

Magic Book

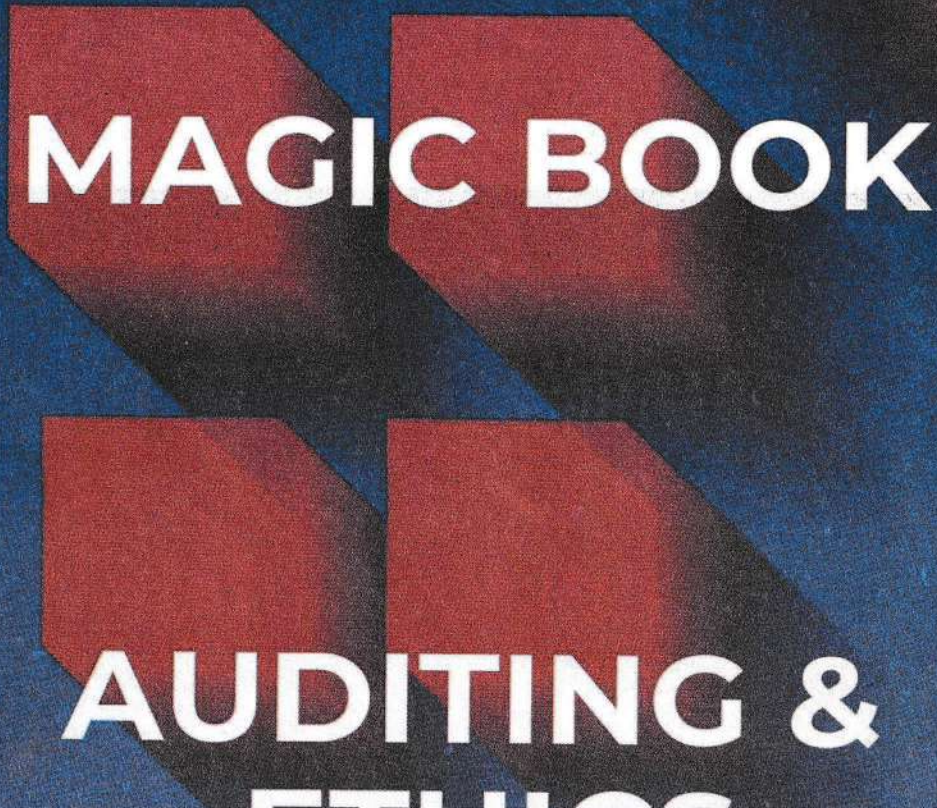
AUDITING & ETHICS

CA Mrugesh Madlani





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MAGIC BOOK

AUDITING & ETHICS

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SUMMARISED
CHARTS OF
AUDITING & ETHICS

CHARTS OF CHAPTER 1

NATURE ,OBJECTIVE & SCOPE OF AUDIT

ADVANTAGES & LIMITATIONS OF AUDIT

Advantages of Audit

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

Inherent Limitations of Audit (FATO)

1. **Nature of Financial Reporting – Judgement by Management** & many financial statements also involve subjective decisions which differs from different management perspective
2. **Nature of Audit Procedures** - Auditors job is to do audit & **not do official investigation** into alleged wrong doing. Fraud if done will always be carefully organized to conceal it
3. **Timeliness of Financial Statements & Balance between Benefit & Cost** – We want **more information early to get more benefit**, but it may involve **more cost** which we are not ready to incur and there is fixed deadline of financial statements. So **maintaining balance between Benefit & cost is difficult** and also completing audit in time
4. **Other Matters That Affect Limitation of Audit** -
 - **Fraud involving Senior Management or collusion**
 - **Existence & completeness of related party relationships**
 - **Non-compliance** with laws & regulations
 - **Future events or conditions** that may cause entity to **cease continue as going concern**

Difference Between Audit & Review

Audit is a reasonable assurance engagement.

However, **Review is a limited assurance engagement**. It provides **lower level of assurance than audit**. Further, **review involves fewer procedures** and gathers sufficient appropriate evidence on the basis of which **limited conclusions can be drawn up**.

