AUDITING AND ETHICS

(AUDIT)

CHAPTER - 1

NATURE, OBJECTIVE AND SCOPE OF AUDIT

1. **INTRODUCTION**

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

2. **ORIGIN OF AUDITING**

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

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

3. **MEANING AND NATURE OF AUDITING**

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

4. **INTERDISCIPLINARY NATURE OF AUDITING- RELATIONSHIP WITH DIVERSE SUBJECTS**

1.	Auditing and Accounting	2.	Auditing and Law
3.	Auditing and Economics	4.	Auditing and Behavioural Science
5.	Auditing and Statistics & Mathematics	6.	Auditing and Data Processing
7.	Auditing and Financial Management	8.	Auditing and Production

5. **OBJECTIVES OF AUDIT**

SA-200 "Overall Objectives of the Independent auditor

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

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

6. **SCOPE OF AUDIT-WHAT IT INCLUDES**

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

(1) Coverage of all aspects of entity

(2) Reliability and sufficiency of financial information

Study and assessment of accounting systems and internal controls and by carrying out appropriate tests, enquiries and procedures.

(3) Proper disclosure of financial information

He should also keep in mind applicable statutory requirements in this regard.

"Historical financial information" means information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

6.1 Scope of audit-What it does not include

- Auditor is not expected to perform duties which fall outside domain of his competence.
- An auditor is not an expert in authentication of documents.
- Audit is distinct from investigation.

7. INHERENT LIMITATIONS OF AUDIT

(1) Nature of financial reporting

These judgments may involve subjective decisions or a degree of uncertainty. Controls may not have operated to produce reliable financial information

(2) Nature of Audit procedures

Management may not provide complete information as requested by auditor. The management may consist of dishonest and unscrupulous people.

(3) Not in nature of investigation

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

Balance has to be struck between reliability of information and cost of obtaining it.

(5) Future events

The business may cease to exist in future due to change in market conditions, emergence of new business models or products.

8. WHAT IS AN ENGAGEMENT?

Engagement means an arrangement to do something.

1.1 ***External audit engagements***

The purpose of external audit engagements *is to enhance the degree of confidence of intended users of financial statements.*

9. *BENEFITS OF AUDIT-WHY AUDIT IS NEEDED?*

- *Audited accounts provide high quality information.*
- *Independent mechanism so that financial information is qualitative and reliable.*
- *Moral check on employees.*
- *Helpful to government authorities.*
- *Relied upon by lenders, bankers for making their credit decisions.*
- *Audit may also detect fraud or error or both.*
- *Audit reviews existence and operations of various controls.*

10. *AUDIT- MANDATORY OR VOLUNTARY?*

There are entities like companies who are compulsorily required to get their accounts audited under law. Many entities may get their accounts audited voluntarily because of benefits from the process of audit.

11. *WHO APPOINTS AN AUDITOR?*

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

12. *TO WHOM REPORT IS SUBMITTED BY AN AUDITOR?*

The report is submitted to person making the appointment.

13. *MEANING OF ASSURANCE ENGAGEMENT*

Engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

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

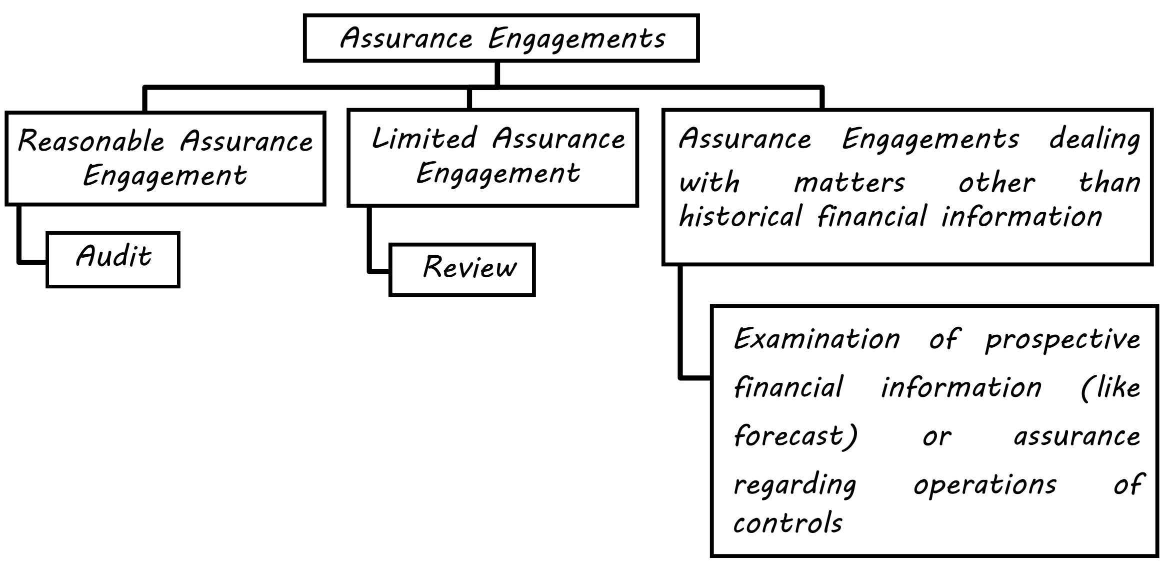
13.2 Meaning of Review; Audit Vs. Review

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

13.3 Types of Assurance Engagements

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

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



14. **QUALITIES OF AUDITOR**

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

He must have the highest degree of integrity backed by adequate independence.

The auditor, who holds a position of trust, must have the basic human qualities.

15. **ENGAGEMENT AND QUALITY CONTROL STANDARDS: AN OVERVIEW**

1. Standards on auditing (SAs) which apply in audit of historical financial information.
2. Standards on review engagements (SREs) which apply in review of historical financial information.
3. Standards on Assurance engagements (SAEs) which apply in assurance engagements
4. Standards on Related Services (SRSs) which apply in agreed upon procedures to information, compilation engagements and other related service engagements.

15.1 **Standards on Auditing**

- SA 200 Overall Objectives
- SA 230 Audit Documentation
- SA 315 Identifying and Assessing the Risks of Material Misstatement
- SA 500 Audit Evidence
- Revised SA 700 Forming an Opinion and Reporting on Financial Statements

15.2 **Standards on Review Engagements**

- SRE 2400 (Revised) Engagements to Review Historical Financial Statements
- SRE 2410 Review of Interim Financial Information

15.3 **Standards on Assurance Engagements**

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

15.4 **Standards on Related Services**

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

15.5 Standards on Quality Control

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

15.6 Why are Standards needed?

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

15.7 Duties in relation to Engagement and Quality Control Standards

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

CHAPTER - 2

AUDIT STRATEGY, AUDIT PLANNING AND AUDIT PROGRAMME

1	**AUDITOR'S RESPONSIBILITY TO PLAN AN AUDIT OF FINANCIAL STATEMENTS**
	SA 300- **Planning an audit of financial statements**
1.1	**Why planning an audit is necessary? - Its Benefits**
1.	Helping the auditor to devote appropriate attention to important areas of the audit.
2.	Helping the auditor identify and resolve potential problems on a timely basis.
3.	Helping the auditor properly organize and manage the audit engagement.
4.	Assisting in the selection of engagement team members with appropriate levels of capabilities and competence.
5.	Facilitating the direction and supervision of engagement team members.
6.	Assisting, where applicable, in coordination of work done by others.
1.2	**Nature of Audit Planning- A Continuous and iterative process**
	Planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:
1.	The analytical procedures to be applied as risk assessment procedures.
2.	Obtaining a general understanding of the legal and regulatory framework
3.	The determination of materiality.
4.	The involvement of experts.
5.	The performance of other risk assessment procedures.
♦	**Involvement of key engagement team members in planning audit**
♦	**Discussion of elements of planning with entity's management**
2	**PLANNING PROCESS - ELEMENTS OF PLANNING**
	The elements of planning can be categorized as under: -
(I)	Preliminary engagement activities
(II)	Planning activities
(I)	**Preliminary engagement activities**

(A) Performing procedures regarding the continuance of the client relationship

(B) Evaluating compliance with ethical requirements, including independence

(C) Establishing an understanding of terms of engagement

(II) Planning activities

Planning activities involve:-

[A] Establishing the overall audit strategy

[B] Developing an audit plan

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

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

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

(i) The resources to deploy for specific audit areas

(ii) The amount of resources to allocate to specific audit areas

(iii) When these resources are to be deployed

(iv) How such resources are managed, directed and supervised

The auditor shall take following factors into consideration while establishing audit strategy:-

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

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

(b) Ascertain the reporting objectives of the engagement

- The entity's timetable for reporting
- Organization of meetings to discuss of nature, timing and extent of audit work
- Discussion with management regarding the expected type and timing of reports
- Discussion with management regarding the expected communications
- Expected nature and timing of communications among engagement team members

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

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

7. DOCUMENTATION

(a) the overall audit strategy

(b) the audit plan and

(c) any significant changes made during the audit engagement

8. AUDIT PROGRAMME

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

8.1 Evolving one audit programme- Not Practicable for All businesses

Businesses vary in nature, size and composition;

8.2 The Assistant to keep an open mind

The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him.

8.3 Periodic review of the audit programme

Whether the same continues to be adequate for obtaining requisite knowledge and evidence.

Many persons believe that this brings an element of rigidity in the audit programme.

This is not true provided the periodic review is undertaken to keep the programme as up-to- date as possible.

8.4 Constructing an audit programme

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

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

(2) Prepare a written audit programme

(3) Determine the evidence reasonably available

(4) Apply only those steps and procedures.

(5) Include the audit objectives

(6) Consider all possibilities of error

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

8.5 Audit Programme- Designed to provide audit evidence

(a) Documentary examination

(b) Physical examination

(c) Statements and explanation of management, officials and employees

(d) Statements and explanations of third parties

(e) Arithmetical calculations by the auditor

(f) State of internal controls and internal checks

(g) Inter-relationship of the various accounting data

(h) Subsidiary and memorandum records

8.6 Advantages and disadvantages of an audit programme

The advantages of an audit programme are:-

(a) Total and clear set of instructions.

(b) Total perspective of the work to be performed.

(c) Selection of assistants for the jobs.

(d) Without a written and pre-determined programme, there is always a danger of ignoring or overlooking certain books and records.

(e) The assistants, by putting their signature on programme, accept the responsibility.

(f) The principal can control the progress.

(g) It serves as a guide for audits to be carried out in the succeeding year.

(h) Serves as evidence in the event of any charge of negligence.

The disadvantages are:-

(a) The work may become mechanical and particular parts of the programme may be carried out without any understanding.

(b) The programme often tends to become rigid and inflexible

(c) Inefficient assistants

(d) A hard and fast audit programme may kill the initiative of efficient

CHAPTER - 3

RISK ASSESSMENT AND INTERNAL CONTROL

1 AUDIT RISK

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

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

1.1 Risks of material misstatement

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

Few examples of misstatements could be:-

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

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

(i) The overall financial statement level

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

1.2 Components of risk of material misstatement

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

1.2A Inherent risk

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

Few examples of inherent risks could include:-

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

1.2B Control risk

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

Examples of control risk could include:-

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

1.3 Detection risk

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

Detection risk comprises sampling and non-sampling risk.

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

1.4 Audit risk-What is not included?

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

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

1.5 Assessment of risks- A matter of professional Judgment

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

1.5.1 Combined Assessment of the Risk of Material Misstatement

Audit risk = Risks of material misstatement X Detection risk

Audit risk = Inherent risk X Control risk X Detection risk

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

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

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

(a) the financial statement level

(b) the assertion level

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

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

(b) Assess the identified risks

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

(d) Consider the likelihood of misstatement.

1.7 Risk Assessment Procedures

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

- Inquiries directed toward internal audit personnel
- Inquiries of employees
- Inquiries directed toward in-house legal counsel
- Inquiries directed towards marketing or sales personnel
- Inquiries directed to the risk management function
- Inquiries directed to information systems personnel

(b) Analytical Procedures:

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

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

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

	management and others
▪	The entity's operations
▪	Documents
▪	Reports prepared by management
▪	The entity's premises and plant facilities
1.8	**Information obtained by performing risk assessment procedures - Used as audit evidence**
	The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.
2	**MATERIALITY**
2.1	**What is meant by materiality?**
	SA 320 Materiality in Planning and Performing an Audit
	Materiality is not always a matter of relative size.
2.2	**Materiality in Planning and performing an audit- Auditor's responsibility**
	Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:
•	Could reasonably be expected to influence the economic decisions of users.
•	Size or nature of a misstatement, or a combination of both;
•	Based on a consideration of the common financial information needs of users as a group.
	In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:
(a)	Determining the nature, timing and extent of risk assessment procedures;
(b)	Identifying and assessing the risks of material misstatement; and
(c)	Determining the nature, timing and extent of further audit procedures.
	If there is any statutory requirement of disclosure, it is to be considered material irrespective of the value of amount.
2.3	**Determination of materiality- a matter of professional judgment**
	In this context, it is reasonable for the auditor to assume that users:
(a)	Have a reasonable knowledge of business and economic activities
(b)	Understand that financial statements are prepared, presented and audited.

(c) Recognize the uncertainties inherent in the measurement of amounts.

(d) Make reasonable economic decisions.

2.4 Performance Materiality

Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

2.5 Determining Materiality and Performance Materiality when Planning the Audit

When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. The auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

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

Factors that may affect the identification of an appropriate benchmark.

- The elements of the financial statements.
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused.
- The nature of the entity, where the entity is at in its life cycle.
- The relative volatility of the benchmark.

Examples of benchmarks profit before tax, total revenue, gross profit and total expenses, total equity or net asset value.

