussed by auditor's staff with client's employees to get clear picture
- Auditor then prepares report of deficiencies & recommendations for



# CHAPTER 4 Risk Assessment & Internal Control

## Testing of Internal Controls

After understanding & reviewing controls , auditor needs to examine whether and how far same is actually in operation

For this he will do actual testing of system in operation

He does this on selective basis , he can plan testing in such a manner that all important areas are covered in a period of say 3 years

It is done by application of procedural tests & auditing in depth

### Test of controls

Test of Controls are performed to obtain audit evidence about effectiveness of the –

- **Design of accounting & internal controls systems** , i.e whether they are suitably designed to prevent or detect and correct material misstatements &
- **Operation of Internal control throughout the period**

### Test of controls Include

1. **Inspection** – of documents supporting transactions & other events to gain audit evidence that internal controls have operated properly
2. **Inquiries** – about & observation of internal controls which leave no audit trail
3. **Reperformance** – involves auditor's independent execution of procedures or controls that were originally performed as part of entity's internal control

When obtaining audit evidence about **effectiveness of controls** , auditor considers –

1. How they were applied
  2. By whom they were applied
  3. The consistency with which they were applied during the period
- When deviations are detected , auditor makes specific inquiries regarding these matters , & ensure test of controls appropriately cover such period of change or fluctuation

### Materiality & Audit Risk

Materiality & Audit risk are considered through out the audit in particular when –

1. Identifying and assessing risk of material misstatements
2. Determining the nature , timing & extent of further audit procedures
3. Evaluating effect of uncorrected misstatements , if any on financial statements & in forming opinion in the auditor's report

### Satisfactory Control Environment – Not an Absolute Deterrent to Fraud

- Existence of satisfactory control environment can be a positive factor when auditor assesses the risks of material misstatement
- However it may reduce fraud , a satisfactory control environment is not an absolute deterrent to fraud
- Control environment in itself does not prevent or detect & correct a material misstatement
- It may , however influence auditor's evaluation of effectiveness of other controls & thereby auditor's assessment of risks of material misstatements

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# CHAPTER 4 RISK ASSESSMENT & INTERNAL CONTROLS

## SECTION 138 INTERNAL AUDIT

### Internal Audit

An Independent management functions which involves **continuous & critical appraisal** of functioning of an entity with a view to suggest improvement thereto and **add value to & strengthen the overall governance mechanism of the entity including entity's strategic risk management & internal control system**

### Applicability of Provisions of Internal Audit

#### Every Listed Company

#### Every Unlisted Public Company having

1. Deposits  $\geq 25$ cr at any point of time during preceding financial year
2. Paid up Share Capital  $\geq 50$ cr during preceding financial year
3. Borrowings  $> 100$  cr at any point of time during preceding financial year
4. Turnover  $\geq 200$  cr during preceding financial year

#### Every Private company having

1. Borrowings  $> 100$  cr at any point of time during preceding financial year
2. Turnover  $\geq 200$  cr during preceding financial year

### Who can be Appointed as Internal Auditor ?

As per Section 138 , Internal Auditor shall be

1. A Chartered Accountant or a cost accountant (whether engaged in practice or not) or
2. Such other Professional as may be decided by board

Internal Auditor may or may not be an employee of the company

### Objective & Scope of Internal Audit Function

#### Activities Relating to Governance –

May Assist Governance process in accomplishing of objectives on ethics & values , performance management & accountability , communication risks & control information to appropriate areas of organization & effectiveness of communication among TCWG , external & internal auditors & management

#### Activities Relating to Risk Management –

May assist in identifying & evaluating significant exposures to risk and contributing to improvement of risk management & internal control

#### Activities relating to internal control

1. **Evaluation of Internal Control** – May be assigned specific responsibility for reviewing controls , evaluating their operation & recommending improvements thereto
2. **Examination of financial & operating information** – May be assigned to review means to identify , recognise , measure , classify & report financial & operating information & to make specific inquiry into individual items , including detailed testing of transactions , balances & procedures
3. **Review of Operating Activities** – May be assigned to review economy , effectiveness & efficiency of operating activities including non-financial activities of an entity
4. **Review of Compliance with laws & regulations** – Assigned to review compliance with laws , regulations & other external requirements & management policies & directives



# CHAPTER 4 RISK ASSESSMENT & INTERNAL CONTROL

## INTERNAL FINANCIAL CONTROLS

**Internal Financial Control** – The policies & procedures adopted by the company for ensuring orderly & efficient conduct by business including (PASTA)

1. Prevention & detection of errors & frauds
2. Adherence to company's policies
3. Safeguarding of its assets
4. Timely preparation of reliable financial information
5. Accuracy & Completeness of the accounting records

### **Internal Financial Controls – Regulatory Requirements**

- Section 143(3)(i) requires Auditor to state that whether company has adequate internal financial controls in place & operating effectiveness of such controls. Auditor has to express an opinion on internal financial controls over financial reporting. It is carried out along with audit of financial statements
- It is carried along with an audit of financial statements
- Rule 8(5)(vii) of Companies Rules , 2014 requires Board report of all companies to state details in respect of internal financial controls with reference to financial statements

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# CHAPTER 5 Fraud & Responsibilities of Auditor in this Regard

## Fraud Basics

### Fraud

As per **SA 240 Fraud** is :

**Intentional Act** by one or more individuals among management , those charged with governance , employees or even third party **involving use of deception to obtain an unjust or illegal advantage**

Auditor is concerned with those fraud that **causes material misstatement in financial statements**

### Characteristics of Fraud

1. **Intentional** – Misstatements in Financial Statements can arise from error or fraud. The misstatement which is intentional is fraud
2. **It is Broad Legal Concept** – Auditor is concerned with fraud that causes material misstatement in the financial statements

### Reasons for Committing Frauds (TOM)

1. **Temptations** – Individuals possess an attitude character or set of ethical values that allow them knowingly & intentionally to commit a dishonest act . By seeing them even honest individuals can do fraud
2. **Opportunity** – It exists when an individual believes internal controls can be compromised
3. **Management** – Incentive or pressure on management to achieve an expected earnings target or financial outcome exist when management is under pressure from sources inside or outside the entity.

### Why do Management / Employees commit Fraud (FM Ke Don)

- **Financial Obligations** / Pressure
  - **Management's** unrealistic goals
  - **Dissatisfied** Employees
  - **Opportunity** to commit fraud
  - **Name Game**
- 
- **2 Types of Intentional Misstatements are relevant to Auditor**
    1. **Fraudulent Financial Reporting**
    2. **Misappropriation of Assets**

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# CHAPTER 5 Fraud & Responsibilities of Auditor in this Regard

## Fraudulent Financial Reporting & Misappropriation of Assets

### Fraudulent Financial Reporting –

Fraudulent Financial Reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statements users

**Fraudulent financial reporting can be accomplished by :**

1. **Manipulation , Falsification , Alternation of accounting records or supporting documentation**  
Auditor requires great tact & intelligence to detect manipulation of accounts as it involves higher management in this type of fraud & is conducted in planned way
  - Reason
    - I. Tax
    - II. Dividend
    - III. Receive higher remuneration which is linked to profits
2. **Misrepresentation or intentional omission** from the financial statements of events , transactions or other significant information
3. **Intentional misapplication of accounting principles** relating to amounts , classification , manner of presentation or disclosure

### Detection of Fraud & Error – Duty of an Auditor

1. **Reasonable Assurance** – Auditor has to obtain reasonable assurance that financial statements are free from material misstatement
2. **Risk** – Risk of not detecting material misstatement from fraud is higher than risk because fraud is planned in a manner to conceal it
3. **Management Fraud** – Management fraud is difficult to detect as compared to employee because management can override controls
4. **Auditors Attitude** – Auditor should maintain professional skepticism throughout the audit ,