However, **both "audit" and "review" are related to financial statements prepared on the basis of historical financial information**

CHAPTER 1 NATURE , OBJECTIVE & SCOPE OF AUDIT

Audit Definition

An Audit is **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**

Scope of Audit

- Audit should cover **all aspects of Enterprise relevant to financial statements** being audited
- To form an opinion on Financial Statements , auditor should be reasonably satisfied information contained in **accounting records & other source data is reliable & sufficient** for preparation of financial statements
- Auditor assess **reliability & sufficiency of accounting records & source data by**
 1. Making a **study & evaluation of accounting systems & internal control**
 2. Carrying out **tests , enquiries & other verification procedures**
- Auditor should also decide **whether Information is properly disclosed in financial statements** as per statutory requirements
- Auditor determines Information is properly disclosed by
 1. Comparing **Financial Statements with Accounting records & other source data**
 2. Considering judgements that management has made in preparing financial statements
- Auditor is not expected to perform duties **which fall outside the scope of his competence**
- Constraints on the **scope of audit should be set out in his report & a qualified or disclaimer of opinion** should be expressed as appropriate

Auditor Should Keep in Mind Following Points to Ensure Financial Statements are not Misleading

(Entries & Financial Statements)

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

Types of Audit

Audit required under law

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

Voluntary audit

- Proprietary Entities
- Partnership Firms
- Hindu Undivided Families

As per SA 200 Over-all Objectives of Independent Auditor -

- To obtain **Reasonable Assurance** about whether financial statements as a whole **are free from material misstatement &**
- To **report** on Financial Statements & **Communicate** as required by SA's

SUMMARY OF SA , SRE , SAE , SRS

Assurance – Practitioner gives Assurance to users of financial statements

Historical Financial Statements –

1. **Absolute Assurance** – Not Possible in Audit (Inherent Limitation of Audit)
2. **Reasonable Assurance** – High Level of Assurance – Audit Assignment – **Standards on Audit (SA's) 100 – 999**
3. **Limited Assurance** – Lower Level of Assurance & Performing Fewer Procedures as compared to Reasonable Assurance Eg – LR – **Standards on Review Engagement (SRE's) 2000 – 2699**

Prospective Financial Information – Information based on events may occur in future & possible actions. Eg – Report on Internal Controls, Budgets , Projected Financial Statements

1. **Limited Assurance** – It is moderate level of assurance, because on future, we can never give Reasonable Assurance ---
Standards on Assurance Engagements (SAE) – 3000 - 3699

Standards on Quality Control (1 -99) – All Engagements follow System of Quality Control – Historical as well as Assurance Engagements, so Reports are issued as appropriate

Non-Assurance – Practitioner does not give Assurance , but perform agreed upon procedures regarding Financial Information . Eg – Accounting , Compilation of Consolidated Financial Statements , Tax Representation , Designing & Implementing Internal Controls

↓
Standards on Related Services (SRS) 4000-4699

Why Standards are Needed ??

- Standards ensure **carrying out of audit against established benchmarks** at par with global practices.
- Improve **quality of financial reporting** thereby helping users to make diligent decisions.
- Promote **uniformity as audit of financial statements** is carried out following these Standards
- Equip **Professional accountants with Professional knowledge and skill.**
- **Ensure Audit Quality**

Relationship of Audit with Other Disciplines

Auditing and Accounting: Auditing reviews the financial statements which are nothing but a result of the overall accounting process.

Auditing and Law: An auditor should have a **good knowledge of business laws affecting the entity.**

Auditing and Economics: Auditor is expected to be **familiar with the overall economic environment of the client.**

Auditing and Behavioural Science: Knowledge of human behaviour is essential for an auditor to effectively discharge his duties.

Auditing and Statistics & Mathematics: Auditor is also expected to have the knowledge of **statistical sampling for meaningful conclusions** and mathematics for verification of inventories.

Auditing and Data Processing: EDP auditing in itself is developing as a discipline in itself.

Auditing and Financial Management : Auditor is expected to have **knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc.**

Auditing and Production: Good auditor is one who understands the client and his business functions such as production, cost system, marketing etc.