2.6.1 Chosen Benchmark – Relevant financial data

- Prior periods' financial results and financial positions,
- The period to-date financial results and financial position, and
- Budgets or forecasts for the current period

2.6.2 Determining a percentage to be applied

A percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

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

Factors that may indicate

1. Whether law, regulations or the applicable financial reporting framework

2.	The key disclosures in relation to the industry
3.	Whether attention is focused on a particular aspect of the entity's business
2.8	**Revision in Materiality level as the Audit Progresses**
	Actual financial results are likely to be substantially different from the anticipated period end financial results.
2.9	**Documenting the Materiality**
(a)	Materiality for the financial statements as a whole
(b)	If applicable, the materiality level or levels for particular classes of transactions
(c)	Performance materiality and
(d)	Any revision of (a)-(c) as the audit progressed
2.10.	**Materiality and Audit Risk**
3.	**UNDERSTANDING THE ENTITY AND ITSENVIRONMENT**
	Auditor shall obtain an understanding of the following:-
(a)	**Relevant industry, regulatory, and other external factors including the applicable financial reporting framework**
(b)	**The nature of the entity, including**
(c)	**The entity's selection and application of accounting policies, including the reasons for changes thereto**
(d)	**The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.**
(e)	**The measurement and review of the entity's financial performance**
3.1	**Why understanding the entity and its environment is significant?**
3.2	**Understanding the entity-a continuous process**
▪	Assessing risks of material misstatement of the financial statements.
▪	Determining materiality in accordance with SA 320.
▪	Considering the appropriateness of the selection and application of accounting policies.
▪	Identifying areas where special audit consideration may be necessary.
▪	Developing expectations for use when performing analytical procedures.
▪	Evaluating the sufficiency and appropriateness of audit evidence.
4.	**INTERNAL CONTROL**

4.1	**Meaning of Internal Control – Defined in purpose**
4.2	**As derived from above definition, the purpose ofInternal Control is as under**
▪	The reliability of the entity's financial reporting;
▪	The effectiveness and efficiency of its operations;
▪	Its compliance with applicable laws and regulations; and
▪	Safeguarding of assets.
4.3	**Benefits of Understanding of Internal Control**
(i)	Identifying types of potential misstatements;
(ii)	Identifying factors that affect the risks of material misstatement, and
(iii)	Designing the nature, timing, and extent of further audit procedures.
4.4	**Limitations of Internal Control**
(i)	Internal control can provide only reasonable assurance
(ii)	Human judgment in decision-making
(iii)	Lack of understanding the purpose
(iv)	Collusion among People
(v)	Judgements by Management
(vi)	Limitations in case of Small Entities
4.5	**Components of Internal Control**
(A)	The control environment
(B)	The entity's risk assessment process
(C)	The information system
(D)	Control activities
(E)	Monitoring of controls
4.5(A)	**Control Environment**
	What is included in Control Environment?
(i)	the governance and management functions and
(ii)	the attitudes, awareness, and actions of those charged with governance
(iii)	the control environment
	Elements of the Control Environment
(a)	Communication and enforcement of integrity and ethical values
(b)	Commitment to competence
(c)	Participation by those charged with governance

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

Factors relevant to the auditor's judgment

- Materiality.
- The significance of the related risk.
- The size of the entity.
- The nature of the entity's business
- The diversity and complexity of the entity's operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems
- Whether, and how, a specific control

4.7 Controls over the completeness and accuracy of Information

4.8 Internal control over safeguarding of assets

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

In certain circumstances, the statute or the regulation governing the entity may require the auditor to report on compliance with certain specific aspects of internal controls as a result, the auditor's review of internal control may be broader and more detailed.

4.10 Nature and Extent of the Understanding of Relevant Controls

Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include-

- Inquiring of entity personnel.
- Observing the application of specific controls.
- Inspecting documents and reports.
- Tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes.

5. RISKS THAT REQUIRE SPECIAL AUDIT CONSIDERATION

(a) Whether the risk is a risk of fraud

(b) Whether the risk is related to recent significant economic, accounting

(c) The complexity of transactions

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

(e) The degree of subjectivity

(f)	Whether the risk involves significant transactions that are outside the normal course.
5.1	**Identifying Significant Risks**
	The following are always significant risks:
▪	Risks of material misstatement due to fraud
▪	Significant transactions with related parties that are outside the normal course of business for the entity
5.2	**Risks of Material Misstatement Greater for Significant Non-Routine Transactions**
▪	Greater management intervention to specify the accounting treatment.
▪	Greater manual intervention for data collection and processing.
▪	Complex calculations or accounting principles.
▪	The nature of non-routine transactions.
5.3	**Risks of material misstatement- Greater for Significant Judgmental Matters**
▪	Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
▪	Required judgment may be subjective or complex
6.	**EVALUATION OF INTERNAL CONTROL SYSTEM**
6.1	**Benefits of Evaluation of Internal Control to the Auditor**
(i)	whether errors and frauds are likely to be located
(ii)	whether an adequate internal control system is in use
(iii)	whether an effective internal auditing department is operating.
(iv)	whether any administrative control has a bearing on his work.
(v)	whether the controls adequately safeguard the assets.
(vi)	how far and how adequately the management is discharging its function.
(vii)	how reliable the reports
(viii)	the extent and the depth of the examination that he needs to carry out
(ix)	what would be appropriate audit technique.
(x)	what are the areas where control is weak.
(xi)	whether some worthwhile suggestions.
6.2	**Evaluation of Internal Control - Methods**
(A)	Narrative record
(B)	Check List

(C)	Internal Control questionnaire and
(D)	Flow chart
6.2(A)	**The Narrative Record**
	Actual testing and observation are necessary before such a record can be developed.
	It may be recommended in cases where no formal control system is in operation and would be more suited to small business.
6.2 (B)	**Check List**
	This is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer.
	The complete checklist is studied by the Principal/Manager/Senior to ascertain existence of internal control and evaluate its implementation and efficiency.
6.2 (C)	**Internal Control Questionnaire**
	This is a comprehensive series of questions concerning internal control. This is the most widely used form for collecting information about the existence, operation and efficiency of internal control in an organisation.
6.2 (D)	**Flow Chart**
	It is a graphic presentation of each part of the company's system of internal control. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form.
	It gives bird's eye view of the system.
7.	**TESTING OF INTERNAL CONTROL**
	Test of controls may include:
▪	Inspection of documents
▪	Inquiries about, and observation of, internal controls
▪	Re-performance
▪	Testing of internal control operating on specific computerised applications
8.	**WHAT IS AN AUTOMATED ENVIRONMENT?**
8.1	**Key features of an automated environment**
•	Enables faster business operation
•	Accuracy in data processing and computation

- Ability to process large volume of transactions
- Integration amongst business operations
- Better security and controls
- Less prone to human errors
- Provides latest information
- Connectivity and networking capability

8.2 Understanding and documenting automated environment

- Information systems being used
- Their purpose
- Location of IT systems - local vs global
- Architecture
- Version
- Interfaces within systems
- In-house vs Packaged
- Outsourced activities
- Key persons

8.3 Risks arising from use of IT Systems

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

8.4 Impact of IT related risks

- Impact on substantive checking
- Impact on controls
- Impact on reporting

8.5 Types of Controls in an automated environment

(A) General IT controls

(B) Application controls

(C)	IT-dependent controls
8.5 (A)	**General IT controls**
	General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:
•	Data centre and network operations
•	Program change
•	Access security
•	Application system acquisition, development, and maintenance
•	General IT controls are known as "pervasive" controls or "indirect" controls.
(a)	**Controls over Data centre and network operations**
	Overall management of computer operation activities, preparing, scheduling and executing of batch jobs, monitoring, storage and retention of backups.
	Matters such as BCP (Business continuity plan) and DRP (Disaster recovery plan)
(b)	**Program Change**
	Change management process, recording, managing and tracking change requests, making and testing changes etc.
(c)	**Access Security**
	Security organization & management, security policies & procedures, application security, data security, operating system security, network security, physical security etc.
(d)	**Application system acquisition, development, and maintenance**
	Management of development activities, project initiation, analysis & design, construction, testing & quality assurance etc.
8.5 (B)	**Application Control**
	Application controls include both automated or manual controls that operate at a business process level. Examples of automated applications include edit checks and validation of input data, sequence number checks, user limit checks, reasonableness checks, mandatory data fields.
8.5 (C)	**IT dependent Controls**
	IT dependent controls are basically manual controls that make use of some form of data or information or report produced from IT systems and applications.
8.6	**General IT Controls vs. Application Controls**

General IT Controls are needed to support the functioning of application controls

8.7 Testing methods in an automated environment

Inquiry is the most efficient audit test but it also gives the least audit evidence. Inquiry alone is not sufficient. Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming.

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

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

- ♦ Obtain an understanding of how an automated transaction is processed.
- ♦ Observe how a user processes transactions under different scenarios.
- ♦ Inspect the configuration defined in an application.

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

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

(b) Controls in IT systems consist of a combination of automated controls and manual controls.

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

Manual elements in internal control may be more suitable.

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances.
- In monitoring the effectiveness of automated controls.

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

- High volume or recurring transactions
- Control activities where the specific ways to perform the control

10. AUDIT APPROACH IN AN AUTOMATED ENVIRONMENT

1. Risk Assessment

2.	Understand and Evaluate
3.	Test for Operating Effectiveness
4.	Reporting
11.	**DATA ANALYTICS FOR AUDIT**
	Data analytics can be used in testing of electronic records and data residing in IT systems:
▪	Check completeness of data and population
▪	Selection of audit samples
▪	Re-computation of balances
▪	Reperformance of mathematical calculations
▪	Analysis of journal entries Fraud investigation.
▪	Evaluating impact of control deficiencies.
12.	**DIGITAL AUDIT**
	Auditors are making use of artificial intelligence, data analytics and other latest technologies to help understand business processes in a better way.
13.	**INTERNAL FINANCIAL CONTROLS AS PER REGULATORY REQUIREMENTS**
	Term Internal Financial Controls (IFC)
▪	Reliability of financial reporting
▪	Effectiveness and efficiency of operations
▪	Compliance with applicable laws and regulations
▪	Safeguarding of assets
▪	Prevention and detection of frauds
14.	**DOCUMENTING THE RISKS**
	The auditor shall document:
(a)	The discussion among the engagement team
(b)	Key elements of the understanding obtained regarding each of the aspects
(c)	The identified and assessed risks of material misstatement
(d)	The risks identified, and related controls

15.	**ASSESS AND REPORT AUDIT FINDINGS**
▪	Are there any weaknesses in IT controls?
▪	What is the impact of these weaknesses on overall audit?
▪	Report deficiencies to management – Internal controls memo or Management letter.
▪	Communicate in writing any significant deficiencies to those Charged with governance.
16.	**THE AUDITOR'S RESPONSES TO ASSESSED RISKS**
	SA 330 The auditor's responses to assessed risks
(a)	The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.
(b)	The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.
	In designing the further audit procedures to be performed, the auditor shall:
(a)	Consider the reasons for the assessment given to the risk of material misstatement
(i)	The likelihood of material misstatement
(ii)	Whether the risk assessment takes into account the relevant controls
(b)	Obtain more persuasive audit evidence the higher the auditor's assessment of risk.
	The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:
(a)	includes an expectation that the controls are operating effectively or
(b)	Substantive procedures alone cannot provide sufficient appropriate audit evidence
16.1	**Nature and Extent of Test of Controls**
	In designing and performing test of controls, the auditor shall:
(a)	Perform other audit procedures in combination with inquiry
(i)	How the controls were applied at relevant times during the period under audit.
(ii)	The consistency with which they were applied.
(iii)	By whom or by what means they were applied.
(b)	Determine whether the controls to be tested depend upon other controls
	Matters the auditor may consider in determining the extent of test of controls
▪	The frequency of the performance of the control
▪	The length of time during the audit period that the auditor is relying

▪	The expected rate of deviation from a control.
▪	The relevance and reliability of the audit evidence.
▪	The extent to which audit evidence is obtained from tests of other controls.
16.2	**Timing of Test of Controls**
	The auditor shall test controls for the particular time, or throughout the period.
16.3	**Using Audit Evidence Obtained in Previous Audits**
	The auditor shall consider the following:
(a)	The effectiveness of other elements of internal control
(b)	The risks arising from the characteristics of the control
(c)	The effectiveness of general IT-controls
(d)	The effectiveness of the control
(e)	Whether the lack of a change in a particular control
(f)	The risks of material misstatement and the extent of reliance on the control
16.4	**Evaluating the Operating Effectiveness of Controls**
	The absence of misstatements detected by substantive procedures, however, does not
	provide audit evidence that controls related to the assertion being tested are effective.
16.5	**Specific inquiries by auditor when deviations from controls are detected**
(a)	The test of controls that have been performed provide an appropriate basis
(b)	Additional test of controls are necessary or
(c)	The potential risks of misstatement need to be addressed using substantive
	procedures.
	This requirement reflects the facts that:
(i)	the auditor's assessment of risk is judgmental
(ii)	there are inherent limitations to internal control
16.6	**Tests of Details**
	Tests of details are further classified into tests of transactions i.e., vouching
	and tests of balances i.e., verification.
16.7	**Substantive analytical procedures**
16.6.1	**Nature and extent of Substantive procedures**
•	Performing only substantive analytical procedures.
•	Only tests of details are appropriate.
•	A combination of substantive analytical procedures and tests of details

CHAPTER - 4

AUDIT EVIDENCE

1. **AUDIT EVIDENCE**

1.1 **Introduction**

Enable the auditor to obtain sufficient appropriate audit evidence.