### Misappropriation of Assets

It can be done in no of ways

1. Embezzling receipts
2. Stealing physical assets or Intellectual Property
3. Causing entity to pay for goods & services
4. Using an entity's assets for personal use

### Misappropriation of Goods

**Measures to prevent the misappropriation of goods include :**

1. Requirements of **record keeping about physical quantity**
2. **Periodic checks**
3. **Physical Verification** of goods should be conducted
4. **Rules & Procedures** for allowing person where goods are kept
5. **External Security arrangements** to ensure no goods are taken out without proper authority
6. **Ratio Analysis** to be made

### Defalcation of Cash

- **By Inflating Cash Payments**
  1. Making Payments against Fictitious Vouchers
  2. Making payments against vouchers amount whereof have been inflated
  3. Manipulating total wage rolls either by including dummy workers or inflating them
  4. Casting larger total for petty cash expenditure and adjusting excess in totals of detailed columns so that cross totals show agreement
- **Supressing Cash Receipts**
  1. Teeming & Lading
  2. Adjusting unauthorized or fictitious rebates , allowances , discounts etc
  3. Writing off as debts in respect of balances against which cash has already been received
  4. Not accounting cash sales fully
  5. Not accounting for miscellaneous receipts



# CHAPTER 5 Fraud & Responsibilities of Auditor in this Regard

## Fraud Reporting to Central Government

As per Section 143(12) & Rule 13 (1) of Companies Act , Auditor during performance of his duties as **statutory auditor** has reason to believe that an **offence of fraud** which **involves or is expected to involve** individually an amount of **1 crore or above** is **being or has been committed** against company by **officers or employee** , auditor will report that **matter to central government**

**Manner of Reporting the matter to Central Government as follows :**

- Auditor shall report the matter to **Board or the Audit Committee** as the case may be immediately **but not more than 2 days of his knowledge of fraud**
- After reporting **Management or Audit Committee** is given time to **reply or observations within 45 days**
- On receipt of such reply , **auditor shall forward the report and with reply or observation of Board or Audit Committee along with his comments to Central government within 15 days from date of receipt of such reply or observation**
- In case auditor **fails to get any reply within 45 days** , auditor shall forward his report to **central government along with note within 15 days of expiry of 45 days**
- Report shall be sent to **Secretary , Ministry of Corporate Affairs in Registered Post** with acknowledgement due or **speed cost followed by confirmation on email**
- Report shall be in form of a **statement specified in Form ADT-4**

**Reporting under CARO**

- Auditor is also required to report under CARO whether **any frauds by the company or on the company by its officers or employees** has been noticed or reported during the year
- If yes **nature & amount is to be indicated**

### REPORT TO AUDIT COMMITTEE OR BOARD

Section 143(12) prescribes for **fraud less than 1 cr** , Auditor shall report matter to **Audit Committee** constituted under section 177 or to **Board immediately** , but **not more than 2 days of his knowledge of fraud** and shall report on matters specifying : **(PAN)**

1. **Parties Involved**
2. **Amount Involved &**
3. **Nature of Fraud with description**

These provisions shall also apply mutatis mutandis to **cost auditor and secretarial auditor** as per Section 148 & 204

If we **fail** to comply with the provisions fine shall be **Min 1 lacs and Max 25 lacs**.

### Auditor Unable to Continue Engagement

If as a result of **misstatement resulting from fraud or suspected fraud** , auditor encounters exceptional circumstances that bring question the **auditor's ability to continue performing audit** , the auditor shall

1. Determine **Professional & Legal responsibilities** applicable in the circumstances , including whether there is a **requirement for the auditor to report to person or persons who made appointment or regulatory authority**
2. Whether it is appropriate to withdraw , **withdrawal is possible under applicable law or regulation**

**If Auditor Withdraws ,**

1. Discuss with **appropriate level of management & those charged with governance** reasons for withdrawal
2. Determine **professional & legal requirement to report to person or persons who made appointment or regulatory authority & reasons for withdrawal**



# CHAPTER 6 Audit in Automated Environment

## Automated Environment

### Automated Environment

It basically refers to business environment where (POAD)

1. Processes
2. Operations
3. Accounting &
4. Decisions

Are carried out by computer systems also known as Information Systems or **Information Technology Systems**

### Key Features of an Automated Environment

- Ability to **process large volume of transactions**
- Enables **Faster business operations**
- Accuracy in **data processing & computation**
- **Integration** between business operations
- **Better Security & Controls**
- **Less prone to human errors**
- Provides **latest information**
- **Connectivity & networking capability**

### Relevance of IT in an Audit

*When Business operates in an automated environment it is likely we will see several business functions and activities within system :*

1. **Computation & calculations** are automatically carried out
2. **Entries are posted automatically**
3. **Business policies & procedures** including internal controls are automatically applied
4. **Reports used in business** are produced from system and management & stakeholders rely on these information
5. **User access & security** are controlled by assigning system roles to users

### Situations in which IT will be relevant for Audit

- Increased use of **Systems & Applications** (ERP)
- Volume of **transactions is high** (Insurance , Banks)
- **Complexity of transactions** has increased (Multiple systems , network of systems)
- **Hi-tech nature of business** . Eg – Telecomm , E-Commerce
- **Company Policy**
- **Regulatory requirements** (IT Act , 2008 , Companies Act , IFC)
- Required by **Indian & International Standards** (ISO , SA-315)
- Increases **effectiveness & efficiency of audit**

### Understanding of IT Environment

Understanding involves How IT department is organized , IT activities & IT dependencies , relevant risks & control

1. **Information systems** being used (One or more Application system / O/s etc)
2. Their **purpose** (Financial v/s Non-Financial)
3. **Location** of IT systems (local v/s global)
4. **Architecture** (client server , web application , cloud )
5. **Version** (Features change with version)
6. **Interfaces** within system
7. **Inhouse v/s Packaged**
8. **Outsourced activities** (IT Maintenance & support)
9. **Key Persons** (CIO , CISO , Administrators)

All understanding should be documented in **standard format or template**

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# CHAPTER 6 Audit in Automated Environment

## Risks & Controls in Automated Environment

### Auditor should Understand risks that arise from use of IT Systems

1. **Unauthorized access** to data
2. **Unauthorized changes** to systems or programs
3. **Excessive access** / privileged access (super users)
4. **Incorrect processing** of data or **processing inaccurate** data or both
5. **Direct data changes** (Backend changes)
6. **Loss of Data**
7. **Failure to make necessary changes** to system or programs
8. **Lack of adequate segregation of duties**

### Impact of IT risks i.e on Substantive Audit , Controls & Reporting

1. **Impact on Controls** – If we can't rely on automated controls , we also cannot rely on IT dependent controls  
Then system data & reports should be tested substantively for completeness & accuracy  
More Substantive work is needed
2. **Impact on Substantive Audit** – Cannot rely on data obtained from systems , system data should be tested for completeness and accuracy  
More audit Evidence is needed
3. **Impact on Reporting** – Communicate to those charged with governance & Issue modified auditors report

### Types of Controls in an Automated Environment

**General IT Controls** – These are policies & procedures that relate to many applications & support effective functioning of application controls

It maintains integrity & security of data and includes –

1. **Access security** – To ensure access to programs and data is authenticated and authorised to meet financial reporting objectives
2. **Application & System Acquisition , Development & Maintenance** – To ensure systems are developed , configured and implemented to meet financial reporting objectives
3. **Program change** – To ensure that modified systems continue to meet financial reporting objectives
4. **Data Center & Network operations** – To ensure that production systems are processed to meet financial reporting objectives