CHARTS OF CHAPTER 2

AUDIT STRATEGY, PLANNING & PROGRAMME

AUDIT STRATEGY

Establishment of Over-all Audit Strategy (Audit ki TRP)

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

Documentation of Audit Plan

Auditor shall document:

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

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

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

Over-all Audit Strategy & Plan is Auditor's Responsibility
Auditor may **discuss elements of planning with management to facilitate the conduct & management of audit engagement**

Although these discussions often occur, **overall strategy & plan remain auditor's responsibility**

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

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

Capabilities & Competence of Individual team members performing work

Area of the audit

Assessed risk of material misstatements

Size & Complexity of entity

Audit Strategy Assists Auditor in / Benefits of Audit Strategy

1. **Employment of Qualitative Resources** – Which Resource to Deploy. Eg – Exp member for High-Risk Areas
2. **Allotment of Quantity of Resources** – Number of Resources to be Allocated for Inventory count
3. **Timing of Deployment of Resources** – When to Deploy, Interim Audit or cut-off dates
4. **Management of Resources** – Resources are managed, directed & supervised, briefing & debriefing meeting are expected to be held

of Risk assessment procedures & further assessment procedures

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

CHAPTER 2 AUDIT STRATEGY , PLANNING & PROGRAMME

AUDIT PLANNING

Any Audit Plan Should Cover:

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

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

Benefits of Planning in Audit of Financial Statement

1. Proper Organisation & Management of Audit Engagement – Done in effective & efficient manner
2. Attention to Important Areas
3. Timely Resolution of Potential Problems
4. Proper Selection of Engagement Team – Appropriate levels of capabilities & competence
5. Direction & Supervision of Engagement Team
6. Easy Coordination – Coordination with experts

Following Audit Procedures need to be Completed Prior to Performance of Further Audit Procedures & include –

- Analytical Procedures to be applied as RAP
- General Understanding of Legal & Regulatory Environment Applicable to the Entity
- Determination of Materiality
- Involvement of Experts
- Performance of other Risk Assessment Procedures

Planning Process – Elements of Planning

- Preliminary Engagement Activities
 1. Performing Procedures regarding Continuance of Client Relationships & Audit Engagement – Appropriate Procedures regarding acceptance & continuance are followed
 2. Evaluating Compliance with Ethical Requirements including Independence – Engagement Partner should see entire team has followed ethical requirements including Independence
 3. Understanding Terms of Engagement – Auditor should send Engagement letter to avoid confusion with client regarding Terms of Engagement
- Planning Activities – It involves
 1. Establishment of Over-all Audit Strategy
 2. Over-all Audit Plan

CHAPTER 2 AUDIT STRATEGY , PLANNING & PROGRAMME

AUDIT PROGRAMME

Audit Programme

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

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

Advantages of Audit Programme

Written Audit programme serves Assistants & Principal with Total Perspective of work

- In absence of **Written Programme** , there is danger of ignoring certain Books & Records
- **Serves as a Guide** for audits to be carried out in succeeding years
- **Serves as a Evidence** in event of charge of Negligence against Auditor
- It gives **Assistants clear set of instruction** of work to be done
- **Selection of Assistants for Jobs** on basis of capability becomes easier when work is divided / segregated
- **Assistants by putting Signature** on programme accept responsibility of work and work can be traced back
- **Principal can control progress of various audits** by audit programme
- In case of **major audits**, it gives **Total Perspective** of work to be performed

Constructing Audit Programme –

While developing an audit programme, the auditor may conclude that **relying on certain internal controls is an effective and efficient way** to conduct his audit. However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence

FOLLOWING POINTS TO BE KEPT IN MIND

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

Disadvantages of Audit Programme (MARI)

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

Open Mind while Developing Programme

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

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

CHARTS OF CHAPTER 3

RISK ASSESSMENT & INTERNAL CONTROL

CHAPTER 2 Audit Strategy , Planning & Programme

SA-320 Materiality in Planning & Performing the Audit

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

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

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

Determining Materiality & Performance Materiality while Planning the Audit

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

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

Use of Benchmark in Determining Materiality for Financial Statements as Whole (NEUV)

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

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

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

Revision of Materiality as Audit Progresses

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

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

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CHAPTER 4 Risk Assessment & Internal Controls

AUDIT RISK

Audit Risk (IR * CR * DR) –

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

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

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

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

Risk Assessment Procedures Include –

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

Risk of Material Misstatement at 2 levels –

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

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

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

Identifying & Assessing Risk of Material Misstatement Auditor shall → SA 315 *objective*