1.2 **Meaning of Audit Evidence as per SA 500**

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

1.3 **Types of Audit Evidence**

1. **Depending upon nature:**

- **Visual**
- **Oral**
- **Documentary**

2. **Depending upon source:**

- **Internal Evidence**
- **External evidence**

The external evidence is generally considered to be **more reliable as they come from third parties** who are not normally interested in manipulation of the accounting information of others.

As an ordinary rule, the auditor should try to **match internal and external evidence as far as practicable.**

1.4 **Relevance and Reliability of audit evidence**

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

1.4.1 **Relevance** deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration.

1.4.2 **Reliability**

Reliability of information to be used as audit evidence, and therefore of **the audit evidence**

itself, is influenced **by its source and its nature**, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant.

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

- When it is obtained from independent sources outside the entity.
- Generated internally is increased when the related controls.
- Audit evidence obtained directly by the auditor
- Audit evidence in documentary form
- Audit evidence obtained as original documents

1.5 Sufficient appropriate audit evidence

1.5.1 Sufficiency and Appropriateness are interrelated.

Sufficiency is the measure of the **quantity of audit evidence.**

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

1.5.2 Obtaining Sufficient and appropriate Audit Evidence by the Auditor

Audit evidence is necessary to support the auditor's opinion and report.

Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions.

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

1. Materiality

2. Risk of material misstatement

3. Size & characteristics of a population

1.6 Source of audit evidence

Some audit evidence is obtained by performing audit procedures to test the accounting records.

More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually.

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

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

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

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

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

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

1.7.3 Nature and Timing of the Audit Procedures

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

1.8 Assertions

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

1.8.1 Assertions contained in the Financial Statements.

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

i. Occurrence ii. Completeness iii. Accuracy

iv. Cut-off v. Classification

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

i. Existence ii. Rights and obligations

iii. Completeness iv. Valuation and allocation

(c) Assertions about presentation and disclosure:

i. Occurrence and rights and obligations ii. Completeness

iii. **Classification and understandability** iv. **Accuracy and valuation**

The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered.

For example, where the Government is a major stakeholder, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

Explicit assertions are made when otherwise the reader will be left with an incomplete picture; it may even be misleading.

Negative assertions are also encountered in the financial statements and the same may be expressed or implied.

1.9 Audit Trail

An audit trail is a documented flow of a transaction. It is used to investigate how a source document was translated into an account entry and from there it was inserted into financial statement of an entity.

Audit trails (or audit logs) act as record-keepers that document evidence of certain events, procedures or operations, because their purpose is to reduce fraud, material errors, and unauthorized use.

However, audit trails involve costs.

Systems which have a feature of audit trail inspires confidence in auditors. Since audit trails also enhance data security, these can be used by auditor while performing audit procedures thus increasing reliability of audit evidence obtained.

1.10 Information to Be Used as Audit Evidence

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

- The nature and complexity of the matter
- The risks of material misstatement.
- The availability of alternative sources.

- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity.
- The extent to which management can exercise control or influence.
- Whether the management's expert is subject to technical performance standards.
- The nature and extent of any controls within the entity over the management's expert's work.
- The auditor's knowledge and experience.
- The auditor's previous experience of the work of that expert.

1.10.2 **When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances:**

(a) Obtaining audit evidence about the accuracy and completeness of the information;

(b) Evaluating whether the information is sufficiently precise and detailed.

1.11 Selecting Items for Testing to Obtain Audit Evidence

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

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

(b) Selecting specific items; and

(c) Audit sampling

1.11(a) Selecting All Items

100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details.

100% examination may be appropriate when,

- The population constitutes a small number of large value items;
- There is a significant risk.
- The repetitive nature of a calculation or other process performed.

1.11(b) Selecting Specific Items

The auditor may decide to select specific items from a population.

The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

- **High value or key items**
- **All items over a certain amount**

Nature of the entity or the nature of transactions.

1.11(c) **Audit Sampling**

1.12 Inconsistency in or Doubts over Reliability of Audit Evidence

If:

(a) audit evidence obtained from one source is inconsistent with that obtained from another; or

(b) the auditor has doubts over the reliability of information to be used as audit evidence,

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

1.13 Relying on the work of a management's expert

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

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

(c) Evaluate the appropriateness of that expert's work as audit evidence

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

2.1 Definition of Internal Audit Function

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

The objectives and scope of internal audit functions

(1) Activities Relating to Governance

(2) Activities Relating to Risk Management

(3) Activities Relating to Internal Control

Evaluation of internal control

- **Examination of financial and operating information**
- **Review of operating activities**
- **Review of compliance with laws and regulations**

2.2 Ways in which the external auditor may make use of the function for purposes of the audit.

(i) to obtain information that is relevant to the external auditor's assessments of the risks of material misstatement.

(ii) May decide to use work that has been performed by the internal audit function.

(iii) Internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

2.3 Scope of SA 610

(a) using the work of the internal audit function

(b) using internal auditors to provide direct assistance.

2.4 External Auditor's Responsibility for the audit

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

(a) To determine whether the work of the internal audit function or direct assistance.

(b) Determine whether that work is adequate for purposes of the audit; and

(c) Provide direct assistance, to appropriately direct, supervise and review their work.

2.6 Evaluating the Internal Audit Function

(A) Organizational status and relevant policies and procedures support the **objectivity**

(B) The level of **competence**

(C) A **systematic and disciplined approach, including quality control.**

2.6A Objectivity and its evaluation

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

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

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

(c) Relate to work with which the internal auditors have been involved

(d) Relate to decisions the external auditor makes in accordance with this SA.

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

(a) Obtain written agreement from an authorized representative of the entity

(b) Obtain written agreement from the internal auditors that they will keep confidential.

2.12. Distinction between Internal Financial Control and Internal Control over financial reporting

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

On the other hand, Internal controls over financial reporting is required where auditors are required to express an opinion on the effectiveness of an entity's internal controls over financial reporting, such opinion is in addition to and distinct from the opinion expressed by the auditor on the financial statements.

3. AUDIT SAMPLING (SA 530)

3.1 Sampling: An Audit Procedure

3.2 Meaning of Audit Sampling

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

3.3 Population

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

3.3.1 Characteristics of Population

1. **Appropriateness:** Appropriate means population from which the samples are drawn

shall be ***relevant.***

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

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

3.4 Sampling Unit

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

Sample must be representative

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

- **SAMPLING PROCESS is performed on**

1\. **Tests of controls** 2. **Tests of details**

3.5 Approaches to Sampling (Types of Sampling)

Audit sampling can be applied using either

A) non-statistical **or**

B) **statistical** sampling approaches.

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

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

3.5 A Statistical Sampling-More Scientific

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

2\. Statistical sampling has reasonably wide application

3\. There is no personal bias

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

3.5 B Non-Statistical Sampling

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

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

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

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

3.6 Sampling Vs Traditional method of Auditing

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

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

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

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

3.7 Appropriateness of Sampling Approaches

The advantages of statistical sampling may be summarized as follows-

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

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

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

3.9.2 Sample Size

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

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

(i) **the greater the reliance the auditor places on the operating effectiveness of controls** sample size will increase.

(ii) Increase in the tolerable rate of deviation. Larger will be the sample size.

(iii) Increase in the expected rate of deviation of the population ***larger the sample size.***

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

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

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

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

(ii) The more the auditor is relying on other substantive procedures *the smaller the sample size can be.*

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

(iv) An increase in tolerable misstatement will decrease the sample size.

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

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

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

3.9.3 Selection of Items for Testing

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

3.9.3 A Sample Selection Methods

(1) **Random Sampling:** Random selection ensures that all items in the population or within each stratum have a known chance of selection.

(i) **Simple Random Sampling: Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum). It is suitable for a homogeneous population having a similar range.**

(ii) **Stratified Sampling:** This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them.

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

(2) **Interval Sampling or Systematic Sampling:** Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval. Although the starting point may be determined haphazardly.

(3) **Monetary Unit Sampling:** It is a type of value-weighted selection.

(4) **Haphazard sampling:** Haphazard selection, in which the auditor selects the sample without following a structured technique.

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

(5) **Block Sampling:** This method involves selection of a block(s) of contiguous items from within the population.

3.10 Performing Audit Procedures

(i) The auditor shall perform audit procedures, appropriate to the purpose.

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

(iii) If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation.

(iv) An example of when it is necessary to perform the procedure on a replacement item is when a cancelled cheque is selected while testing for evidence of payment authorization.

(v) An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost.

(vi) An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.

(vii) Another example for replacement of a sample could be, if all transactions of computerized sales are being checked.

3.11 Nature and Cause of Deviations and Misstatements

(i) In analyzing the deviations and misstatements identified, the auditor may observe that many have a **common feature**.

(ii) The auditor may decide to identify all items in the population that possess the common feature.

(iii) The auditor shall investigate the nature and causes of any deviations.

(iv) Auditor considers a misstatement or deviation discovered in a sample to be an **anomaly**.

(v) The auditor shall obtain this degree of certainty.

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

3.12 Projecting Misstatements

(i) To obtain a broad view of the scale of misstatement.

(ii) **Anomaly**, it may **be excluded** when projecting misstatements to the population.

(iii) For tests of details, the auditor shall project misstatements whereas for tests of controls, **no explicit projection of deviations** is necessary.

3.13 Evaluating Results of Audit Sampling

The auditor shall evaluate-

(a) The results of the sample; and

(b) Whether the use of audit sampling has provided a reasonable basis.

Few Important terms to make the understanding better

Stratification

Tolerable misstatement – A monetary amount set by the auditor

Tolerable rate of deviation – A rate of deviation from prescribed internal control.

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

4.1 Meaning of Audit Evidence- Specific Considerations for Selected Items

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

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

(A) Existence and condition of inventory;

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

(C) Presentation and disclosure of segment information.

4.3 Inventory

When inventory is material to the financial statements.

(1) Attendance at physical inventory counting.

(i) Evaluate management's instructions and procedures.

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

(iii) Inspect the inventory; and

(iv) Perform test counts.

(2) Performing audit procedures over the entity's final inventory records.

4.4 Attendance at Physical Inventory Counting

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

(b) Observing compliance with management's instructions

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

4.5 Matters Relevant in Planning Attendance at Physical Inventory Counting

(a) Nature of inventory.

(b) Stages of completion of work in progress.

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

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

(e) Whether adequate procedures are expected to be established.

(f) The timing of physical inventory counting.

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

(h) The locations at which inventory is held

(i) Whether the assistance of an auditor's expert is needed.

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

The auditor shall, in addition to the procedures required above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

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

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

4.8 Attendance at Physical Inventory Counting becomes impractical

The auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory.

If it is not possible to do so SA 705.

In some cases, attendance at physical inventory counting may be impracticable.

The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure.

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

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

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

(a) *Request confirmation from the third party.*

(b) *Perform inspection or other audit procedures appropriate.*

For Example

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

4.10 ***Litigation and Claims***

(a) *Inquiry of management*

(b) *Reviewing minutes of meetings*

(c) *Reviewing legal expense accounts.*

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

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

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

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

If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, the auditor may seek direct communication through a letter of specific inquiry. A letter of specific inquiry includes:

(a) A list of litigation and claims;

(b) Management's assessment of the outcome

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

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

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

ii) The matter is complex.

iii) There is disagreement between management and the entity's external legal counsel.

Further if:

(a) Management refuses to give the auditor permission and

(b) the auditor is unable to obtain sufficient appropriate audit evidence the auditor shall modify the opinion.

4.12 Segment Information

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

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

(a) Obtaining an understanding of the methods used by management.

(i) Evaluating whether such methods are likely to result in disclosure

(ii) Where appropriate, testing the application of such methods; and

(b) Performing analytical procedures.

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

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

4.15 Understanding of the Methods Used by Management

Whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

1. Sales, transfers and charges between segments
2. Comparisons with budgets and other expected results.
3. The allocation of assets and costs among segments.
4. Consistency with prior periods.

5. EXTERNAL CONFIRMATIONS (SA 505);

5.1 Introduction

SA 500 indicates that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

5.2 Scope of this SA

Use of external confirmation procedures **to obtain audit evidence.**

5.3 Definition of External Confirmation:

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

5.4 Definitions of other terms:

- **Positive confirmation request –** A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees.
- **Negative confirmation request –** Respond directly to the auditor only if the confirming party disagrees with the information.
- **Non-response –** A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.
- **Exception –** Difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

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

(a) Determining the information to be confirmed or requested;

(b) Selecting the appropriate confirming party;

(c) Designing the confirmation requests

(d) Sending the requests, including follow-up requests

(a) Determining the Information to be Confirmed or Requested

Are performed to confirm or request information regarding account balances and their elements.

(b) Selecting the Appropriate Confirming Party

Responses to confirmation requests provide more relevant and reliable audit evidence.

(c) Designing Confirmation Requests

1. Design of a confirmation request

May directly affect the confirmation response rate, and the reliability.

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

(i) The assertions being addressed.

(ii) Specific identified risks of material misstatement.

(iii) The layout and presentation.

(iv) Prior experience

(v) The method of communication

(vi) Management's authorisation

(vii) The ability of the intended confirming party to confirm.

3. Positive confirmation request

Confirming party to reply to the auditor in all cases. **A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence.** Positive confirmation requests that do not state the amount (or other information) on the confirmation request.

4. Determination of properly addressed requests

Testing the validity of some or all of the addresses.

(d) Follow-Up on Confirmation Requests

May send an additional confirmation request.

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

5.8 **Evaluating the Evidence Obtained**

The auditor may categorise such results as follows:

(a) A response by the appropriate confirming party indicating agreement.

(b) A response deemed unreliable;

(c) A non-response; or

(d) A response indicating an exception.