### Application Controls

- These are both automated & manual controls that operate at a business process levels
- Automated Application controls are embedded into IT Applications . Eg – Edit Checks , User limit check , Validation of input data , reasonableness checks , mandatory data fields

### IT Dependent Controls –

These are basically manual controls that make use of some form of data or information or report product from IT Systems & Applications

- Design & effectiveness of such controls depends on reliability of source data
- Automated application controls & IT dependent controls require General IT Controls to be effective



# CHAPTER 6 Audit in Automated Environment

## Testing of Automated Controls & Report on Controls

### Testing Methods to Test Controls

4 Types of audit tests that should be used are :

1. **Inquiry** – Most efficient method , but gives least evidence
2. **Observation**
3. **Inspection &**
4. **Reperformance** – most effective gives best evidence, but very lengthy and time consuming

Applying **Inquiry in combination with inspection gives us most effective & efficient audit evidence**

However which audit test to use , when & in what combination is a matter of professional judgement

**While testing in an automated environment , some more methods are as follows :**

1. Obtain understanding of how an **automated transaction is processed by doing a walkthrough of one end to end transaction** using combination of **inquiry , observation & inspection**
2. Observe **how a user processes transaction** under different scenarios
3. **Inspect configuration** defined in an application
4. **Inspect system logs** to determine any changes made since last audit testing
5. **Inspect technical manual / user manual** of systems & applications
6. **Carry out a test check** and observe errors
7. **Conduct reperformance using raw source data** & independently applying formulae , business rules or validations using CAATs

### Data Analytics for Audit

- Combination of tools , techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics
- Even Auditors can use these tools & techniques in audit process & obtain good results
- Tools & Techniques auditor use in applying principles of data analytics are known as CAAT or Computer assisted Auditing Techniques

**It is used in Testing electronic records & data . We use specialised tools like IDEA & ACL to :**

1. Check **Completeness of data** and population that is used in **test of controls or substantive tests**
2. **Selection of audit samples**
3. **Re-computation of balances** – reconstruction of trial balance from transaction data
4. **Reperformance of mathematical calculations** – Depreciation , Bank Interest calculation
5. **Analysis of journal entries** as required by SA 240
6. **Fraud Investigation**
7. Evaluating **impact of control deficiencies**

### Assess & Report Audit Findings

1. At conclusion of each audit there will be **findings or exceptions in IT environment & IT controls** of the company , **Normal Deficiency** in Control will be reported to **Management** , but **significant deficiencies** are reported to **TCWG**
2. **Deficiency in internal control** exists if Control is designed , implemented or operated in such a way it **cannot prevent or detect & correct misstatements in financial statements on timely basis** or control is missing



# CHAPTER 7 - SA 530 – Audit Sampling

## SA 530 AUDIT SAMPLING

### Audit Sampling

It is defined as **application of audit procedures to less than 100 % of items within a population** of audit relevance such that all the sampling units have **equal chance of selection**, so **auditor can draw conclusion about entire population**

### Characteristics of Population (CAR)

1. **Completeness** – Population also needs to be complete so auditor can draw conclusions about whether control is operating effectively during the reporting period, population **needs to include all the relevant items from throughout the entire period**
2. **Appropriateness** – Population from which sample is drawn is **appropriate for specific audit objective**. Items which make up population are known as sampling units
3. **Reliable** – **Information** upon which sampling is performed is **sufficiently complete & accurate**

### Approaches to Sampling

**Statistical Sampling** – It is approach to sampling that has

- **Random selection of the sample items &**
- Use of **probability theory** to evaluate sample results including measurement of sampling risk characteristics
- It is **more scientific than testing based on auditors judgement** because It involves mathematical laws of probability in determining sample
- It is used when population to be tested **involve large number of similar items**
- Eg – Compliance testing, payroll, invoices vouching, petty cash vouching

### Non Statistical Sampling

- Under this Approach **sample size & it's composition** are determined on the basis of **personal experience & knowledge of auditor**
- It is **simple** in operation
- It is **neither objective nor scientific**
- **Closeness of qualities** projected by sample results with that of **whole population cannot be measured** because sample has not been **selected in accordance with mathematically based statistical techniques**

### ADVANTAGES OF STATISTICAL SAMPLING

- Amount of Testing **does not increase** in proportion in increase in population
- Sample Selection is **more objective** & therefore more **defensible**
- Method provides means of **estimating minimum sample size** with **specified risk and precision**
- It will Select Samples in such a way, that it is **examining all records in the group**
- It provides **better description of large mass of data**, than complete examination of all data

### Factors to be considered for extent of checking based on sample

- Size of Organization under Audit
- Adequacy & reliability of books & records
- State of Internal Control
- Tolerable error range
- Degree of desired confidence



# CHAPTER 7 - SA 530 – Audit Sampling

## Sample Design , Size & Selection of Items for Testing

**Sample Design** – While Designing Audit sample , auditor's consideration includes -

1. **Specific Purpose to be achieved & combination of audit procedures likely to best achieve that purpose**
2. **Nature of audit evidence sought & possible deviation or misstatement conditions** that will assist auditor in defining what population to use for sampling
3. **Expected rate of deviation is considered to design audit sample in case of Test of controls**

Value of risk auditor is willing to accept will determine sample size , **lower the sampling risk more the sample size**

### Examples of Factors Influencing Sample Size for Test of Controls

- Auditor's **risk assessment of relevant controls**
- **Increase in tolerable rate of deviation** , lower the sample size because we can tolerate some rate of deviation
- **Increase in Expected rate of deviation** , more sample size because then auditor can make reasonable estimate of actual rate of deviation
- **Increase in auditor's desired level of assurance** , more size , only then he can get increased assurance
- **In case of large population** , actual size of population has little effect on sample size . **For small Population however audit sampling is not best method** to obtain sufficient appropriate evidence , there are **alternative means**

### Sample Selection Methods

1. **Random Sampling** – In this all the items in the population have known chance of selection. It includes 2 popular methods :
  - a) **Simple Random Sampling** – In this we will choose numbers from random numbers by computers or picking random numbers from drum. It is considered simple & easy to use It is appropriate only when in population we have similar units
  - b) **Stratified Sampling** – In this whole population is to be tested in few groups called strata . Each stratum is treated as if it were a separate population & proportionate of items is selected from each stratum
    - No of groups in which population is divided is based on auditor's judgement
    - From each group auditor may pick different percentages of items
2. **Interval Sampling**
  - In this no of sampling units in population is divided by sample size to give a sampling interval. Eg – 50 then every 50<sup>th</sup> unit is sample
  - Although starting point may be determined haphazardly , sample is truly random if determined by used of computerized random number generator or random number tables
  - Method is effective only when population is not structured in a way that sampling interval matches with particular pattern in population
3. **Monetary Unit Sampling** – It is type of value weighted selection in which sample size , selection & evaluation results in conclusion in monetary amounts
4. **Haphazard sampling** - In this auditor selects sample without any structured technique
  - It is selected without any bias & thus attempt to ensure all items have equal chance of selection.
  - It is not appropriate when using statistical sampling
5. **Block Sampling** – It involves selection of block of adjacent items within the population.
  - It is not effective because items in sequence have similar characteristics from items as compared to elsewhere in population
  - It is not effective when we want to draw valid inferences about whole population