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

UNDERSTANDING OF ENTITY & IT'S ENVIRONMENT, INCLUDING ENTITY'S INTERNAL CONTROL

Auditor shall obtain Understanding of –

- 1. Relevant Industry, Regulatory & Other External Factors including Applicable Financial Reporting Framework** – Industry factors eg – Competitive environment , supplier , customer relationships & technology developments
- 2. Nature of Entity** – Operations, Ownership & Governance Structures, Types of Investments , way it is structured
- 3. Entity's Selection & Application of Accounting Policies** – Accounting Policies are consistent with applicable financial reporting framework
- 4. Entity's Objectives & Strategies & those Business Related Risks that may result in ROMM** – Strategies are approaches management uses to achieve objectives , which can also result in ROMM
- 5. Measurement & Review of Financial Performance** – Performance measures create pressure on entity , it will help auditor understand , whether due to these pressures on management , there is risk of ROMM

CHAPTER 3 RISK ASSESSMENT & INTERNAL CONTROL

INTERNAL CONTROL

Internal Controls

As per SA 315 Internal Control can be defined as

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

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

Objectives of Internal Control

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

Study of Various Aspects of Internal Control

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

General Nature & Characteristics of Internal Control

Purpose of Internal Control

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

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

Limitations of Internal Control (JUDGEMENT IN LIC)

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

CHAPTER 3 RISK ASSESSMENT & INTERNAL CONTROL

CONTROLS RELEVANT TO AUDIT

Nature & Extent of Understanding of Relevant Controls

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

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

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

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

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

Components of Internal Control

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

Controls Relevant to Audit –

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

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

Controls over Completeness & Accuracy of information

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

Internal Controls over Safeguarding of Assets

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

Controls Relating to Objectives that are not relevant to audit

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

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

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

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CHAPTER 3 RISK ASSESSMENT & INTERNAL CONTROLS

Components of Internal Control Part 2

Control Activities

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

Control Activities that are relevant to Audit are :

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

Auditor should consider following points in deciding significant risks

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

Identifying Significant Risks

Following are always Significant Risks –

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

Monitoring of controls

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

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

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CHAPTER 3 RISK ASSESSMENT & INTERNAL CONTROL

COMPONENTS OF INTERNAL CONTROL PART 1

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

Elements of Control Environment – Which helps us in understanding the Control Environment are: **(PC -COMA)**

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

Entity's Risk Assessment Process

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

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

Information system including related business process relevant to financial reporting

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

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

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

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

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CHAPTER 3 RISK ASSESSMENT & INTERNAL CONTROL

Evaluation of Internal Control by Auditor

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

Benefits of Evaluation of Internal Control to the Auditor

- Whether **adequate internal control system is in use & operating as planned** *by request*
- Whether **effective internal auditing department is operating**
- **What are areas where control is weak or excessive**
- **Extent & depth of examination** he needs to carry out in different areas of accounting
- What would be **appropriate audit techniques & procedures** in given circumstances
- Whether **controls adequately safeguard the assets**
- Whether **errors & frauds are likely to be located in ordinary in course of business**
- Whether **worthwhile suggestions can be given to improve control system**

Formulate Audit Program After Understanding of Internal Controls

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

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

Narrative record

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

Flowchart

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

Check List

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

INTERNAL CONTROL QUESTIONNAIRE

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

CHAPTER 3 RISK ASSESSMENT & INTERNAL CONTROL

Automated Environment

Automated Environment

It basically refers to business environment where **(POAD)**

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

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

Key Features of an Automated Environment

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

Auditor should Understand risks that arise from use of IT Systems

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

Understanding of IT Environment

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

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

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

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CHAPTER 3 Risk Assessment & Internal Control

Testing of Internal Controls

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

For this he will do actual testing of system in operation

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

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

Test of controls

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

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

Test of controls Include

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

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

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

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Risks & Controls in Automated Environment

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

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

Types of Controls in an Automated Environment

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

It maintains integrity & security of data and includes –

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

Application Controls

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

IT Dependent Controls –

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

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

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CHAPTER 6 Audit in Automated Environment

Testing of Automated Controls & Report on Controls

Testing Methods to Test Controls

4 Types of audit tests that should be used are :

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

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

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

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

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

Data Analytics for Audit

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

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

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

Assess & Report Audit Findings

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

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CHAPTER 4 RISK ASSESSMENT & INTERNAL CONTROLS

AUDIT PROCEDURES TO OBTAIN AUDIT EVIDENCE

AUDIT PROCEDURES TO OBTAIN AUDIT EVIDENCE

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

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

Risk Assessment Procedures

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

Nature & Timing of Audit Procedures

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

Further Audit Procedures

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

Nature of Test of Controls –

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

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

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

Determining Extent of Test of Controls includes :