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

6.1 Scope of this SA

Opening balances when conducting an initial audit engagement.

6.2 Definitions

1. **Initial audit engagement refers** to an engagement in which either:

(i) The financial statements for the prior period were not audited; or

(ii) The financial statements for the prior period were audited by a predecessor auditor.

2. **Opening balances means** those account balances that exist at the beginning of the period.

3. **Predecessor auditor** – The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

6.3 Objective of Auditor with respect to Opening Balances–

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

(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements.

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

The auditor shall obtain sufficient appropriate audit evidence

(a) Determining whether the prior period's closing balances have been correctly brought forward to the current period

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

(c) Performing one or more of the following:

(i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements;

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

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

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

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

6.5.1 Nature and extent of Audit Procedures

Depend on such matters as:

- The accounting policies
- The nature of the account balances, classes of transactions and disclosures.
- The significance of the opening balances.
- Whether the prior period's financial statements were audited.

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

The current auditor can place reliance except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

6.5.3 For current assets and liabilities

For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures.

6.5.4 For non- current assets and liabilities

- such as property plant and equipment, investments and long-term debt, some audit evidence may be obtained by **examining the accounting records and other information**
- In certain cases, the auditor may be able to obtain some audit evidence regarding

opening balances **through confirmation with third parties.**

6.6 Consistency of Accounting Policies relating to opening balances

If the auditor concludes that:

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

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

6.7 Reporting by the auditor with regard to opening balances

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

7. RELATED PARTIES (SA 550)

7.1 Scope of this SA

Auditor's responsibilities regarding related party relationships and transactions.

7.2 Definition of Related Party

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

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

a. A person or other entity that has **control or significant influence**

b. Another entity over which the reporting entity has **control or significant influence**

c. Another entity that is under common control.

i. Common controlling ownership;

ii. Owners who are close family members; or

iii. Common key management.

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

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

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

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

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

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

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

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

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

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

7.4 Meaning of Related Parties with Dominant Influence

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

7.5 Meaning of Special-Purpose Entities as Related Parties

Entity may in substance control.

7.6 Nature of Related Party Relationships and Transactions

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

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

For example

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

(B) Information systems may be ineffective.

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

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

8. ANALYTICAL PROCEDURES (SA 520)

8.1 Meaning of Analytical Procedures

"Analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.

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

- Comparable information for prior periods.
- Anticipated results of the entity.
- Similar industry information.
- Among elements of financial information that would be expected to conform to a predictable pattern.
- Between financial information and relevant non-financial information.

8.2 Scope of SA 520

The objectives of the auditor are:

(a) To obtain relevant and reliable audit evidence.

(b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion.

8.3 Purpose and timing of Analytical Procedures

8.3A Purpose of Analytical Procedures

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

8.3 B Timing of Analytical Procedures

- Planning Phase
- Testing Phase
- Completion Phase

8.3 C Analytical Procedures in Planning the Audit

In identifying areas of potential risk

8.4 Substantive Analytical Procedures

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures.

8.5 Factors to be considered for Substantive Audit Procedures

(i) **Availability of Data**

(ii) **Disaggregation**

(iii) **Account Type**

(iv) **Source**

(v) **Predictability**

(vi) **Nature of Assertion**

(vi) **Inherent Risk or "What Can Go Wrong"**

8.6 Techniques available as Substantive Analytical Procedures

(i) **Trend analysis** – Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances.

(ii) **Ratio analysis** – Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts.

(iii) **Reasonableness tests** – This analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period.

(iv) **Structural modelling** – A modelling tool constructs a statistical model.

8.7 Analytical Procedures used as Substantive Tests

When designing and performing substantive analytical procedures.

(i) Determine the suitability of particular substantive analytical procedures.

(ii) Evaluate the reliability of data

(iii) Develop an expectation of recorded amounts or ratios

(iv) Determine the amount of any difference

8.8 Suitability of particular analytical procedures for given assertions

1.	More applicable to large volumes
2.	Is based on the expectation
3.	Depend upon the auditor's assessment of how effective it will be in detecting a misstatement.
4.	Even an unsophisticated predictive model may be effective.

8.9 The reliability of DATA

(i) Source of the information available.

(ii) Comparability of the information available.

(iii) Nature and relevance of the information available.

(iv) Controls over the preparation of the information.

8.10 Evaluation of whether the expectation is sufficiently precise

Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement.

(i) The accuracy with which the expected results of substantive analytical procedures

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

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

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

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

8.12 Investigating results of Analytical Procedures

(i) Inquiring of management and obtaining appropriate audit evidence.

(ii) Performing other audit procedures as necessary in the circumstances.

8.13 Analytical procedures that assist when forming an overall conclusion

Are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements.

CHAPTER - 5

AUDIT OF ITEMS OF FINANCIAL STATEMENTS

1) **INCOME STATEMENT CAPTIONS COMPRISING REVENUE AND EXPENSE BALANCES:**

i) **Occurrence:**

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

ii) **Completeness:**

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

iii) **Cut-off:**

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

iv) **Measurement:**

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

v) **Presentation and Disclosure:**

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

2) **BALANCE SHEET CAPTIONS COMPRISING ASSETS, LIABILITIES AND EQUITY BALANCES:**

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

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

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

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

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

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

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

REFER MAIN BOOK CONTENT

CHAPTER - 6

AUDIT DOCUMENTATION

1. **AUDIT DOCUMENTATION**

SA 230 on "Audit Documentation"

1.1 **Definition of Audit Documentation:**

Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

1.2 **Objective of the Auditor:**

(a) A sufficient and appropriate record of the basis for the auditor's report; and

(b) Evidence that the audit was planned and performed in accordance with SAs

1.3 **Nature of Audit Documentation**

(a) evidence of the auditor's basis for a conclusion

(b) evidence that the audit was planned and performed in accordance with SAs

1.4 **Purpose of Audit Documentation**

1. Assisting the engagement team to plan and perform the audit.
2. Assisting members of the engagement team to direct and supervise the audit work
3. Enabling the engagement team to be accountable for its work.
4. Retaining a record of matters of continuing significance to future audits.
5. Enabling the conduct of quality control reviews
6. Enabling the conduct of external inspections

1.5 **Form, Content and Extent of Audit Documentation**

(a) The nature, timing and extent of the audit procedures performed.

(b) The results of the audit procedures performed and the audit evidence obtained and

(c) Significant matters arising during the audit and the conclusions reached

♦ Further in documenting the nature, timing and extent of audit procedures,

(a) The identifying characteristics of the specific items or matters tested.

(b) Who performed the audit work and the date such work was completed;

(c) Who reviewed the audit work performed and the date and extent of such review.

- The auditor shall document discussions of significant matters with management
- If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter

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

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed.
3. The identified risks of material misstatement.
4. The significance of the audit evidence obtained.
5. The nature and extent of exceptions identified.
6. The need to document a conclusion.
7. The audit methodology and tools used.

1.6 Examples of Audit Documentation

Audit Documentation Include:

Audit programmes

Analyses

Issues memoranda

Summaries of significant matters

Letters of confirmation and representation

Checklists

Correspondence

1.7 Timely Preparation of Audit Documentation

The auditor shall prepare audit documentation on a timely basis.

1.8 Audit File

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

1.9 **Assembly of the Final Audit File**

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

Examples of such changes include:

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

1.10 **Documentation of Significant Matters and Related Significant Professional Judgements**

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

Matters that give rise to significant risks.

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

1.11 **Completion Memorandum or Audit Documentation Summary**

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

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

1.12 **Ownership of Audit Documentation**

- Standard on Quality Control (SQC) 1

CHAPTER - 7

COMPLETION AND REVIEW

1. SUBSEQUENT EVENTS

1.1 Subsequent events

A. Events occurring between the date of the financial statements and the date of the auditor's report

B. Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued

C. Facts which become known to the auditor after the financial statements have been issued

1.2 Objectives of auditor in accordance with SA 560

(a) Obtain sufficient appropriate audit evidence

(b) Respond appropriately to facts

1.3 Audit procedures relating to events occurring between the date of the financial statements and the date of the auditor's report

(a) Obtaining an understanding of any procedures management has established

(b) Inquiring of management

(c) Reading minutes if

(d) Reading the entity's latest subsequent interim financial statements

The auditor shall request management to provide a written representation.

1.4 Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued

(a) Discuss the matter with management

(b) Determine whether the financial statements need amendment and, if so,

(c) Inquire how management intends to address the matter.

If management amends the financial statements, the auditor shall:

(a) Carry out the audit procedures necessary in the circumstances.

(b) Unless the circumstances in succeeding para apply

(i) Extend the audit procedures, already referred, to the date of the new auditor's report and

(ii) Provide a new auditor's report on the amended financial statements.

When law, regulation or the financial reporting framework does not prohibit management from restricting the amendment

In such cases, the auditor shall either:-

(a) Amend the auditor's report to include an additional date or

(b) Provide a new or amended auditor's report that

In some entities, management may not be required by the applicable law, regulation or the financial reporting framework to issue amended financial statements

(a) If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion as required by SA 705 or

(b) If the auditor's report has already been provided to the entity, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, not to issue the financial statements to third parties before the necessary amendments.

1.5 Facts which become known to the auditor after the financial statements have been issued

(a) Discuss the matter with management

(b) Determine whether the financial statements need amendment and, if so,

(c) Inquire how management intends to address the matter

If the management amends the financial statements, the auditor shall:-

(a) Carry out the audit procedures necessary in the circumstances on the amendment.

(b) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.

(c) Unless such circumstances when law, regulation or the financial reporting framework does not prohibit management.

(i) Extend the audit procedures

(ii) Provide a new auditor's report on the amended financial statements.

(d) When the circumstances are such that law, regulation or the financial reporting framework does not prohibit management amend the auditor's report, or provide a new auditor's report as already discussed.

If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management.

If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

2. MEANING OF GOING CONCERN AND ITS SIGNIFICANCE

Going concern is one of the fundamental accounting assumptions.

2.1 SA 570 Going Concern

SA 570 Going Concern deals with the auditor's responsibilities

2.2 Responsibility for assessment of the entity's ability to continue as a going concern

The following factors are relevant to that judgment:-

- The degree of uncertainty associated with the outcome of an event or condition
- The size and complexity of the entity
- Any judgment about the future is based on information available

2.3 Responsibilities of the auditor

Obtain sufficient appropriate audit evidence regarding and conclude on the appropriateness of management's use.

2.4 Objectives of auditor in accordance with SA 570

(a) To obtain sufficient appropriate audit evidence

(b) To conclude based on the audit evidence obtained

(c) To report in accordance with this SA

2.5 Risk assessment procedures and related activities

(a) If such an assessment has been performed, the auditor shall discuss the assessment with management.

(b) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern.

Examples of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern

Financial events or conditions

- Net liability or net current liability position
- Fixed-term borrowings approaching maturity without realistic prospects
- Indications of withdrawal of financial support by creditors
- Negative operating cash flows
- Adverse key financial ratios
- Substantial operating losses
- Arrears or discontinuance of dividends
- Inability to pay creditors on due dates
- Inability to comply with the terms of loan agreements
- Change from credit to cash-on-delivery transactions with suppliers
- Inability to obtain financing for essential new product development

Operating events or conditions

- Management intentions to liquidate the entity or to cease operations
- Loss of key management without replacement
- Loss of a major market
- Labour difficulties
- Shortages of important supplies

- Emergence of a highly successful competitor

Other events or conditions

- Non-compliance with capital or other statutory or regulatory requirements
- Pending legal or regulatory proceedings
- Changes in law or regulation or government policy
- Uninsured or underinsured catastrophes when they occur

2.6 Evaluating management's assessment

It is not the auditor's responsibility to rectify the lack of analysis by management. If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the date of the financial statements, the auditor shall request management to extend its assessment period to at least twelve months from that date.

2.7 Additional audit procedures when events or conditions are identified

(a) Requesting management to make its assessment.
(b) Evaluating management's plans for future actions
(c) Where the entity has prepared a cash flow forecast, and analysis
(i) Evaluating the reliability of the underlying data
(ii) Determining whether there is adequate support for the assumptions.
(d) Considering whether any additional facts or information.
(e) Requesting written representations from management

2.8 Auditor's conclusions

Appropriate disclosure of the nature and implications of the uncertainty is necessary.

2.9 Adequacy of disclosures when events or conditions have been identified and a material uncertainty exists

(a) Adequately disclose the principal events or conditions
(b) Disclose clearly that there is a material uncertainty

2.10 Adequacy of disclosures when events or conditions have been identified but no material

uncertainty exists

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

2.11 Implications for the auditor's report

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

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

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

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

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

The auditor shall:

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

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

(III) Management unwilling to make or extend its assessment

A qualified opinion or a disclaimer of opinion

3. EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

3.1 SA 450 Evaluation of Misstatements Identified during the Audit

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

3.2 Objectives of auditor in accordance with SA 450

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

(b) *The effect of uncorrected misstatements*

3.3 Accumulation of misstatements identified during the audit

3.4 Consideration of identified misstatements as the audit progresses

The auditor shall determine whether the overall audit strategy and audit plan need to be revised if:

(a) The nature of identified misstatements when aggregated with misstatements accumulated during the audit, could be material or

(b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320.

3.5 Communication and correction of misstatements

The auditor shall communicate on a timely basis all misstatements with the appropriate level of management, unless prohibited by law or regulation.

If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons.

3.6 Evaluating the effect of uncorrected misstatements

The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:-

(a) The size and nature of the misstatements, and

(b) The effect of uncorrected misstatements related to prior periods

3.7 Communication with those charged with governance

3.8 Written Representation from management regarding effects of uncorrected statements

A summary of such items shall be included in or attached to the written representation.