# CHAPTER 7 - SA 530 – Audit Sampling

## SAMPLING RISK

### Sampling Risk

It is risk that **auditor's conclusion based on sample** may be different from **auditor's conclusion if entire population was subjected to same audit procedure** . It can lead to **2 types of wrong conclusions** :

1. In case of **test of controls that controls are more effective than they actually are** or in **case of test of details that material misstatement does not exist when actually it does** . This will affect **audit effectiveness** and is more likely to lead to an **inappropriate audit opinion**
2. In case of **test of controls , control are less effective than they actually are** or in **case of test of details material misstatements exist when in actual it does not** . This would lead to **additional work** to establish that initial conclusions were incorrect and will **affect audit efficiency**

### Non Sampling Risk

It is risk that **auditor reaches to erroneous conclusion for any reason not related with sampling risk**

Sources of Non Sampling risk are

- Human mistakes
- Misinterpreting sample results
- Applying Audit Procedures not appropriate to objectives of audit

### Performing Audit Procedures

Auditor shall perform audit procedures appropriate to the purpose on each item selected –

If Audit procedure is **not applicable to selected item** , the auditor shall perform procedure on **replacement item**

If auditor is **unable to apply designed audit procedure or suitable alternative procedure** to selected item , auditor shall treat it as **deviation from control in case of test of control or a misstatement in case of test of details**

### Nature & Cause of Deviation & Misstatement

- In analysing the deviations & misstatement identified , auditor may observe **many have a common feature** .
- In such circumstances auditor may **decide to identify all items in population that has common feature and extend audit procedures to those items**.
- In addition such deviation or misstatements may be intentional & indicate the **possibility of fraud**
- In case **misstatement or deviation in a sample is an anomaly** , auditor shall obtain high degree of certainty by **performing additional audit procedures** to obtain sufficient appropriate audit evidence that it **does not effect remainder of the population**

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# PROJECTING MISSTATEMENTS & EVALUATING RESULTS OF SAMPLING

### Projecting Misstatements

Auditor is required to **project misstatements for the population to obtain broad view of scale of misstatement** but this projection **may not be sufficient to determine an amount to be recorded**

When **misstatement is an anomaly**, it is **excluded when projecting misstatements to population**.

However **effect of any such misstatement if uncorrected**, still needs to be **considered in addition to projection of non-anomalous misstatements**

Auditor shall **project misstatement found in sample to population only for test of details**

In case of **Test of controls no explicit projection of deviation is necessary since sample deviation rate is also projected deviation rate for population as a whole**

### Evaluating Results of Audit Sampling

- **For Test of controls**, an **unexpectedly high rate of sample deviation** may lead to **increase in assessed risk of material misstatements**, unless further audit evidence proves otherwise
- **For Test of details**, an **unexpectedly high misstatement amount in sample** may cause auditor to believe **class of transactions or account balance is materially misstated** in absence of further audit evidence that no material misstatement exists
- In case of **Test of Details**, **projected misstatement plus anomalous misstatement if exceeds or is equal to tolerable misstatement**, auditor may conclude there is **Sampling Risk** that **actual misstatement may exceed tolerable misstatement**
- Auditor will perform **additional audit procedures** to obtain additional audit evidence that **Actual misstatement exceeds tolerable misstatement** & risk can be reduced if additional evidence is obtained
- If **Sample has not provided reasonable basis for conclusion for entire population**, It will also **request management to investigate misstatements identified & potential for further misstatements & make necessary adjustments or tailor nature, timing & extent of further audit procedures to achieve required assurance.**
- In case of **test of controls** auditor might **extend sample size, test alternative control** or modify substantive procedures



# CHAPTER 8 - SA 520 - ANALYTICAL PROCEDURES

## SA 520 ANALYTICAL PROCEDURES

As per **SA 520 Analytical Procedures** means **Evaluation of financial information** through **analysis of plausible relationships** among both **financial & non-financial data** .

It also covers **investigation of identified fluctuations** or relationships that are inconsistent with other **relevant information or that differ from expected values** by a significant amount

### Purpose & Timing of Analytical Procedures

#### Purpose

1. To obtain **relevant & reliable audit evidence**
2. To **design & perform audit procedures near the end of audit** that assist auditor in forming an **overall conclusion as to whether financial statements are consistent with auditor's understanding of entity**

#### Timing

Analytical Procedures are required in **planning phase , testing phase** and also required during **completing phase**

### Analytical Procedures in Planning the Audit

1. In Planning stage , analytical procedures help the auditor in :
  - Understanding the **client's business &**
  - Identifying areas of **potential risk** by identifying those things which auditor was unaware of
2. Assist Auditor in **determining nature , timing & extent of his other audit procedures**
3. In Analytical procedure in planning the audit use both **financial & non-financial information**

### Factors to be Considered for Substantive Procedures (PRASAD)

**Predictability** – More appropriate when account balance or relationships between items of data are predictable

**Inherent Risk** – When Inherent risk in any area is high , only analytical procedures won't solve purpose , we should may design test of details to address higher inherent risk

**Availability of Data** – Availability of relevant & reliable data will help in performing analytical procedures

**Account Type** – More useful for income statement accounts because they are predictable , whereas Balance sheet accounts represent net effect of transactions at a point in time

**Source** – More suitable for transactions that are of similar nature , whereas transactions by non-routine and estimation SCOT are often subject to management judgement and therefore difficult to predict

**Nature of Assertion** – It is more effective for some assertions than for others. Analytical Procedures using data analytics can be used to address completeness , valuation / measurement & occurrence

**Disaggregation** – Degree to which data can be disaggregated will directly help in detecting misstatements



# CHAPTER 8 - SA 520 - Analytical Procedures

## Analytical Procedures at the time of Performance / Testing

While **Designing & Performing Substantive Analytical Procedures** either alone or in combination with test of details, auditor shall

1. Determine the **suitability of substantive analytical procedures for given assertions** taking into account assessed risk of material misstatements
2. Evaluate the **reliability of data** from which auditor's expectation of recorded amount or ratios is developed
3. Determine an **expectation of recorded amounts or ratios**
4. Determine the **amount of difference of recorded amounts from expected values** so we can investigate

### Suitability of Particular Analytical Procedure for Given Assertions

- It is more applicable to **large volume of transactions** that are **predictable over time**
- It is based on expectation that **relationships among data exists**
- Suitability will depend upon **auditor's assessment of how effective it will be in detecting material misstatements**
- Different types of analytical procedures provide **different levels of assurance**
- Determination of suitability of particular substantive analytical procedure is influenced by **nature of assertion & auditor's assessment of risk of material misstatement**
- **Particular substantive analytical procedures** may also be considered **when test of details are performed on same assertion**

### Extent of Reliance on Reliability of Data for Analytical Procedures

1. **Source of the information** available.  
**External is more reliable** than Internal
2. **Comparability of the information** available with Industry data
3. **Nature & relevance of the information** available
4. **Control over preparation of the information** that are designed to ensure its completeness, accuracy & validity

### Risk of Material Misstatements – Whether Expectation can be developed sufficiently precisely

1. Accuracy with which the **expected results of Substantive Analytical Procedures** can be predicted
2. Degree of which **information can be disaggregated**
3. Availability of **Information both financial & non-financial**. If Information is available auditor may consider reliability of information

### Investigating the Results of Analytical Procedures – If there are fluctuations with Expected Values

1. **Inquiring with the Management & Obtaining appropriate audit evidence** relating to **management's responses** and evaluating those responses and taking into account auditor's understanding of the entity & other audit evidence obtained during the course of audit
2. **Performing other audit procedures** as necessary in the circumstances when **management is unable to provide an explanation** or **management's response is not considered adequate**