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

Timing of Test of Controls

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

Using Audit Evidence Obtained in Previous Audits

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

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

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CHARTS OF CHAPTER 4

AUDIT EVIDENCE

CHAPTER 4 AUDIT EVIDENCE

DESIGNING & PERFORMING SUBSTANTIVE PROCEDURES

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

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

Designing & Performing Substantive Procedures

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

There are **inherent limitations to internal control including management override**

Depending Upon Circumstances auditor may determine that –

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

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

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

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

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

Assertions

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

PC MOVE RIGHT

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

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CHAPTER 4 AUDIT EVIDENCE

SA 500 AUDIT EVIDENCE

Audit Evidence

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

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

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

It includes –

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

Types of Audit Evidence

Depending upon Nature

- Visual
- Oral
- Documentary

Depending Upon Source

- Internal
- External

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

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

Sufficiency is **quantum of evidence (quantity)**

Appropriateness relates to **relevance & reliability (quality)**

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

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

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

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

Reliability of Audit Evidence

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

CHAPTER 3 – AUDIT EVIDENCE

SA 530 AUDIT SAMPLING

Audit Sampling

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

Characteristics of Population (CAR)

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

Approaches to Sampling

Statistical Sampling – It is approach to sampling that has

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

Non Statistical Sampling

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

ADVANTAGES OF STATISTICAL SAMPLING (POSE)

- Amount of Testing does not increase in proportion in increase in population
- Sample Selection is more objective & therefore more defensible
- Method provides means of estimating minimum sample size with specified risk and precision
- It provides better description of large mass of data, than complete examination of all data
- It provides means of deriving "calculated risk" & corresponding precision

Factors to be considered for extent of checking based on sample

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

CHAPTER 3 - SA 530 – Audit Evidence

Sample Design , Size & Selection of Items for Testing

Sample Design – While Designing Audit sample , auditor's consideration includes (MSD) -

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

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

Examples of Factors Influencing Sample Size for Test of Controls

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

Sample Selection Methods

1. **Random Sampling** – In this all the items in the population have known chance of selection. It includes 2 popular methods :

- a) **Simple Random Sampling** – In this we will choose numbers from random numbers by computers or picking random numbers from drum. It is considered simple & easy to use. It is appropriate only when in population we have similar units (*Homogeneous Population*)
- b) **Stratified Sampling** – In this whole population is to be tested in few groups called strata . Each stratum is treated as if it were a separate population & proportionate of items is selected from each stratum

- No of groups in which population is divided is based on auditor's judgement
- From each group auditor may pick different percentages of items (*Heterogeneous population*)

2. **Interval Sampling**

- In this no of sampling units in population is divided by sample size to give a sampling interval. Eg – 50 then every 50th unit is sample
 - Although starting point may be determined haphazardly , sample is truly random if determined by used of computerized random number generator or random number tables
 - Method is effective only when population is not structured in a way that sampling interval matches with particular pattern in population
3. **Monetary Unit Sampling** – It is type of value weighted selection in which sample size , selection & evaluation results in conclusion in monetary amounts

4. **Haphazard sampling** - In this auditor selects sample without any structured technique

- It is selected without any bias & thus attempt to ensure all items have equal chance of selection.
- It is not appropriate when using statistical sampling

5. **Block Sampling** – It involves selection of block of adjacent items within the population.

- It is not effective because items in sequence have similar characteristics from items as compared to elsewhere in population
- It is not effective when we want to draw valid inferences about whole population

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CHAPTER 4 AUDIT EVIDENCE

SAMPLING RISK

Sampling Risk

It is risk that **auditor's conclusion based on sample may be different from auditor's conclusion if entire population was subjected to same audit procedure**.