3.9 Documentation regarding misstatements identified during audit

The audit documentation shall include:-

(a) The amount below which misstatements would be regarded as clearly trivial;

(b) All misstatements accumulated

(c) The auditor's conclusion as to whether uncorrected misstatements are material

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

4.7 Description of management's responsibilities in the written representations

4.8 Other Written representations

They may include representations about the following:-

- Whether the selection and application of accounting policies are appropriate; and
- Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognized, measured, presented or disclosed
  - Plans or intentions that may affect the carrying value of assets
  - Liabilities, both actual and contingent;
  - Title to, or control over, assets
  - Aspects of laws, regulations and contractual agreements

4.9 Additional Written representations about information provided to the auditor

4.10 Written representations about specific assertions

When obtaining evidence about, or evaluating, judgments and intentions, the auditor may consider one or more of the following:

- The entity's past history in carrying out its stated intentions.
- The entity's reasons for choosing a particular course of action.
- The entity's ability to pursue a specific course of action.
- The existence or lack of any other information

4.11 Date of and Period (s) covered by Written Representations

Shall be as near as practicable to, ***but not after,*** the date of the auditor's report on the financial statements.

4.12 Form of Written representations

The written representations shall be in the form of a representation letter addressed to the auditor.

4.13 Doubt as to the reliability of written representations

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

4.14 Requested Written representations not provided

(a) Discuss the matter with management;

(b) Re-evaluate the integrity of management

(c) Take appropriate actions

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

The auditor shall disclaim an opinion

(a) The auditor concludes that there is sufficient doubt about the integrity of management.

(b) Management does not provide the written representations relating to fulfilling its responsibilities.

5. SIGNIFICANCE OF COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

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

(a) Constructive working relationship

(b) Information relevant to the audit.

(c) Fulfilling their responsibility

5.1 Who are "Those charged with governance"?

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

5.2 Scope of SA 260- Communication with Those Charged with Governance

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

5.3 Objectives of auditor in accordance with SA 260

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

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

5.8 Adequacy of the communication process

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

5.9 Documentation

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

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

Auditor's responsibility to communicate appropriately

6.2 Objective of auditor in accordance with SA 265

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

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

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

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

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

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

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

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

- The importance of the controls to the financial reporting process,

(b – 1) Examples of indicators of significant deficiencies in internal control

- Evidence of ineffective aspects of the control environment, such as:-
  - Indications that significant transactions
  - Identification of management fraud
  - Management's failure to implement appropriate remedial action
- Absence of a risk assessment process
- Evidence of an ineffective entity risk assessment process
- Evidence of an ineffective response to identified significant risks
- Misstatements detected by the auditor's procedures
- Disclosure of a material misstatement due to error or fraud as prior period items.
- Evidence of management's inability to oversee the preparation

6.4 Determination of significant deficiencies in internal control

6.5 Communication of significant deficiencies in internal control to those charged with governance

The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis:-

(a) In writing, significant deficiencies in internal control

(b) Other deficiencies in internal control

The auditor shall include in the written communication of significant deficiencies in internal control:-

(a) A description of the deficiencies

(b) Sufficient information

In particular, the auditor shall explain that: -

(i) The purpose of the audit

(ii) The audit included consideration of internal control relevant to the preparation of the financial statements.

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

CHAPTER - 8

AUDIT REPORT

1. INTRODUCTION

The purpose of an audit is to enhance the degree of confidence of intended users of the financial statements.

2. FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS

SA 700 (Revised)- "Forming an Opinion and Reporting on Financial Statements".

2.1 Objective of the Auditor

The objectives of the auditor as per SA 700 (Revised) are:

- To form an opinion on the financial statements
- To express clearly that opinion through a written report

2.2 To Form Opinion – Auditor to Obtain Reasonable Assurance

That conclusion shall take into account:

(a) Whether sufficient appropriate audit evidence has been obtained;

(b) Whether uncorrected misstatements are material, individually or in aggregate;

(c) The evaluations

2.3 Evaluations by the Auditor

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects.

2.3.1 Qualitative Aspects of the Entity's Accounting Practices

1. Management makes a number of judgements.
2. SA 260 (Revised) contains a discussion of the qualitative aspects.
3. Indicators of a lack of neutrality include the following:

(i) The selective correction of misstatements brought to management's attention

(ii) Possible management bias in the making of accounting estimates.

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

Basic Elements of an Audit Report are given below:

1. **Title**

2. **Addressee**

3. **Auditor's Opinion**

The Opinion section of the auditor's report shall also:

- Identify the entity whose financial statements have been audited;
- State that the financial statements have been audited;
- Identify the title of each statement comprising the financial statements;
- Refer to the notes, including the summary of significant accounting policies; and
- Specify the date of, or period covered by, each financial statement comprising the financial statements.

Unmodified Opinion:

The phrases **"present fairly, in all material respects," and "give a true and fair view"** are regarded as being equivalent

When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as "with the foregoing explanation" or "subject to" in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

4. **Basis for Opinion**

1. States that the audit was conducted in accordance with Standards on Auditing;
2. Refers to the section that describes the auditor's responsibilities.
3. Includes a statement that the auditor is independent of the entity
4. The audit evidence the auditor has obtained is sufficient and appropriate.

5. **Going Concern:**

6. **Key Audit Matters**

7. **Responsibilities for the Financial Statements:**

(a) Preparing the financial statements and for such internal control as management determines is necessary.

(b) Assessing the entity's ability to continue as a going concern.

8. **Auditor's Responsibilities for the Audit of the Financial Statements:**

1. **This section of the auditor's report shall state:**

(a) **That the objectives of the auditor are to:**

(i) Obtain reasonable assurance

(ii) Issue an auditor's report

(b) That reasonable assurance is a high level of assurance, but is not a guarantee

(c) That misstatements can arise from fraud or error, and either

(i) Describe that they are considered material

(ii) Provide a definition or description of materiality

II. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further:

Auditor's responsibility section to further

(a) the auditor exercises professional judgement and maintains professional skepticism.

(b) Describe an audit by stating that the auditor's responsibilities are:

- To identify and assess the risks of material misstatement
- To obtain an understanding of internal control.
- To evaluate the appropriateness of accounting policies.
- To conclude on the appropriateness of management's use of the going concern basis.
- Overall presentation, structure and content of the financial statements.

(c) When SA 600 applies, further describe the auditor's responsibilities

III. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall:

(a) the planned scope and timing of the audit and significant audit findings

(b) For audits of financial statements of listed entities, that the auditor has complied with relevant ethical requirements regarding independence

(c) For audits of financial statements of listed entities key audit matters are communicated in accordance with SA 701,

9. Location of the description of the auditor's responsibilities for the audit of the financial statements:

- Within the body of the auditor's report
- Within an appendix to the auditor's report
- A website of an appropriate authority

10. Other Reporting Responsibilities

11. Signature of the Auditor

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

6.2 **Objective of the Auditor- To Express Clearly an Appropriately Modified Opinion**

6.3 **Types of Modified Opinions:**

1. A qualified opinion 2. An adverse opinion 3. A disclaimer of opinion

6.3.1. **Qualified Opinion**

The auditor shall express a qualified opinion when:

(a) Concludes that misstatements, individually or in the aggregate, are material, but not pervasive or

(b) The auditor is unable to obtain sufficient appropriate audit evidence auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

6.3.2. **Adverse Opinion**

Obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

6.3.2.1 **Definition of Pervasive**

(i) Are not confined to specific elements, accounts or items of the financial statements;

(ii) If so confined, represent or could represent a substantial proportion

(iii) In relation to disclosures, are fundamental to users' understanding

6.3.3. **Disclaimer of Opinion:** The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

6.4 **Which type of opinion is appropriate?**

(a) The nature of the matter giving rise to the modification

(b) The auditor's judgement about the pervasiveness of the effects or possible effects

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

1) the auditor shall request that management remove the limitation.

2) If management refuses to remove the limitation referred above, the auditor shall communicate the matter to those charged with governance.

3) If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:

(a) Could be material but not pervasive, the auditor shall qualify the opinion; or

(b) Could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:

(i) Withdraw from the audit

(ii) Disclaim an opinion on the financial statements.

4) If the auditor withdraws as contemplated by point (b)(i) above, before withdrawing, the auditor shall communicate to those charged with governance.

6.6 Form and Content of the Auditor's Report When the Opinion is Modified

Auditor's Opinion

When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section.

(1) Qualified Opinion

The auditor shall state that, in the auditor's opinion, **except for the effects of the matter(s) described in the Basis for Qualified Opinion section.**

(2) Adverse Opinion

The auditor's opinion, **because of the significance of the matter(s) described in the Basis for Adverse Opinion section,**

(3) Disclaimer of Opinion

The auditor shall:

(a) State that the auditor does not express an opinion

(b) **The auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements;**

(c) State that the auditor was engaged to audit the financial statements.

6.7 Basis for Opinion

- **Amend the heading "Basis for Opinion" required by SA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and**
- **Within this section, include a description of the matter giving rise to the modification.**
- If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements a description and quantification of the financial effects.
- If it is not practicable to quantify the financial effects, the auditor shall so state in this section.
- If there is a material misstatement of the financial statements that relates to narrative disclosures, explanation of how the disclosures are misstated.
- If there is a material misstatement of the financial statements non-disclosure of information required to be disclosed, the auditor shall:

(a) Discuss the non-disclosure

(b) Describe in the Basis for Opinion

(c) Unless prohibited by law or regulation, include the omitted disclosures.

- If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.
- When the auditor disclaims an opinion on the financial statements, the auditor's report shall not include the following elements required by SA 700 (Revised).

(a) A reference to the section of the auditor's report where the auditor's responsibilities.

(b) A statement about whether the audit evidence obtained is sufficient and appropriate.

6.8 Description of Auditor's Responsibilities for the Audit of the Financial Statements When the Auditor Disclaims an Opinion on the Financial Statements

(a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing.

(b) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate.

(c) The statement about auditor independence and other ethical responsibilities.

6.9 Considerations When the Auditor Disclaims an Opinion on the Financial Statements

The auditor's report shall not include a Key Audit Matters section.

6.10 Communication with Those Charged with Governance

7. EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT

7.1 Objective of the Auditor as per SA 706

As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report".

(a) *It is fundamental to users' understanding*

(b) *Is relevant to users' understanding*

7.2 Emphasis of Matter Paragraphs in the Auditor's Report

The auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

(a) *The auditor would not be required to modify the opinion in accordance with SA 705.*

(b) *When SA 701 applies, the matter has not been determined to be a key audit matter.*

7.2.1 Separate section for Emphasis of Matter paragraph

(a) *Include the paragraph within a separate section.*

(b) *Include in the paragraph a clear reference to the matter being emphasized.*

(c) *Indicate that the auditor's opinion is not modified in respect of the matter emphasized.*

Some examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph.

- *An uncertainty relating to the future outcome*
- *A significant subsequent event*
- *Early application*
- *A major catastrophe*

7.3 An Emphasis of Matter paragraph is not a substitute for:

(a)	*A modified opinion in accordance with SA 705*
(b)	*Disclosures in the financial statements*
(c)	*Reporting in accordance with SA 570*

7.4 Other Matter Paragraphs in the Auditor's Report

The auditor shall include an Other Matter paragraph in the auditor's report, provided:

(a)	*This is not prohibited by law or regulation; and*
(b)	*When SA 701 applies, the matter has not been determined to be a key audit matter.*

7.4.1 Separate section for Other Matter paragraph

A separate section with the heading "Other Matter," or other appropriate heading.

7.5 Communication with Those Charged with Governance

8. COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT (SA 701)

8.1 Purpose of Communicating Key Audit Matters

Communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency.

8.2 Objectives of the Auditor regarding Key Audit Matters

Determine key audit matters and, having formed an opinion on the financial statements.

8.3 Determining Key Audit Matters

The auditor shall take into account the following:

- **Areas of higher assessed risk of material misstatement, or significant risks.**
- **Significant auditor judgements relating to areas in the financial statements.**
- **The effect on the audit of significant events or transactions.**

8.4 Communicating Key Audit Matters

The introductory language in this section of the auditor's report shall state that:

(a) Were of most significance in the audit of the financial statements.

(b) The auditor does not provide a separate opinion on these matters.

8.5 Communicating Key Audit Matters- not a substitute for disclosure in the Financial Statements etc.

(a) A substitute for disclosures in the financial statements

(b) A substitute for the auditor expressing a modified opinion

(c) A substitute for reporting in accordance with SA 570

(d) A separate opinion on individual matters.

8.6 Communication with Those Charged with Governance

9. STANDARD ON AUDITING - 710, "COMPARATIVE INFORMATION CORRESPONDING FIGURES AND COMPARATIVE FINANCIAL STATEMENTS"

9.1 The essential audit reporting differences between the approaches are:

(a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas

(b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

9.2 Audit Procedures regarding comparative information

(a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and

(b) The accounting policies reflected in the comparative information are consistent.

♦ If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances.

♦ As required by SA 580, the auditor shall request written representations.

9.3 Audit Reporting regarding Corresponding Figures

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

1. **If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion** and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements.
2. **If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements** on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion.
3. **Prior Period Financial Statements Not Audited-**

Prior Period Financial Statements Audited by a Predecessor Auditor

The auditor shall state in an Other Matter paragraph in the auditor's report:

(a) That the financial statements of the prior period were audited by the predecessor auditor

(b) The type of opinion expressed by the predecessor auditor.

(c) The date of that report.