# CHAPTER 8 - SA 520 - ANALYTICAL PROCEDURES

## TECHNIQUES AVAILABLE AS SUBSTANTIVE ANALYTICAL PROCEDURES

### Techniques Available as Substantive Analytical Procedures

1. **Trend Analysis** – Comparison of the data with prior period balance or with a trend of 2 or more prior period balances
2. **Ratio Analysis** – Useful for analysing asset, liability, income, expenses. Ratios can be compared over time or to ratios of separate entities within the group or with the ratios of other companies in the same industry
3. **Reasonableness Tests** – This relies upon non-financial data for the audit period under consideration. These are more applicable to income statement accounts & certain accrual or prepayment accounts
4. **Structural Modelling** – It constructs a statistical model from financial & non-financial data of prior accounting periods to predict current account balances

### Analytical Procedures that Assist When Forming an Overall Conclusion

- The conclusions drawn from results of analytical procedures designed & performed in accordance with are intended to **corroborate conclusions formed during audit of individual components or elements of financial statements**
- This assists auditor to **draw reasonable conclusions on which to base auditor's opinion**

### Considerations Specific to Public Sector Entities

- The **relationships between financial items** in traditional business entities **may not always be relevant in audit or government or public sector entities**
- In Public Sector entities there is **little relationship between revenue & expenditure**
- In Addition **because expenditure on acquisition of assets may not be capitalised** there is no relationship between expenditures. Eg – Inventories & FA and amount of those reported in financial statements
- Also **Industry data or statistics or comparative purpose may not be reliable in public sector**
- However **other relationships are there cost per kilometer of road construction**

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# CHAPTER 10 THE COMPANY AUDIT

## QUALIFICATIONS & DISQUALIFICATIONS OF AUDITOR

### Section 141

#### Qualifications for Company Auditor

A person who is eligible for appointment as an auditor of company should be **Chartered Accountant having Certificate of Practice**

A firm can become Auditor if majority of partners practicing in India & are qualified for appointment .

Firm including LLP can be appointed as auditor of company only partners who are CA can sign on behalf of firm

### Section 144 – Certain Services shall not be Rendered by Auditor (BAD MAFIA)

1. Investment **Banking** Services
2. Investment **Advisory** Services
3. **Design** & Implementation of Financial Systems
4. **Management** Services
5. **Actuarial** Services
6. Rendering of **Outsourced Financial Services**
7. **Internal Audit**
8. **Accounting & Book Keeping Services**
9. Any Other kind of Services as may be prescribed

### Section 141 Disqualifications of Auditor

- **Body Corporate** other than LLP
- **Officer or Employee** of the Company
- **Partner or Employee** of officer or Employee of the Company
- **A person or his relative or Partner –**
  1. If they are holding **any security** / Interest in company or its subsidiary co or its holding co or associate co or subsidiary of such holding company
  2. Is **Indebted to company** or its subsidiary or its holding or associate or subsidiary of such holding company in excess of **Rs 5 Lacs**
  3. Has given **guarantee or provided any security in connection with indebtiness of any third person to company** or its subsidiary or Holding or Associate company or subsidiary of such holding company in excess of **Rs 1 lacs**
- Person or firm has **Business Relationship** with Company or its subsidiary or holding co or associate or subsidiary of such holding co except
  1. In nature of **professional services** permitted to be rendered by auditor
  2. In ordinary course of Business at arms length price for **HAT industry i.e Hotel , Hospital , Airlines , Telecommunication**
- A Person whose **relative is a Director** or is in **employment** of the company as **Director or Key Managerial Personnel**
- A Person who is **in full time employment elsewhere** or if person or partner of the firm is holding audit of **more than 20 companies other than OPC , Small co , Dormant Co & Private Co's having paid-up share capital less than 100 crs**
- A Person who has been **convicted by Court** of an offence involving **Fraud & 10 yrs** has not elapsed from the **date of such conviction**
- Any person whose **subsidiary or associate is providing any services to company or its holding company or subsidiary company** as provided in **Section 144**



# CHAPTER 10 THE COMPANY AUDIT

## Section 139 Appointment of First Auditors

### NON-GOVERNMENT COMPANY

#### Section 139(6)

- By **BOD** within **30 Days of Date of Registration of Company**
- If they Fail , by members within **90 Days at EGM**
- Tenure : Till Conclusion of Next AGM

### GOVERNMENT COMPANY

#### Section 139(7)

- By Comptroller & Auditor General of India within **60 days from Date of Registration of Company**
- If they Fail , **BOD will appoint within 30 days from expiry of 60 Days**
- If they also Fail , **by members within 60 days at EGM**
- Tenure : Till Conclusion of Next AGM

## SECTION 139 APPOINTMENT OF SUBSEQUENT AUDITORS

### NON GOVERNMENT COMPANY

#### SECTION 139(1)

- By **Members in the AGM**
- Tenure : Till Conclusion of its **6<sup>th</sup> AGM** , Meeting in which he is appointed is his **1<sup>st</sup> AGM**

### GOVERNMENT COMPANY

#### SECTION 139(5)

- By **Comptroller & Auditor General of India** within **180 days from commencement of Financial year**
- Tenure : Till Conclusion of his **next AGM**

### SECTION 139(8) FILING OF CASUAL VACANCY (NON-GOVERNMENT COMPANY)

#### RESIGNATION BY AUDITOR

- If it is due to **Resignation** , then should first BOD will come out with their **recommendation in meeting within 30 Days**
- Such Appointment shall be **approved by members within 3 months from date of recommendation**

#### OTHER THAN RESIGNATION

- If it is due to **Death , Dissolution , Disqualification** it shall be filled by BOD within **30 Days**

### SECTION 139(8) FILING OF CASUAL VACANCY

#### GOVERNMENT COMPANY

If it is due to **Death , Dissolution , Disqualification or Resignation** , It will be Filled by **C & AG** within **30 days**  
If they Fail , filled by **BOD** within **30 days** after failure by C & AG.

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# CHAPTER 10 THE COMPANY AUDIT

## SECTION 139(2) ROTATION OF AUDITORS

### APPLICABLE

1. Listed Public Companies or
2. Unlisted Public Company  
Paid up Share Capital >=10cr or
3. Private Co Paid up Share Capital >=50 cr or
4. Co's other than (2) & (3)  
Having Borrowing >=50cr
  - Borrowings include from Bank or Financial Institution , Public Deposits

### NOT APPLICABLE

- Small Company
- One Person Company

### Section 142 Auditor's Remuneration

- Remuneration of **Auditor shall be fixed in its general meeting** or in such other manner as determined
- However **Board may Fix Remuneration of First Auditor**

It Includes :

- Fees Payable
- Expenses if any incurred by auditor in connection with audit &
- Any facility extended to him

Does not include :

- Any other services rendered by him at request of the company (Tax Audit , GST Filing , Recruitment etc)

**Company to whom Section 139(2) is applicable shall not appoint / reappoint**

1. An Individual Auditor for more than **one term of 5 consecutive years** or
2. Audit Firm for **more than 2 terms of 5 consecutive years**

Note : No Audit Firm having common partner or partners to other audit firm whose tenure has expired in a company immediately preceding the financial year shall be appointed as auditor of same company for period of 5 years

- Internal Rotation of Auditors is allowed in the firm
- Incoming Auditor or Audit firm shall not be eligible if such auditor or audit firm is associated with outgoing auditor or audit firm under **same network of audit firms**
- Same network means firms operating under **same brand name , trade name or common control**
- A break in term of 5 years shall be considered as fulfilling requirement of rotation

### Ceiling of No of Audits

Company Audits Per Person 20

Tax Audits Per Person 60

### Doubts ?

- *Company Audit*
- *Company Tax Audit*
- *Company Statutory & Tax Audit*
- *Individual Tax Audit*
- *Company Filing of I.Tax Returns*

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# CHAPTER 10 THE COMPANY AUDIT

## SECTION 177 CONSTITUTION OF AUDIT COMMITTEE

### APPLICABLE

- Listed Public Company
- Unlisted Public Company having:
  1. Paid-up Share Capital  $\geq 10$  cr or
  2. Borrowings  $\geq 50$  cr or
  3. Turnover  $\geq 100$  cr
- Borrowings includes Deposits or Debentures or loans or borrowings

### NOT APPLICABLE

Following Types of Public Co :

- Wholly Owned Subsidiary Co
- Joint Ventures
- Dormant Co's

### Manner & Procedure of Selection & Appointment of Auditors

#### If Board Agree with Audit Committee

- AC will refer the Auditors Name to the BOD
- BOD is satisfied with the Auditor's Name
- Further Recommendation is made by BOD to members who will appoint Auditor in the AGM.