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

Non Sampling Risk

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

Sources of Non-Sampling risk are

- Human mistakes
- Misinterpreting sample results
- Applying Audit Procedures not appropriate to objectives of audit
- Relying on erroneous information. Eg – Wrong confirmations

Performing Audit Procedures

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

- If **Audit procedure is not applicable to selected item**, the auditor shall perform procedure on replacement item
- If auditor is unable to apply designed audit procedure or suitable alternative procedure to selected item, auditor shall treat it as **deviation from control in case of test of control** or a **misstatement in case of test of details**

Nature & Cause of Deviation & Misstatement

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

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CHAPTER 3 AUDIT EVIDENCE

PROJECTING MISSTATEMENTS & EVALUATING RESULTS OF SAMPLING

Projecting Misstatements

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

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

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

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

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

Evaluating Results of Audit Sampling

- For Test of controls ,
 - ✓ High Sample Deviation Rate
 - ✓ High Control Risk
 - ✓ Increase in Risk of Material Misstatements
 - ✓ Increase in Substantive Procedures
- For Test of Details

PROJECTED MISSTATEMENTS + Anamaulous Uncorrected Misstatements >= TOLERABLE MISSTATEMENTS

1. There is Unacceptable Sampling Risk that Actual Misstatement can exceed Tolerable Misstatement
2. We may request Management to investigate about Misstatements & Potential for Further Misstatements or
3. Change Nature , Timing & Extent of those Further Audit Procedures to achieve Best Assurance

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CHAPTER 4 AUDIT EVIDENCE

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

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

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

Existence & Condition of Inventory

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

Attendance at Physical Inventory Counting –

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

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

Matters Relevant in Planning Attendance at Physical Inventory Counting

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

Physical inventory counting conducted other than at date of financial statements

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

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

Attendance at Physical Inventory Counting is Impracticable

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

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

When Inventory is with 3rd Party, and it is material,

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

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CHAPTER 4 AUDIT EVIDENCE

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

Litigation & Claims

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

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

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

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

Auditor can also Meet External Legal Counsel when –

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

CHAPTER 4 AUDIT EVIDENCE

External Confirmations SA-505

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

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

External Confirmation Procedures –

Auditor shall maintain control over external confirmation requests including

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

When to send negative confirmation request ? (PSL)

- High Chance that **Parties will Respond** to Request
- Items of population are **small, homogenous**
- A very **low exception rate** is expected
- **Low risk of Material Misstatements and strong controls** at assertion level

Determining the Information to be Confirmed or Requested

External Confirmation Procedures frequently are performed to confirm information regarding Account Balance & their elements. They may also be used to confirm terms of agreement, contracts or transactions between entity and other parties or confirm agreements if any

Designing Confirmation Requests –

Factors to be kept in mind which directly affect confirmation rate (MASS Presentation)

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

Management's refusal to allow auditor to send confirmation request

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

CHAPTER 4 AUDIT EVIDENCE

Initial Audit Engagement (SA-510)

It is Engagement in which either –

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

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

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

Audit Procedures Regarding Opening Balances

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

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

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

CONSISTENCY OF ACCOUNTING POLICIES RELATING TO OPENING BALANCES

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

Conclusion

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

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CHAPTER 4 AUDIT EVIDENCE

RELATED PARTY (SA 550)

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

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

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

Responsibilities of Auditor –

Related Party Relationships & Transactions

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

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

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

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CHAPTER 4 AUDIT EVIDENCE

SA 520 ANALYTICAL PROCEDURES

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

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

Purpose & Timing of Analytical Procedures

Purpose

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

Timing

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

Analytical Procedures in Planning the Audit

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

Factors to be Considered for Substantive Procedures (PRASAD)

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

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

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

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

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

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

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

CHAPTER 4 AUDIT EVIDENCE

ANALYTICAL PROCEDURES DURING PERFORMING AUDIT

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

1. Determine the **suitability of substantive analytical procedures for given assertions** taking into account assessed risk of material misstatements
2. Evaluate the **reliability of data from which auditor's expectation of recorded amount or ratios is developed**
3. Determine an **expectation of recorded amounts or ratios**
4. Determine the **amount of difference of recorded amounts from expected values** so which is **acceptable without investigation**

Suitability of Particular Analytical Procedure for Given Assertions

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

Extent of Reliance on Reliability of Data for Analytical Procedures

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

Risk of Material Misstatements – Whether Expectation can be developed sufficiently precisely (DAR)

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

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

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

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CHAPTER 4 AUDIT EVIDENCE

TECHNIQUES AVAILABLE AS SUBSTANTIVE ANALYTICAL PROCEDURES

Techniques Available as Substantive Analytical Procedures (TRS)