9.4 Comparative Financial Statements

1. **When reporting on prior period financial statements in connection with the current period's audit,** if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph.
2. **Prior Period Financial Statements Audited by a Predecessor Auditor**

The auditor shall state in an Other Matter paragraph:

(a) That the financial statements of the prior period were audited by a predecessor.

(b) The type of opinion expressed by the predecessor auditor.

(c) The date of that report, unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.

3. **Prior Period Financial Statements Not Audited**

10. AUDIT OF BRANCH OFFICE ACCOUNTS

- **Principal auditor**
- **Other auditor**
- **Component**

SA 600, "Using the Work of another Auditor". When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

(a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts.

(b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

11. JOINT AUDIT

In specific terms the **advantages** that flow may be the following:

(i) Sharing of expertise.
(ii) Advantage of mutual consultation.
(iii) Lower workload.
(iv) Better quality of performance.
(v) Improved service to the client.
(vi) Lower staff development costs.
(vii) Lower costs to carry out the work.

The general **disadvantages** may be the following:

(i) The fees being shared.
(ii) Psychological problem
(iii) General superiority complex of some auditors.

(iv) Problems of co-ordination of the work.

(v) Areas of work of common concern being neglected.

(vi) Uncertainty about the liability for the work done.

Standard on Auditing (SA) 299 (Revised), "Joint Audit of Financial Statements".

This Standard deals with the special considerations in carrying out audit by joint auditors. It requires that–

(i) each of the joint auditors should be involved in planning the audit.

(ii) the joint auditors should jointly establish an overall audit strategy.

(iii) joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:

(a) identify division of audit areas and common audit areas;

(b) ascertain the reporting objectives of the engagement;

(c) consider and communicate among all joint auditors

(d) consider the results of preliminary engagement activities

(e) ascertain the nature, timing and extent of resources.

(iv) each of the joint auditors should consider and assess the risks of material misstatement.

(v) the joint auditors should discuss and document the nature, timing, and the extent of the audit procedures.

(vi) the joint auditors should obtain common engagement letter and common management representation letter.

(vii) the work allocation document.

Each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. On the other hand, all the joint auditors shall be jointly and severally responsible for:

(i) the audit work which is not divided among the joint auditors

(ii) decisions taken by all the joint auditors

(iii) matters which are brought to the notice of the joint auditors by any one of them.

(iv) examining that the financial statements of the entity comply with the requirements.

(v) presentation and disclosure of the financial statements;

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

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

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

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

12. DUTIES OF AUDITORS

Sections 143 of the Companies Act, 2013

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

(a) Loans and advances made by the company on the basis of security

(b) Transactions of the company which are represented merely by book entries

(c) Company not being an investment company or a banking company, whether securities have been sold at a price less than that at which they were purchased.

(d) Loans and advances made by the company have been shown as deposits;

(e) Personal expenses have been charged to revenue account;

(f) Books and documents of the company that any shares have been allotted for cash.

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

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

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

(a) whether he has sought and obtained all the information and explanations.

(b) whether, in his opinion, proper books of account as required by law have been kept.

(c)	whether the report on the accounts of any branch office.
(d)	whether the company's balance sheet and profit and loss account dealt.
(e)	whether, in his opinion, the financial statements comply with the accounting standards;
(f)	the observations or comments of the auditors on financial transactions have any adverse effect on the functioning of the company;
(g)	whether any director is disqualified sub-section (2) of the section 164;
(h)	any qualification, reservation or adverse remark.
(i)	whether the company has adequate internal financial controls.
	(Note: Clause (i) of Sub-Section (3) of Section143 shall not apply to a private company: - (i) which is a one person company or a small company; or (ii) which has turnover less than rupees fifty crores as per latest audited financial statement and which has aggregate borrowings from banks or financial institutions or anybody corporate at any point of time during the financial year less than rupees twenty five crore)
(j)	such other matters
(1)	whether the company has disclosed the impact, if any, of pending litigations
(2)	material foreseeable losses, if any, on long term contracts including derivative contracts;
(3)	delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.
(4)	
(i)	no funds have been advanced or loaned or invested by the company to or in any other person(s) or entity(ies), including foreign entities with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company.
(ii)	no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified.
(iii)	believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.
(5)	compliance with section 123 of the Companies Act, 2013.

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

5\. **Duty to report on frauds:**

Fraud Reporting
[Section 143(12) of Companies Act, 2013 & Rule 13 of CAAR, 2014

- Fraud involving amount of less than ₹ 1 crore
  - Auditor to Report to Board/Audit Committee
    - Within 2 days of knowledge of fraud,
      ↓
      Report the following matters:
      (a) Nature of Fraud with description;
      (b) Approximate amount involved; and
      (c) Parties involved.
  - Company bound to disclose certain specified details in Board's Report such as:
    (a) Nature of Fraud with description;
    (b) Approximate amount involved;
    (c) Parties involved, if remedial action not taken; and
    (d) Remedial actions taken.
- Fraud involving amount of ₹ 1 crore or above
  - Auditor to Report to Central Government in following manner:
    - Within 2 days of knowledge of fraud,
      ↓
      Report to Board/Audit Committee
    - Seek reply within 45 days
      - Reply/observations received within stipulated time
        - Forward Report + Reply/observations + Comments to CG within 15 days of receipt of such reply/observations
      - Reply/observations not received within stipulated time
        - Forward Report + Note containing details of report for which failed to receive any reply / observations to CG

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

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

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

12.1 Reporting Under CARO, 2200

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

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

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

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

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

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

iv) A One Person Company

v) A small company

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

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

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

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

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

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

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

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

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

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

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

(xii)	**(a)** Whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability.
	(b) Whether the Nidhi Company is maintaining ten per cent unencumbered term deposits
(xiii)	Whether all transactions with the related parties are in compliance
(xiv)	**(a)** Whether the company has an internal audit system
	(b) Whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor
(xv)	Whether the company has entered into any non - cash transactions
(xvi)	**(a)** Whether the company is required to be registered under section 45 - IA
	(b) Whether the company has conducted any Non - Banking Financial
	(c) Whether the company is a Core Investment Company (CIC)
	(d) Whether the Group has more than one CIC as part of the Group
(xvii)	Whether the company has incurred cash losses in the financial year
(xviii)	Whether there has been any resignation of the statutory auditors
(xix)	The auditor's knowledge of the Board of Directors and management plans
(xx)	**(a)** Whether, in respect of other than ongoing projects, the company has transferred unspent amount to a Fund specified in Schedule VI
	(b) Whether any amount remaining unspent under subsection (5) of Section 135.
(xxi)	Whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports.

CHAPTER - 9

SPECIAL FEATURES OF AUDIT OF DIFFERENT TYPES OF ENTITIES

1. **GOVERNMENT AUDIT**

1.1 **Introduction**

Government auditing is

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

OBJECTIVES:-

(a) Accounting for Public Funds:

(b) Appraisal of Government policies

(c) Base for Corrective actions

Administrative accountability

1.2 **Legal Framework and Comptroller & Auditor General**

1. **APPOINTMENT & REMOVAL**

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

2. **TENURE**

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

3. **VARIOUS CONSTITUTIONAL PROVISIONS**

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

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

(1) **Audit against Rules & Orders**

These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:

(i) Rules and orders regulating the powers to incur and sanction expenditure.

(ii) Rules and orders dealing with the mode of presentation of claims against government.

(iii) Rules and orders regulating the conditions of service, pay and allowances.

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

(a) they are not inconsistent with any provisions of the Constitution.

(b) they are consistent with the essential requirements of audit.

(c) they do not come in conflict with the orders.

(d) in case they have not been separately approved by competent authority.

(2) **Audit of sanctions -** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority.

(3) **Audit against provision of funds** - That the amount of such expenditure does not exceed the appropriation made.

(4) **Propriety audit** - Audit against propriety seeks to ensure that expenditure conforms to these principles.

(a) The expenditure should not be prima facie more than the occasion demands.

(b) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

(c) Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

(i) the amount of expenditure involved is insignificant; or

(ii) a claim for the amount could be enforced in a Court of law; or

(iii) the expenditure is in pursuance of a recognised policy or custom; and

(iv) the amount of allowances, such as travelling allowances.

(5) **Performance audit** - The scope of audit has been extended to cover efficiency, economy and effectiveness audit or performance audit.

1.5 Audit of Receipts

Correctly assessed, realised and credited to government account.

(ii) Adequate regulations and procedures have been framed.

(iii) Regulations and procedures are actually being carried out;

(iv) Adequate checks are imposed

(v) review of systems and procedures.

(vi) The extent and quantum of audit required to be done under each category of audit are determined by the C&AG.

1.6 Audit of Stores and Inventories

Audit is conducted:-

- to ascertain whether the Regulations governing purchase, receipt and issue.
- to bring to the notice of the government any deficiencies.
- to verify that the purchases are properly sanctioned.
- to ensure that the prices paid are reasonable.
- to check the accounts of receipts, issues and balances regarding accuracy, correctness and reasonableness of balances.

1.7 Audit of Commercial Accounts

Generally classified under three categories—

(a) departmental enterprises (b) statutory bodies, corporations (c) government companies

Role of C & AG is prescribed under sub section (5), (6) and (7) of section 143

(1) Power to appoint Government Company Auditor

(2) Power to conduct Supplementary Audit & comment thereupon:- Within 60 days from the date of receipt of the audit report have a right to.

(a) conduct a supplementary audit under section 143(6)(a)

(b) comment upon or supplement such audit report under section 143(6)(b)

(3) Test Audit: Cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor- General's Act, 1971, shall apply to the report of such test audit.

2. AUDIT OF LOCAL BODIES

2.1 Background

(1) A **Municipality** can be defined as a unit of local self-government in an urban area.

(2) **Municipal government in India covers five distinct types of urban local authorities-**

- the municipal corporations,
- the municipal councils,
- the notified area committees,
- the town area committees and
- the cantonment committees.

(3) **Municipal authorities are endowed with specific local functions covering**

(a) regulatory, (b) maintenance and (c) development activities

(4) **Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads:**

(a) general administration and revenue collection, (b) public health,

(c) public safety, (d) education,

(e) public works, and (f) others such as interest payments, etc.

(5) **Property taxes and octroi are the major sources of revenue of the municipal authorities;**

(6) **Local bodies may receive different types of grants**

(a) General purpose grants (b) Specific purpose grants

(c) Statutory and compensatory grants

2.2 Financial Administration

(a) Budgetary Procedure (b) Expenditure Control (c) Accounting System

2.3 Objective of Audit of Local Bodies

The important objectives of audit are:

(a) reporting on the fairness of the content and presentation of financial statements;

(b) reporting upon the strengths and weaknesses of systems of financial control;

(c) reporting on the adherence to legal and/or administrative requirements;

(d) reporting upon whether value is being fully received on money spent; and

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

2.4 Audit Programme for Local Bodies

(i) **APPOINTMENT:-** The Local Fund Audit Wing of the State Govt.

(ii) **AUDITOR'S CONCERNS:-** Should report on the objectives.

(iii) **RULES & REGULATIONS:-** Conforms to the relevant provisions.

(iv) **AUTHORISATIONS**

(v) **PROVISIONING**

(vi) **PERFORMANCE**

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

3.1 Background

1. NGOs can be defined as non-profit making organisations.

2. Religious organisations, voluntary health and welfare agencies, **charitable organisations.**

(3) Non-Governmental Organisations are generally incorporated as societies under the **Societies** Registration **Act, 1860** or as a trust under the **India Trust Act, 1882**, NGOs can also be incorporated as a company under section 8 of the **Companies Act, 2013.**

3.2 Sources and Applications of Funds

(1) Grants and donations, fund raising programmes, advertisements, fees subscriptions, gifts, sale of produce or publications, etc.

(a) Promoter's contribution are in the nature of capital receipts.

(b) Voluntary contributions made with a specific direction.

(c) Revolving Fund

(d) Acquisition of specific fixed assets

(e) Contributions in kind.

(2) The areas of application of funds for an NGO include Establishment Costs, Office and

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

3.3 Provisions Relating to Audit

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

(i) Knowledge of the NGO's work,

(ii) Updating knowledge of relevant statutes

(iii) Reviewing the legal form of the Organisation

(iv) Reviewing the NGO's Organisation chart

(v) Examination of minutes of the Board/Managing Committee

(vi) Study the accounting system

(vii) Setting of materiality levels

(viii) The nature and timing of reports

(ix) The involvement of experts

(x) Review the previous year's Audit Report.

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

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

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

(i) Contributions and Grants for projects and programmes

(ii) Receipts from fund raising programmes

(iii) Membership Fees

(iv) Subscriptions

(v) Interest and Dividends

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

LLP is governed by Limited Liability Partnership Act, 2008.

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

a) the **Contribution** of which, does not exceed **twenty-five lakh rupees**

b) the **Turnover** does not exceed **forty lakh rupees**

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

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

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

Advantages / Purpose / Need of Audit

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

Returns to be maintained and filed by an LLP

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

Appointment of Auditor

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

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

Auditor's Duty Regarding Audit of LLP

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

6. AUDIT OF CHARITABLE INSTITUTION

(1) General

(i) Studying the **constitution**

(ii) Verifying whether the institution is being managed.

(iii) Examining the **system of internal check**

(iv) Verifying in detail the income and confirming that the amounts received.

(v) Examine the Trust Deed

(2) Subscriptions and donations

(i) **Annual or life membership**

(ii) Whether **official receipts**

(3) Legacies - Verifying the amounts received

(4) Grants -

(i) Vouching the amount

(ii) Obtaining a certificate

(5) Investments Income

(i) Vouching the amounts

(ii) Checking the calculations

(iii) Comparing the amounts of dividend

(6) Rent

(i) Examining the rent roll

(ii) Vouching the rent

(7) Special function, etc.