#### If Board Does not Agree with Audit committee

- AC will refer the Auditors Name to the BOD
- If Board Disagrees with the AC , it shall refer back recommendation to AC citing reasons for disagreement
- If the AC after seeing reasons for Board , decides not to reconsider its original recommendation
- Then Board shall record reason for disagreement with AC & sent its own recommendation to members in AGM

### APPROVAL OF TRANSACTIONS BY AUDIT COMMITTEE $\leq 1$ CR

- IF any Transaction  $\leq 1$  cr is entered by Director or Officer of the company without obtaining Approval of AC & it is not ratified by AC within 3 months from date of transaction
- Then such transaction is voidable at the option of AC & IF transaction is with related party to any director or authorised by any director , Director shall indemnify the losses
- This clause shall not apply to Section 188 Transactions between Holding & Wholly owned Subsidiary co

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# CHAPTER 10 THE COMPANY AUDIT

## AUDITORS DUTY IN CASE OF RESIGNATION & REMOVAL OF AUDITOR

### Section 140(2) Auditor's Duty in Case of Resignation

- Within **30 Days** File a Statement in form **ADT-3** with the company & registrar , stating facts & other reason causing resignation
- For Government company we also need to File a statement **ADDITIONALLY to C & AG**
- If we **fail within 30 days** , then on 31<sup>st</sup> Day **u/s 140(3)** we are punishable for **Minimum 50,000 or auditor's remuneration whichever is less**
- If we still fail from **32<sup>nd</sup> Day 500 per day till we don't file ADT-3 , restricted to Max 500,000**

### Section 140(4) Appointment of Auditor other than Retiring Auditor

- **Special Notice** is required for a resolution for appointing auditor other than Retiring Auditor & **copy of notice is sent to Retiring Auditor**
- Retiring Auditor can **make representation in writing to company** why he should not be removed
- These representation should be **circulated along with notice to AGM (21 days before meeting)** to every member of the company
- **If Company Fails to Circulate** – Either received late or Company's Default , **auditor may read out at the meeting**
- If copy of representation is not sent to members , it should be filed with Registrar
- If Any Aggrieved Person or Company complains auditor is misusing his right , & Tribunal agrees , then copy of representation need not be sent or need not be read at meeting

### Section 140(1) Removal of Auditor Before Expiry of Term

- **BOD shall pass resolution** in a meeting
- After resolution **Inform Central Government through form ADT -2 along with fees within 30 Days** of passing resolution
- After **Approval from Central Government**
- Members will pass **special resolution within 60 days** from date of approval of Central Govt in EGM.
- Auditor should be given **reasonable opportunity of being heard**

### Joint Audit (SA-299)

It means pooling together resources & expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually.

### ADVANTAGES OF JOINT AUDIT

- Sharing of Expertise
- Advantage of Mutual Consultation
- Better quality of performance
- Improved Service to client
- Lower Workload
- Lower Staff Development costs
- Lower costs to carry out the work
- Displacement of auditor of a company taken over in takeover
- In respect of multi-national companies , work can be spread using expertise of local firms
- A sense of healthy competition towards a better performance

### Disadvantages of Joint Audit

- Fees being Shared
- Psychological problem where firms of different standing are associated in Joint Audit
- General Superiority complexes of some Auditors



# CHAPTER 10 THE COMPANY AUDIT

## SECTION 148 COMPANIES (COST RECORDS & AUDIT) RULES , 2014

### Maintenance of Cost Records (CRA-1)

#### Applicable

- **Class of Companies** Engaged in Manufacturing or Production of Goods or providing services
- Including Foreign Company

Having Total Turnover of  $\geq 35$  Cr

#### Not applicable

- Companies Classified as Micro enterprise & small enterprise as per the turnover criteria provided under MSME Development Act , 2006

### Applicability of Cost Audit – Class of Companies

#### Regulated Sector

- Individual Turnover  $\geq 25$  cr of any product , service for which records are maintained &
- Total Turnover  $\geq 50$  Cr of all its products & services during immediately preceding financial year

#### Non regulated

- Individual Turnover  $\geq 35$  Cr &
- Total Turnover  $\geq 100$  Cr

#### Exemption from Cost Audit

- Its operating from Special Economic Zone or
- 75 % of the Total Revenue is Revenue from Exports or
- Engaged in Generation of electricity for captive consumption through Captive Generating Plant

### Class of Companies

#### Regulated sector

##### SET DIP

- Sugar
- Electricity
- Telecommunications
- Drugs & Pharmaceuticals
- Industrial Alcohol
- Petroleum & Gas

#### Non regulated sector

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- Arms & Ammunitions
- Tyres
- Tubes
- Turbo Jets
- Steel
- Cement &
- Medical Devices

### Appointment of Cost Auditor

- Cost Auditor has to be appointed within **180 days from commencement of Financial Year by Board**
  - Company will inform Cost Auditor of his appointment & file a **notice of his appointment with Central Government in form CRA -2**
1. Within **30 days of Board Meeting in which Auditor is appointed or**
  2. **Within 180 Days of commencement of Financial Year whichever is earlier**
- Auditor Will Submit **Cost Audit Report to BOD in form CRA-3** within **180 days from closure of Financial Year** to which report relates
  - BOD will send **report to Central Government in form no CRA-4 within 30 days of receipt of report with information & explanation of every reservation**
  - If company has taken extension of time in holding AGM , such extension may also be available in filing CRA 4 to Central Government



# CHAPTER 10 THE COMPANY AUDIT

## POWERS & DUTIES OF AUDITORS

### Power / Rights of Auditor

#### Right to Access Books of Accounts –

1. At all Times
2. Registered office & Branch Office
3. Auditor of Holding company can access records of Subsidiary & associates as far as it relates to consolidation of financial statements

#### Right to Obtain Information & Explanation from Officers

#### Right to Attend General Meeting –

Auditors are entitled to attend any general meeting but not meeting of directors

It is not compulsory to exercise his right, except

- I. Where he has reason to believe directors are concealing state of affairs from shareholders or shareholders are likely to misinterpret the report
- II. If he comes to know anything after signing report, had he known before, his report would have been different

#### Right to Report to Members of the company on Accounts Examined by him –

Auditor shall make a report (FAST)

- a. On every **financial statements** which are required by or under the act
- b. On the **accounts**
- c. **Accounting & Auditing standards** and matters which are required to be included in audit report
- d. **Whether financial statements show true & fair view** of state of affairs of the company