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

Analytical Procedures that Assist When Forming an Overall Conclusion

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

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CHARTS OF CHAPTER 6

AUDIT DOCUMENTATION

CHAPTER 6 AUDIT DOCUMENTATION

SA 230 AUDIT DOCUMENTATION

AUDIT DOCUMENTATION

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

COMPLETION MEMORANDUM / AUDIT DOCUMENTATION SUMMARY

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

Benefits

It helps in **effective & efficient review & inspection** of audit documentation Assist Auditor's consideration of significant matters

Helps to see if **any SA is not followed** which will **prevent auditor from achieving its objectives**

AUDIT DOCUMENTATION – PROPERTY OF AUDITOR

SQC 1 provides that **Audit Documentation is property of the auditor**

He may at his **discretion make portions or extracts from audit documentation available to client** if it does not **affect independence of auditor or undermine the validity of work performed by him**

Purpose of Audit Documentation

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

Form, Content & Extent of Audit Documentation

- **Size & Complexity of Audit**
- **Identified risk of material misstatements**
- **Nature of Audit Procedures to be performed**
- **Significance of Audit Evidence obtained**
- **Nature & Extent of Exception Identified**
- **Need to Document a conclusion or basis for a conclusion** not readily determinable from documentation of work performed
- **Audit Methodology & Tools used**

Assembly of Final Audit File

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

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

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

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

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

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

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CHARTS OF CHAPTER 7

COMPLETION & REVIEW

CHAPTER 7 COMPLETION & REVIEW

Written Representations from Management (SA 580)

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

If management does not provide one or more of the Requested Written Representations, the Auditor shall:

- (a) Discuss the matter with management;
- (b) Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
- (c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705

OBJECTIVES OF AUDITOR REGARDING WRITTEN REPRESENTATION (ROSE)

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

Management From Whom Written Representations Requested

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

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

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

CHAPTER 7 COMPLETION & REVIEW

SUBSEQUENT EVENTS (SA 560)

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

Objectives

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

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

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

Auditor's Obligations Regarding Subsequent Events

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

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CHAPTER 7 AUDIT EVIDENCE & AUDIT DOCUMENTATION

Auditor & Going Concern Assumption (SA-570)

Auditor's Responsibility Regarding Going Concern

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

Additional Audit Procedures when events or conditions are identified

Auditor shall perform following procedures :

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

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

Financial

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

Operating Indicators

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

Other indicators

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

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Steps in SA 570 → going concern is always valid for foreseeable future
As per ASI 1 foreseeable future is 12 months from B/Ls date

Auditor & Going Concern Assessment Part 2

Use of Going Concern BASIS OF ACCOUNTING is INAPPROPRIATE

If Management has prepared FS as per Going concern , but according to Auditor Going concern is not valid , then Auditor shall express Adverse Opinion , as it will affect all accounts

If Management has prepared FS on liquidation basis , Auditor shall express UNMODIFIED Opinion , but may express EMPHASIS OF MATTER Paragraph in accordance with SA 706 to draw User's attention to alternate method of accounting

Use of Going Concern Basis of Accounting , but Material Uncertainty exists

If adequate disclosure about Material Uncertainty is made in FS , Auditor shall express UNQUALIFIED Opinion

But Auditors report shall include separate section with Heading "Material Uncertainty Related to Going Concern"

If adequate disclosure is not made in Financial Statements , Auditor shall express Qualified or Adverse Report

In basis of Opinion write , Material Uncertainty exists about Going Concern , and same matter is not disclosed in FS

SA 260 - SIGNIFICANCE OF COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

Objectives of Auditor

- Communicate Clearly with TCWG , the responsibilities of auditor in relation to financial statements & overview of planned scope & timings of audit
- Obtain from TCWG information relevant to Audit
- To communicate TCWG , about observations which are significant & relevant to their responsibility to oversee financial reporting process
- Promote effective & 2 way communication between Auditor & TCWG

MATTERS TO BE COMMUNICATED BY AUDITOR

Auditor's Responsibility in relation to Financial Statement Audit

1. Auditor is responsible for forming opinion on FS
2. Planned Scope, Timing of Audit – Includes communicating about Significant risks identified by the entity
3. Significant Findings from Audit - Accounting Practices, Policies if inconsistent with Applicable FRF , Significant Difficulties in Audit , Circumstances that may affect form & content of Audit report , any other significant matter , that are relevant in oversight of financial reporting process

In case of Listed companies, we have to communicate whether Partner, Team & Network firms have complied with Independence