(8) Income Tax Refunds

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

(E)	**Assets & Liabilities:-**
1.	Report any old heavy arrears.
2.	Confirm that caution money.
3.	See that the investments representing endowment funds.
4.	Ascertain that the system ordering inspection on receipt.
5.	Verify the inventories of furniture, stationery, clothing.
(F)	**Compliances:-**
1.	Confirm that the refund of taxes deducted from the income from investment.
2.	Finally, verify the annual statements of account.

8. AUDIT OF HOSPITAL

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

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

9. AUDIT OF CLUB

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

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

10. AUDIT OF CINEMA

The special steps involved in its audit are stated below-

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

(B)	**LEASES:-**
(1)	In a **lease agreement**, a party (called **'lessee'**) acquires the right to use an asset for an agreed period of time in consideration of payment of rent to another party (called **'lessor'**).
(2)	**A normal finance lease transaction usually goes through the following modality:**
I.	The lessee will select the equipment, and satisfy himself
II.	The lessee approaches a lessor.
III.	The lease agreement is broadly negotiated.
IV.	The manufacturer delivers the equipment.
V.	The lease agreement giving detailed terms of contract.
VI.	During the lease period, the lessee:
•	Will pay rentals regularly
•	Will keep the equipment in good repair
•	Will be entitled to any manufacturer's warranties.
VII.	At the end of the lease period, the equipment shall retreat to the lessor.
(3)	**Auditor's Procedures**
(1)	The object clause of leasing company
(2)	Ascertain the credit analysis of lessee.
(3)	The lease agreement should be examined and the following points may be noted:
(i)	the description of the lessor, the lessee, the equipment and the location.
(ii)	the amount of tenure of lease, dates of payment, late charges, deposits or advances.
(iii)	whether the equipment shall be returned to the lessor.
(iv)	whether the agreement prohibits the lessee from assigning the subletting.
(4)	Examine the lease proposal.
(5)	Ensure that the invoice is retained safely.
(6)	Examine the acceptance letter.
(7)	See the Board resolution.
(8)	See that the copies of the insurance policies have been obtained by the lessor.
	Finance Lease: An arrangement with the following attributes qualifies as a Finance Lease:
	Transfers ownership of the asset to the lessee at the end of the lease term;

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

Operating Lease

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

12. AUDIT OF HOTELS

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

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

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

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

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

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

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

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

(6) **Travel Agents & Shops-**

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

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

13. AUDIT OF CO-OPERATIVE SOCIETIES

13.1 Background

A Cooperative (also known as co-operative, co-op, or coop) is "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned enterprise".

13.2 Audit as per Section 17 of the Co-Operative Societies Act, 1912

"Registrar" means a person appointed to perform the duties of a Registrar of Co-operative Societies under this Act.

The following points should be kept in mind in connection with the audit of a co-operative society:

1. Qualifications of Auditors - Apart from a chartered accountant some of the State Co-operative Acts have permitted persons holding a government diploma in co-operative accounts.
2. Appointment of the Auditor - Appointed by the Registrar of Co-operative Societies.
3. Books, Accounts and other records of Co-operative Societies

For example, in Maharashtra, the co-operative societies are required to maintain books.

(i) All sums of money received and expended by the society.

(ii) All sales and purchases of goods by the society.

(iii) Assets and liabilities of the society.

In case of large scale co-operative organisation

(a) Daily cash sales summary register.

(b) A register of collection from debtors if credit sales are allowed.

(c) A register of recovery of loans from salaries and directly by receipts.

(d) Loan disbursement register in case of credit society.

(e) Any other columnar subsidiaries.

4. **Restrictions on share holdings -** Section 5 would exceed a maximum of **twenty percent** of the total number of shares or of the value of shareholding to ₹ **1,000/-**
5. **Restrictions on loans -** Section 29 shall not make a loan to any person other than a member.

6. **Restrictions on borrowings -** Section 30 shall accept loans and deposits from persons who are not members subject to the restrictions and limits.

7. **Investment of funds -** Section 32

(a) In the Central or State Co-operative Bank.

(b) In any of the securities specified in section 20

(c) In the shares, securities, bonds or debentures of any other society

(d) In any co-operative bank

(e) In any other moneys permitted by the Central or State Government.

8. **Appropriation of profits -** Section 33 a prescribed percentage of the profits should be transferred to Reserve Fund.

9. **Contributions to Charitable Purposes -** Section 34 contribute an amount not exceeding 10% of the net profits.

10. **Investment of Reserve Fund outside the business or utilisation as working capital -**

(a) in the business of a society

(b) may invest as per provisions of the Act

(c) may be used for some public purposes

11. **Contribution to Education Fund -** At the appropriate rate as per the class of the society.

13.3 Special Features of Co-Operative Audit

1. **Examination of overdue debts -** Overdue debts for a period from 6 months to 5 years and more than 5 years will have to be classified.
2. **Overdue Interest -** Overdue interest should be excluded
3. **Certification of Bad Debts -** Only when they are certified as bad by the auditor.
4. **Valuation of Assets and Liabilities -** The auditor will have to ascertain existence, ownership and valuation of assets.

5. **Adherence to Co-operative Principles**

6. **Observations of the Provisions of the Act and Rules**

7. **Verification of Members' Register and examination of their pass books**

8. **Special report to the Registrar -** Special report may become necessary:

(i) Personal profiteering by members

(ii) Detection of fraud relating to expenses, purchases, property

(iii) Specific examples of mis-management.

(iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence.

9. **Audit classification of society -** Criteria specified by the Registrar.

10. **Discussion of draft audit report with managing committee**

13.4 Audit, Inquiry and Inspection of Multi-State Co-Operative Societies

Applies to co-operative societies whose objects are not confined to one State.

Books of Accounts

a. all sum of money received and expended

b. all sale and purchase of goods;

c. the assets and liabilities;

d. in the case of a Multi-State Co-operative society engaged in production, particulars relating to utilization of materials or labour.

13.4.1 Audit of Multi-State Co-operative Society-

1. **Qualification of Auditors -** A person who is a Chartered Accountant.

However the following persons are not eligible

(a) A body corporate

(b) An officer or employee of the Multi-State co-operative society.

(c) A person who is a member or who is in the employment, of an officer or employee

(d) A person who is indebted to the Multi-State co-operative society for an amount exceeding one thousand rupees.

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

	by itself or both hold fifty-one percent or more.
4.	**Special Auditor's Powers, Duties & Report**
5.	**Action by the Central Government:-** May take such action on the report as it considers necessary.
6.	**Expenses pertaining to the Special Audit:-** Shall be determined by the Central Government and paid by the Multi-State Co-operative society.
13.4.2	**Inquiry by Central Registrar under Section 78**
1.	**When:-** The Central Registrar may, on a request from :-
•	a federal co-operative
•	a creditor or not less than one-third of the members of the board
•	not less than one-fifth of the total number of members
2.	**How:-** hold an inquiry or direct some person authorized by him.
3.	**Opportunity of being Heard:-** Fifteen days notice must be given
4.	**Powers given**
(a)	Free access to the books, accounts, documents, securities, cash and other properties.
(b)	Require the officers of the society to call a general meeting of the society.
(c)	He may summon any person who is reasonably believed by him to have any knowledge.
5.	**Follow up:-** Within a period of three months communicate the report of inquiry.
13.4.3	**Inspection of Multi-State Co-operative societies under Section 79**
1.	**When:-**The Central Registrar may, on a request from
•	federal co-operative to which a Multi- State Co-operative society is affiliated.
•	not less than one-third of the members of the board or
•	not less than one-fifth of the total number of members.
2.	**How:-** By general or special order in writing in this behalf inspect.
3.	**Opportunity of Being heard:-** Not less than fifteen days.
4.	**Powers available:-**
(a)	Access to all books, accounts, papers, vouchers, securities, stock and other property.
(b)	Shall furnish such information with regard to the working of the society.

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

14. **AUDIT OF TRUSTS & SOCIETIES**

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

BOOKS OF ACCOUNT

(i) cash book;

(ii) ledger;

(iii) journal;

(iv) copies of bills, whether machine numbered or otherwise serially numbered

(v) original bills wherever issued to the person and receipts in respect of payments made

(vi) any other book

FINANCIAL STATEMENTS:- Balance sheet and Income and expenditure statements.

Auditor's responsibility

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

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

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

(a) work done while conducting the audit and by whom;

(b) explanation and information.

(c) decision on the various points taken;

(d) the judicial pronouncements.

(e) certificates issued by the client / management letters.

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

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

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

TRUSTS

The auditor has to ascertain:-

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

SOCIETIES

The auditor's considerations:-

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

CHAPTER - 10

AUDIT OF BANK

1. INTRODUCTION

1.1 Types of Banks

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

Commercial Banks	**Regional Rural Banks**
Co-operative Banks.	**Payment Banks.**
Development Banks (more commonly known as 'Term-Lending Institutions').	**Small Finance Banks.**

1.2 Reserve Bank of India: Regulating Body

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

1.2.1 RBI is responsible for:-

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

1.2.2 Important functions of RBI are:-

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

Banking Operations - Conducted only at Branches

1.3 Regulatory Framework

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

Regional Rural Banks Act, 1976.
Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.
Information Technology Act, 2000. Prevention of Money Laundering Act, 2002.
Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.
Credit Information Companies Regulation Act, 2005.
Payment and Settlement Systems Act, 2007.

1.4 Peculiarities involved:

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

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

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

(a) Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting.

(b) Long Form Audit Report. (LFAR)

(c) Report on compliance with SLR requirements.

(d) Report on treasury operations.

(e) Report on income recognition, asset classification and provisioning.

(f) Report on whether any serious irregularity was noticed.

(g) Report on status of the compliance by the bank Ghosh Committee Jilani Committee.

(h) Report on instances of adverse credit-deposit ratio in the rural areas.

2. BANK AUDIT APPROACH

1. Drawing an Audit Plan

2. Control Environment at the Bank

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

- **Nature of Questions**
  - Who
  - What
  - When
  - Where
  - Why
  - How

3. Engagement Team Discussions

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

(a) Errors that may be more likely to occur;

(b) Errors which have been identified in prior years;

(c) Method by which fraud might be perpetrated by bank personnel

(d) Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;

(e) Need to maintain professional skepticism throughout the audit engagement;

(f) Need to alert for information or other conditions

Advantages of such a discussion:-

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

4. INCOME RECOGNITION POLICY

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

5. FORM AND CONTENT OF FINANCIAL STATEMENTS

Sub-sections (1) and (2) of Section 29 of the Banking Regulations Act, 1949.

Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

6. AUDIT OF ACCOUNTS

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

7. ELIGIBILITY, QUALIFICATIONS AND DISQUALIFICATIONS OF AUDITOR

Applicable as to a Company Auditor

8. APPOINTMENT OF AUDITOR

- The auditor of a banking company is to be appointed at the annual general meeting.
- The auditor of a nationalised bank through its Board of Directors.

(In either case, approval of the Reserve Bank of India is required)

- The auditors of regional rural banks are to be appointed by the bank concerned with the approval of the Central Government.

9. REMUNERATION OF AUDITOR

(a) Section 142 of the Companies Act, 2013.

(b) The remuneration of auditors of nationalised banks and State Bank of India is to be fixed by the Reserve Bank of India in consultation with the Central Government.

10. POWERS OF AUDITOR

Same powers as those of a company's auditor.

11. AUDITOR'S REPORT

In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:

(a) Financial statements present a true and fair view.

(b) Transactions of the bank have been made within the powers of that bank;

(c) Returns received from the offices and branches.

(d) any other matter.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical.

11.1 Format of Report

Standards on Auditing.

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

8. Develop the Audit Plan

9. Audit Planning Memorandum: The auditor should summarise the audit plan

- Describe the expected scope and extent of the audit procedures.
- Highlight all significant issues and risks identified during their planning.
- Provide evidence that they have planned the audit engagement appropriately.

10. Determine Audit Materiality

11. Consider Going Concern

12. Assess the Risk of Fraud including Money Laundering

13. Assess Specific Risks

14. Risk Associated with Outsourcing of Activities

15. Response to the Assessed Risks

16. Stress Testing

17. BASEL III framework: The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB).

18. Reliance on / review of other reports

13. ADVANCES

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

Types of Advances: Funded Loans & Non-Funded Loans

- **Funded** loans are those loans where there is an actual transfer of funds from the bank to the borrower.
- **Non-funded** facilities are those which do not involve such transfer.

13.1 What do ADVANCES comprise:

- Term loans
- Cash credits, Overdrafts, Demand Loans Bills Discounted
- Interest-bearing Staff Loans

13.2 Legal requirements of Disclosure in the Balance Sheet:

A. **(i)** Bills purchased and discounted

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

(iii) Term Loans

B. (i) Secured by tangible assets

(ii) Covered by Bank/Government guarantees

(iii) Unsecured

Classification of Advances

1. Sector Wise

- Priority
- Non Priority

2. Security Wise

- Secured
- Unsecured

3. Prudential Norms

- Standard
- NPAs

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

13.3 Classification of Advances

13.3.1 Sector Wise

RBI issues common guidelines for lending to Priority Sector.