#### Right to Lien –

ICAEW expressed a view Auditor can exercise lien when –

- Documents are of client who owes the money
- They should not be received by irregular or illegal means
- Auditor can retain documents, only if he has done work on them
- Such documents can be retained which are connected with work on which fees has not been paid

#### Such Requirements of Internal Financial Control System are not applicable to following Private Companies

One Person Company or

Small Company or

Company has turnover of less than 50 crores as per latest audited financial statement &

Aggregate Borrowings from Banks / Financial Institution or any body corporate less than 25 cr at any point of time during financial year

### Duties of Auditor

#### Duty of Auditor to Inquire on certain matters

1. **Whether shares have been allotted for cash and whether adequate cash is received**, if no cash is received, position in B/S is properly stated or not
2. **Whether any Investment in the form of shares, debentures or other securities of company are sold at price less than cost price, except Banking & Investment Company**
3. **Whether loans & advances made by the company are properly secured & terms are prejudicial to interest of the company**
4. **Whether loans & advances made by the company have been shown as Deposits**
5. **Whether Personal Expenses** are charged to Revenue A/c
6. **Whether book entry transactions are compromising to the interest of company**

#### Duty to Sign Audit Report

#### Duty to Comply with Auditing Standards

#### Duty to Audit Report –

As per Section 143 (3) Auditor shall also state

- Whether he has **obtained all Information & Explanation necessary for the purpose of audit**, if not details thereof and effect of such Information on FS
- Whether proper **books of accounts are maintained & proper returns have been received** from Branches not visited by him
- Any **qualification, reservation or adverse remark relating to maintenance of accounts**
- Whether **Branch Audit report has been sent to him in case Audit is not done by him & how he has dealt it with**
- Whether **Company's B/S & P/L are in agreement with Books of Accounts & returns**
- Whether **Financial Statements comply with Accounting Standards**
- Observations or comments of **auditors on financial transaction or matters having adverse effect on functioning of the company**
- Whether any **Director is Disqualified** from being Appointed
- Whether Company has **adequate internal financial control system** in place for financial reporting & operating effectiveness of such controls

#### Duty to report on Frauds

#### Duty to report on matters reported by Central Govt

#### Duty of Company's Auditor for Branch Audit

#### Duty to state reason for Qualification / Negative Report



# CHAPTER 11 AUDIT REPORT

## SA 700 FORMING AN OPINION & REPORTING ON FINANCIAL STATEMENTS

### Objectives of Auditor as per SA 700

1. To Form Opinion on **Financial Statements** based on **evaluation of conclusion drawn from audit evidence obtained**
2. To Express Clearly that **Opinion through written report**

### Purpose

1. Aimed at addressing balance between **consistency & comparability** in auditor reporting globally
2. Increase value of auditor by making **auditor's report more relevant to user**

### Expression of Unmodified Opinion on Financial Statements

#### Fair presentation framework

- Gives permission to go for **additional disclosures or amend requirements of Financial Reporting Framework for better presentation**
- Financial statement **give true & fair view in all material respects in accordance with applicable financial reporting framework**

#### Compliance framework

- **No Permission** as given in fair presentation framework
- Financial statements are **prepared in all material respects in accordance with applicable financial reporting framework**

### Basic Elements of Auditors Report

1. **Title** – It should state it is report of Independent Auditor
2. **Addresse** – As required by Circumstances of engagement
3. **Auditor's Opinion** – First Section shall include Auditor's opinion & have heading "**opinion**"

#### Opinion Section will include :

- Identify Entity whose financial statements have been audited
  - State financial statements have been audited
  - Identify title of each statement in financial statement
  - Refer to notes including summary of significant accounting policies
  - Specify date of or period covered by each financial statement
4. **Basis for Opinion** – It shall include :
    - Audit was conducted in accordance with Standard on Auditing
    - Refers to Section of Auditors Report that states Auditor's Responsibilities under SA's
    - Statement that auditor is independent & has followed relevant ethical requirements & code of ethics issued by ICAI
    - Whether Auditor believes that evidence obtained is sufficient & appropriate to provide a basis for auditor's opinion
  5. **Going Concern** – Auditor shall report in accordance with SA 570 , where relevant
  6. **Key Audit Matters** – Auditor shall communicate about Key Audit Matters in accordance with SA 701 for listed companies or as required by law or regulation or if auditor decides
  7. **Responsibilities for the Financial Statements** – This section shall describe management's responsibility as :
    1. Preparing Financial Statements in accordance with applicable Framework
    2. Internal Controls as needed for preparing financial statements that are free from Material Misstatement
    3. Assessing entity's ability to continue as Going concern



# CHAPTER 11 AUDIT REPORT

## SA 700 FORMING AN OPINION & REPORTING ON FINANCIAL STATEMENTS

### 8. Auditor's Responsibility for Audit of Financial Statements

#### This section of Auditor's Report Shall

1. State objective of auditor are to obtain **reasonable assurance** that financial statements are free from **material misstatement**
- Issue an auditor's report that includes auditor's opinion
2. State that **Reasonable assurance is high level of assurance** , but is **not guarantee** that audit done as per SA's will always detect material misstatement when it exist
3. **Misstatements can arise from fraud or error** and either –
  - They are considered material if **they influence economic decision of user**

#### Auditor's Responsibility for audit of Financial Statements shall further

- State that audit is conducted in accordance **with SA's** and auditor has exercised **professional judgement** & skepticism through audit
  - Describe an audit by stating auditor's responsibilities are :
1. To **identify & assess risk of material misstatements** and design and perform audit procedures to respond to such risks
  2. Obtain **understanding of internal controls** relevant to audit , but **not for purpose of opinion on effectiveness** on internal controls as IFC as required by companies
  3. Evaluate on **appropriateness of accounting policies** and reasonableness of **accounting estimates**
  4. To conclude on **management's assessment of going concern** and whether material uncertainty exists
  5. **Whether FS are prepared as per Fair presentation framework** to evaluate over-all presentation structure and context of financial statements
  6. Using **work of another Auditor** , indicating extent to which financial information

### Auditor's responsibility for Audit of Financial Statements also shall

1. State that auditor **communicates with those charged with governance regarding scope & timing of audit & significant audit findings including any significant deficiencies in Internal Control**
2. State that auditor provides **TCWG with statement it has complied all requirements regarding independence and other matters**
3. **Key audit matters** are communicated to TCWG as per SA 701

### 9. Layout of Description of Auditors Responsibility for Audit of FS

#### Auditor's responsibility for audit of FS required by SA shall be included

1. In **body of auditors report**
  2. Within **appendix to auditor's report** , in which we have to give reference to appendix
  3. By specific reference within auditor's report to **location of such description on a website of appropriate authority** , where law or regulation permits
- 10. Other Reporting Responsibilities** – If there are any other reporting responsibilities other than SA , required by law or otherwise these should be addressed in Separate Section “ Reporting on Other Legal & Regulatory Requirements “
- 11. Signature of the Auditor** – Report is signed by auditor in his personal name , where firm is appointed , personal name of auditor and in name of audit firm. Membership no of Partner and in case of firm Registration number of firm , (FRN) , in audit reports signed by them
- 12. Place of Signature** – Auditor's Report shall name Specific Location the city where audit report is signed
- 13. Date of Auditor's Report** – The Date of report would be the date on which audit report is signed



# CHAPTER 11 AUDIT REPORT

## SA 701 Communicating Key Audit Matters in Independent Auditors Report

### Purpose

1. To enhance **communicative value of auditors report**
2. **Provides additional Information to Intended users** of financial statements to assist them in understanding matters that in **auditors judgement** were of **most significance** in audit of financial statements of **current period**
3. Communicating key audit matters may **assist users in understanding entity and areas of significant management judgement** in audited financial statements

### Key audit matters is not a substitute to :

1. Auditor expressing a **modified opinion** when required by circumstances of specific engagement as per SA 705
2. A Substitute for **reporting on SA 570 when a material uncertainty exists** relating to events or conditions that may cast doubt on going concern
3. **Separate opinion on individual matters**

### Applicability

1. It is applicable to **listed companies**
2. Circumstances in which **auditor decided to communicate key audit matters**
3. When required by **law or regulation**

When **Auditor disclaims an opinion** ,  
**we can't use Key audit Matters**

### Determining Key Audit matters –

While considering we should take into account following points

1. Areas of **higher assessed risk of material misstatement or significant risk** identified in accordance with SA 315
2. **Auditor judgement** relating to areas that involve **significant management judgement** including **accounting estimates with high uncertainty**
3. Effect on audit of **significant event or transactions** that occurred during the period

### Communicating Key Audit Matters

**Introductory language in this section of auditor's report shall state that :**

1. Key Audit matters are those that are **most significant in audit of financial statements of current period &**
2. These matters are **addressed in context of financial statements as a whole** and in forming opinion thereon and **auditor does not provide separate opinion on these matters**

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# CHAPTER 11 AUDIT REPORT

## SA 705 Modifications to the Opinion in Independent Auditor's Report

### Qualified Opinion is Issued When ,

- Auditor **after obtaining evidence concludes there are material misstatements , but not pervasive** to financial statements or
- Auditor is **unable to obtain evidence** , but concludes that **can be material misstatements , but not pervasive**
- ✓ *Material – Yes*
- ✓ *Pervasive – No*

### Adverse Opinion – Auditor issues Adverse Opinion when –

- Having **obtained Sufficient appropriate audit evidence** concludes There are **material misstatements & they are pervasive** to financial statements
- ✓ *Material – Yes*
- ✓ *Pervasive – Yes*

### Disclaimer of Opinion – It is issued when –

- Auditor is **unable to obtain Sufficient & appropriate evidence** to form opinion & concludes that **can be possible Material Misstatement & they can be pervasive** to Financial Statements
- ✓ *Material – Yes*
- ✓ *Pervasive - Yes*

### Other considerations relating to an adverse or disclaimer of opinion

When Auditor issues **Adverse or Disclaimer opinion on FS as a whole** , auditor's report shall not include **Unmodified Opinion with respect to same Financial reporting framework on Single FS or one or more specific elements of FS**

### Consequence of Inability to obtain audit evidence due to Management Imposed Limitation

- If Auditor is unable to **obtain Audit Evidence due to Management imposed limitation** , auditor shall **request management to remove limitation**
- If **Management refuses** , auditor shall **communicate matter to those charged with Governance & determine whether it is possible to perform alternate procedures** to obtain audit evidence
- If **auditor is unable to obtain evidence** even after that & if auditor **concludes there are material misstatements but not pervasive** to Financial Statements , he will issue **Qualified Opinion**
- If auditor concludes that **possible effects on financial statements could be both material & pervasive** , that Qualification is not enough – He **will resign from audit , if not prohibited by law , If resignation is not possible then issue Disclaimer of Opinion on Financial Statements**

### Display of Material Misstatement on the Basis of Nature of Material Misstatement

1. **Specific Amounts in FS**
  - Include **description and quantification of financial effects on the misstatement** , unless impracticable
  - If it is **not practicable to quantify effects** , auditor shall state in **basis for modification paragraph**
2. **Narrative Disclosures**
  - Include in basis for **modification paragraph an explanation of how disclosures are misstated**
3. **Non Disclosure of Information required to be Disclosed**
  - Discuss **non-disclosure with TCWG**
  - Describe in **basis of modification paragraph the nature of omitted information**



# CHAPTER 11 AUDIT REPORT

## SA 706 EMPHASIS OF MATTER PARAGRAPH & OTHER MATTER PARAGRAPH IN INDEPENDENT AUDITORS REPORT

### Objective of Auditor

To draw users attention by way of clear additional communication in auditor's report to :

1. Matter **although appropriately presented or disclosed in financial statements** , is of such importance it is **fundamental to users understanding of the Financial statements or**
2. As appropriate **any other matter** that is **relevant to users understanding of audit , auditor's responsibility or auditor's report**

### EMPHASIS OF MATTER

- A Paragraph in auditor's report that refers to **matter appropriately presented or disclosed in FS** , that in **auditor's judgement** should be brought to **notice of users for understanding of financial statements**
- However **Auditors opinion is not modified in this respect**

### OTHER MATTER

- A Paragraph included in auditor's report that refers to a matter **other than those presented or disclosed in FS** , that in **auditors judgement** should be **brought to notice of users for understanding of audit , auditor's responsibility or auditor's report**

**When auditor includes Emphasis of Matter paragraph in auditor's report , auditor shall**

1. Include the paragraph within a **separate section of auditors report** with appropriate heading that includes term **"Emphasis of Matter"**
2. It should **give clear reference to matter being emphasized** and to **where relevant disclosures that fully describe the matter can be found in Financial statements**
3. Indicate that auditors **opinion is not modified in respect of matter emphasized**

When auditor includes other matter paragraph , it should include with separate heading **"Other Matter Paragraph"** or other appropriate heading

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# CHAPTER 11 AUDIT REPORT

## SA 710 – Comparative Information – Corresponding Figures and Comparative Financial Statements

- Nature of Comparative Information depends on requirements of **applicable financial reporting framework**
- There are **2 broad approaches for Comparative Information – Corresponding Figures and Comparative Financial Statements**
- Which approach to follow is **specified by law or regulation , but may also be specified by terms of engagement**

### 2 Broad Approaches of Comparative Information Corresponding figures

- For corresponding figures , **auditors opinion on Financial statements** refers to **current period only**
- Previous year is just **given for comparison Comparative financial statements**
- For comparative financial statements , **auditors opinion refers to each period** for which **financial statements are presented**
- Here we have **given opinion for all previous years for which such Information is given**

### Audit Procedures regarding Comparative Information

Auditor shall see whether **FS include comparative Information as required by applicable Financial Reporting Framework** & whether such information is appropriately classified. For this Purpose auditor shall evaluate –

1. Comparative Information agrees with **amounts & other disclosures presented in prior period**
2. **Accounting policies reflected in comparative information are consistent with current period** or if changes in accounting polices , are properly accounted for , presented & disclosed

### Audit Reporting Regarding Corresponding Figures

When corresponding figures are presented , **auditor opinion shall not refer to corresponding figures except**

1. If **previous year report included Qualified or disclaimer or adverse opinion and matter which gave rise to modification is unresolved** , auditor shall also modify current period's financial statements and also mention both current period figures and corresponding figures in description of matter which gave rise to modification
2. If **auditors obtains evidence that a material misstatement exists in the prior period financial statements on which Unmodified opinion was issued –** Auditor will see whether issue is solved , if not express qualified or adverse opinion in current period financial statements
3. **Prior Period Financial statement not audited –** If they were not audited auditor will write about same in other matter paragraph

### Comparative Financial statements

- In this **amounts and disclosures for prior period are included for comparison with current period** , but if audited are referred to in the auditor's opinion
- In this auditor's opinion shall **refer to each period for which such financial statements are presented** on which auditor opinion is expressed
- When **reporting on prior period Financial statements** in connection with current years audit , **auditor's opinion differs from opinion previously expressed** , auditor shall disclose substantive reasons for different opinion in **Other Matter Paragraph as per SA 706**