13.4 SECURITY WISE

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

Nature of Security

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

B. **Collateral security** is an additional security.

13.5	**Mode of Creation of Security**
(i)	**Mortgage**
•	**Registered Mortgage** can be affected by a registered instrument.
•	**Equitable mortgage** effected by a mere delivery of title deeds.
(ii)	**Pledge:** A pledge thus involves bailment or delivery of goods.
(iii)	**Hypothecation:** Creation of an equitable charge.
(iv)	**Assignment:** Transfer of an existing or future debt, right or property.
(v)	**Set-off:** Set-off is a statutory right of a creditor to adjust.
(vi)	**Lien:** Lien is creation of a legal charge with consent of the owner.
13.6	**Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances:**
	Classification of Advances as per RBI Prudential Norms
1.	**Standard Loans**
(a)	Standard Regular
(b)	SMA – Special Mention Accounts
♦	**SMA 0 (Accounts showing stress signals)**
♦	**SMA 1 (Overdue between 31 to 60 days)**
♦	**SMA 2 (Overdue between 61 to 90 days)**
2.	**NPA Loans**
♦	**Sub – Standard** ♦ **Doubtful [D1/D2/D3]** ♦ **Loss**
(i)	**Non-performing Assets**
	A non-performing asset (NPA) is a loan or an advance where-:
♦	Remain overdue for a period of more than 90 days in respect of a term loan;
♦	the account remains 'out of order' in respect of an Overdraft/Cash Credit
♦	the bill remains overdue for a period of more than 90 days.
(ii)	**Out of Order**
♦	the outstanding balance remains continuously in excess of the sanctioned limit.
♦	There are no credits continuously for 90 days as on the date of Balance Sheet
♦	Credits are there but are not enough to cover the interest debited.

(iii) **Overdue**

Categories of Non-Performing Assets:	**Provision required**
• **Substandard Assets:** Would be one, which has remained NPA for a period less than or equal to 12 months.	15%
• **Doubtful Assets:** Would be one, which has remained in the substandard category for a period of 12 months.	(Secured + Unsecured)
<u>Sub-categories</u>:	
Doubtful up to 1 Year (D1)	25% + 100%
Doubtful 1 to 3 Years (D2)	40% + 100%
Doubtful more than 3 Years (D3)	100% + 100%
• **Loss Assets:** Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Note:-

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

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

(v) **Government Guaranteed advances:-**

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

(vi) **Advances under Consortium:**

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

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

13.7 **Accounts where there is erosion in the value of security / frauds committed by borrowers**

(i) Security is less than 50 per cent of the value straight-away classified under **doubtful category**.

(ii) Is less than 10 per cent of the outstanding straight-away classified as **loss asset**.

13.8 **Advances Against Term Deposits, NSCs, KVPs/ IVPs, etc.**

Need not be treated as NPAs, provided **adequate margin** is available.

13.9 **Agricultural Advances Affected by Natural Calamities**

Banks may decide on their own relief measures.

13.10 **Advances to Staff**

Advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards.

13.11 **Agricultural Advances**

(1) Agricultural Advances for "long duration" crops; and

(2) Agricultural Advances for "short duration" crops.

The "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops.

The following NPA norms would apply to agricultural advances

- Short duration crops if the instalment of principal or interest thereon remains overdue for two crop seasons; and
- Long duration crops if the instalment of principal or interest thereon remains overdue for one crop season.

14. **COMPUTATION OF DRAWING POWER**

1. **Meaning:-** Drawing power is the limit up to which a firm or company can withdraw from the working capital limit sanctioned.
2. **Different from Sanctioned Limit:- Drawing Power** refers to the amount calculated based on primary security less margin as on a particular date.

3. **Considerations:-** The drawing power and the sanctioned limit.

4. **Bank's Duties:-** Covered by the adequacy of the current assets.

5. **Auditor's Concern:-** Stock statements, quarterly returns other statements submitted by the borrower.

6. **Computation of DP:-** As per the extant guidelines formulated by the Board of Directors.

7. **Stock Audit:-** Funded exposure of more than **5 crores**.

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

15. **AUDIT OF ADVANCES**

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

(a) Which are outstanding at the date of the balance sheet.

(b) Advances represent amount due to the bank.

(c) Supported by loan documents and other documents.

(d) There are no unrecorded advances.

(e) The stated basis of valuation of advances is appropriate.

(f) The advances are disclosed, classified and described.

(g) Appropriate provisions towards advances have been made.

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

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

Evaluation of Internal Controls over Advances:

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

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

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

16.1 Income

The following items are included under this head:

Interest Earned	Other Income
• Interest/ Discount on Advances	• Commission, Exchange and Brokerage
• Interest Income on Investments:	(a) Commission on bills for collection.
• Interest on Balances with RBI	(b) Remittances and transfers.
• Others	(c) Letters of credit

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

16.1.1 Audit Approach and Procedures

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

Reversal of Income:

(a) If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed.

(b) In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed.

(c) In case of banks which have wrongly recognised income in the past should reverse.

(d) The auditor should enquire.

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

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

OBJECTIVE OF TAKEOUT FINANCE

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

On Partial Recoveries in NPAs:

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

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

Income from Investments

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

16.2 Expenses

Expenditure is to be shown under three broad heads:

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

16.2.1 Audit Approach and Procedures

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

- The auditor should, on a test check basis, verify the calculation of interest.

(a) Interest has been provided on all deposits.

(b) Interest rates are in accordance with the bank's internal regulations.

(c) Interest on savings accounts are in accordance with the rules framed.

(d) Interest on inter-branch balances.

For audit of Operating expenses, the auditor should:-

- study and evaluate the system of internal control.
- should examine whether there are any divergent trends.
- perform substantive analytical procedures
- verify expenses with reference to supporting documents.

For audit of Provisions and contingencies the auditor should:-

- ensure that the compliances for various regulatory requirements.
- obtain an understanding as to how the bank computes provision.
- obtain the detailed break up.
- obtain the tax provision.
- examine the other provisions.

16.3 Disclosure of the prior period items

Third Schedule to the Banking Regulation Act, 1949 does not specifically provide for disclosure.

CHAPTER - 11

ETHICS & TERMS OF AUDIT ENGAGEMENT

1. MEANING OF ETHICS - A STATE OF MIND

The term "*Ethics*" means moral principles which govern a person's behaviour or his conducting of an activity.

2. NEED FOR PROFESSIONAL ETHICS

A Chartered Accountant, either in practice or in service, has to abide by ethical behaviours. They are expected to follow the fundamental principles of professional ethics while performing their duties.

Any deviation from the ethical responsibilities brings the disciplinary mechanism into action against the Chartered Accountants which may result into fines, suspension of membership, removal from membership or other disciplinary actions.

3. PRINCIPLES BASED APPROACH VS RULES BASED APPROACH TO ETHICS

The essence of principles-based approach to ethics is that it requires compliance with spirit of ethics.

Rules-based approach to ethics strictly follows clearly established rules. It may lead to a narrow outlook and spirit of ethics may be overlooked while strictly adhering to rules. Further, rules- based approach is somewhat rigid.

4. FUNDAMENTAL PRINCIPLES OF PROFESSIONAL ETHICS

1. Integrity
2. Objectivity
3. Professional competence and due care
4. Confidentiality
5. Professional Behaviour

5. INDEPENDENCE OF AUDITORS

(a) **Independence of mind:** allowing an individual to act with integrity, and exercise objectivity and professional skepticism;

(b) **Independence in appearance:** A member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

6. THREATS TO INDEPENDENCE

Following five types of threats to independence of auditors are discussed below:-

1. **Self-interest threats**

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

2. **Self-review threats**

Self-review threats occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client.

3. **Advocacy threats**

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

4. **Familiarity threats**

Familiarity threats are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests.

5. **Intimidation threats**

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

7. SAFEGUARDS TO INDEPENDENCE

To address the issue, the following guiding principles are to be applied:-

- It is essential that auditors should always be and appears to be independent.
- An auditor must conscientiously consider whether it involves threats.
- The auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level.
- He must not accept the work.

8. PROFESSIONAL SKEPTICISM

Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures.

Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions.
- Using inappropriate assumptions.

9. AGREEING THE TERMS OF AUDITENGAGEMENTS

SA 210 deals with the auditor's responsibilities

9A Preconditions for an audit

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

(a) Determine whether the FRF is acceptable and

(b) Obtain the agreement of management

(i) For the preparation of the financial statements

(ii) For such IC as management considers necessary

(iii) To provide the auditor with:

- Access to all information
- Additional information
- Unrestricted access to persons within the entity

9B. Agreement on audit engagement terms

Such a letter includes:-

(a) The objective and scope of the audit of the financial statements

(b) The responsibilities of the auditor

(c) The responsibilities of management

(d) Identification of the applicable financial reporting framework

(e) Reference to the expected form and content of any reports to be issued

10. LIMITATION ON SCOPE PRIOR TO AUDIT ENGAGEMENT ACCEPTANCE

The auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

11. ACCEPTANCE OF A CHANGE IN THE TERMS OF THE AUDIT ENGAGEMENT

11.1 Request from Entity to change the Terms of Audit Engagement-When Reasonable Justification Exists?

Change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances.

11.2 What should auditor consider before agreeing to change the audit engagement to the engagement providing lower level of assurance?

If the auditor concludes that there is reasonable justification to change the audit engagement to a review or a related service, the audit work performed to the date of change may be relevant to the changed engagement.

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

(a) The original audit engagement or

(b) Any procedures that may have been performed in the original audit engagement, except engagement to undertake agreed- upon procedures.

11.3 Recourse available to auditor in situation of non- agreement to a change in terms of engagement and lack of permission from management to continue original audit engagement

(a) Withdraw from the audit engagement

(b) Determine whether there is any obligation, either contractual or otherwise.

12. TERMS OF ENGAGEMENT IN RECURRINGAUDITS

Following factors may make it appropriate to revise the terms of the audit engagement.

(i) Any indication that the entity misunderstands the objective and scope of the audit.

(ii) Any revised or special terms of the audit engagement.

(iii) A recent change of senior management.

(iv) A significant change in ownership.

(v) A significant change in nature or size of the entity's business.

(vi) A change in legal or regulatory requirements.

(vii) A change in the financial reporting framework adopted in the preparation of the financial statements.

(viii) A change in other reporting requirements.

13. AUDIT QUALITY

SQC 1 and SA 220 both deal with quality control.

14. SQC 1 – "QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS AND REVIEWS OF HISTORICAL FINANCIAL INFORMATION, AND OTHER ASSURANCE AND RELATED SERVICES ENGAGEMENTS"

15. ELEMENTS OF SYSTEM OF QUALITY CONTROL

(A) Leadership responsibilities for quality within the firm

(B) Ethical requirements

(C) Acceptance and continuance of client relationships and specific engagements

(D) Human resources

(E) Engagement performance

(F) Monitoring

15A. Leadership responsibilities for quality within the firm

Such policies and procedures should require the firm's chief executive officer or the firm's managing partners to assume ultimate responsibility for the firm's system of quality control.

15B. Ethical requirements

Such policies and procedures should enable the firm to:-

(a) Communicate its independence requirements to its personnel.

(b) Identify and evaluate circumstances and relationships that create threats.

(c) There should exist a mechanism in the firm by which engagement partners provide the firm with relevant information about client engagements.

(d) At least annually, the firm should obtain written confirmation of compliance.

15C. Acceptance and Continuance of Client Relationships and Specific Engagements

Such an information should help firm to decide about: -

- Integrity of Client
- Competence (including capabilities, time and resources) to perform engagement.
- Compliance with ethical requirements

With regard to the integrity of a client, matters that the firm considers

- The identity and business reputation
- The nature of the client's operations
- Information concerning the attitude of the client's principal owners
- Aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering.
- The reasons for the proposed appointment

Policies and procedures on the continuance of the engagement.

(a) The professional and legal responsibilities that apply to the circumstances.

(b) The possibility of withdrawing from the engagement.

15D. Human resources

Recruitment, compensation, training, career development, performance evaluation etc.

15E. Engagement Performance

Consistency in quality of engagement performance briefing, complying, supervision and training, reviewing, appropriate documentation.

Consultation should take place in difficult or contentious matters

Significant judgments made in an engagement should be reviewed by an engagement quality control reviewer.

Engagement quality control review is mandatory for all audits of financial statements of listed entities.

There might be difference of opinion within engagement team, with those consulted and between engagement partner and engagement quality control reviewer. The report should only be issued after resolution of such differences.

The assembly of engagement files should be completed in not more than 60 days after date of auditor's report.

Policies and procedures should be designed to maintain the confidentiality.

Engagement documentation is the property of the firm.

Retention period ordinarily is no shorter than seven years from the date of the auditor's report.

15F. Monitoring

Policies and procedures relating to the system of quality control are relevant.

16. SA 220- "QUALITY CONTROL FOR AN AUDITOF FINANCIAL STATEMENTS"

16A. Leadership responsibilities for quality on audits

(a) The importance to audit quality of:-

(i) Performing work that complies with professional standards;

(ii) Complying with the firm's quality control policies and procedures;

(iii) Issuing auditor's reports;

(iv) The engagement team's ability to raise concerns without fear of reprisals.

(b) The fact that quality is essential in performing audit engagements.

16B. Relevant ethical requirements

- Identifying a threat to independence regarding the audit engagement.
- Reporting by engagement partner to the relevant persons within the firm.

16C. Acceptance and Continuance of Client Relationships and audit Engagements

Is on lines of SQC 1

16D. Assignment of engagement teams

Collectively have the appropriate competence and capabilities

16E. Engagement Performance

For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

(a) Determine that an engagement quality control reviewer has been appointed.

(b) Discuss significant matters arising during the audit engagement.

(c) Not date the auditor's report until the completion of the engagement quality control review.

16F. Monitoring

The engagement partner should document following matters:

(a) Issues identified with respect to compliance with relevant ethical requirements.

(b) Conclusions on compliance with independence requirements.

(c) Conclusions reached regarding the acceptance and continuance.

(d) The nature and scope of, and conclusions resulting from, consultations.