Communication Process

- Auditor shall communicate with TCWG form, timing & expected general content of communications
- Auditor shall communicate in writing Significant Findings from Audit, if auditor feels written communication is not enough
- We need to communicate in writing about Independence, in case of Listed Entities
- If communication is not proper, we will evaluate its effect on ROMM & audit evidence
- Always retain copy of documentation, in those matters communicated in writing and those orally, include them in Audit Documentation, as to when & to whom they were communicated

SA 265 - COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE

Auditor is required to obtain Understanding of Internal Control in identifying & assessing ROMM

Objective of Auditor

- Communicate to Management & TCWG those Deficiencies in Internal Control that are of **sufficient Importance**

Difference between Deficiency & Significant Deficiency in Internal Control

- **Deficiency** – Exists when Control is missing, or is unable to prevent or detect & correct misstatement
- **Significant Deficiency** – Significant Deficiency are those that in auditors judgement are of **utmost importance** or **whose Probability & Impact is High**

Determination of Significant Deficiencies

- We shall determine, whether there are 1 or more deficiencies in Internal Control
- Based on that, auditor shall determine whether individually or in combination they constitute significant deficiencies

Communication of Significant Deficiencies in Internal Control to TCWG

- Auditor shall communicate in writing about Significant Deficiencies in Internal Control to TCWG
- Auditor shall also communicate with Management –
- In writing, significant deficiencies communicated to TCWG or intends to communicate
- Other Deficiencies in Internal Control that are of sufficient importance to merit management's attention

Auditor shall Include Written Communication of Significant Deficiencies

- A description of deficiency & their possible effects
- Sufficient information to enable TCWG to understand context of communication

Our main aim is to do Audit, while doing Audit these were identified, our report is on FS as a whole

SA 450 EVALUATION OF MISSTATEMENTS IDENTIFIED DURING AUDIT

Objective of the Auditor is to Evaluate

1. Effect of Misstatements Identified in Audit
2. Effect of Uncorrected Misstatements, if any on the financial Statements

- Auditor shall accumulate all misstatements identified during audit , unless they are immaterial
- Auditor shall determine whether over-all Audit Strategy & Plan need to be revised if –
 1. If circumstances indicate other misstatements may exist
 2. Aggregate of the Misstatements accumulated during Audit could be Material
- Auditor may request management to examine class of transactions , account balance or disclosures to understand cause of misstatement , perform procedures to know actual amount of misstatement & make appropriate adjustments in the Financial Statements
- If Management has corrected misstatements, Auditor shall perform other procedures to determine any other Misstatements remain

Communication & Correction of Misstatements

- Auditor shall communicate all the Misstatements to appropriate level of Management
- Auditor shall request Management to correct those Misstatements
- If Management refuses to correct , auditor shall obtain understanding of managements reasons for not making corrections & shall take into account , when evaluation whether FS are free from Misstatements

Evaluation Effect of Uncorrected Misstatements

- Prior to Evaluation effect of uncorrected misstatements, Auditor should see Materiality is appropriate as per Entity's actual financial results.
- While seeing effect of Uncorrected Misstatements, Auditor shall evaluate –
 1. Size & Nature of Misstatements, in context individually for particular class of transaction , ac balance or disclosures and financial statements as a whole & circumstances of their occurrence (If unintentional – ignore)
 2. Effect of Uncorrected Misstatements related to prior period on CAD & Financial Statements as a whole

Communicate with Those Charged With Governance

- The auditor shall request Uncorrected misstatements to be corrected
- If TCWG doesn't , Auditor shall communicate effect it may have in Auditor's report
- Auditor shall also communicate effect on uncorrected misstatements related to prior period on relevant class of transactions , ac balances or disclosures

Written Representation Regards Effects of Uncorrected Misstatements

- Auditor shall request Written Representation from Management or where applicable TCWG , whether they believe , effects of misstatements are immaterial individually and in relation to FS as a whole

Documentation Regarding Misstatements Identified During Audit

- Amount below which Misstatements are immaterial (Threshold limit – usually 5 % of materiality)
- All misstatements identified during Audit & whether they are corrected
- Auditor conclusion whether uncorrected misstatement are material individually or in relation

CHARTS OF CHAPTER 8

AUDIT REPORT

CHAPTER 8 AUDIT REPORT

SA 700 FORMING AN OPINION & REPORTING ON FINANCIAL STATEMENTS

Objectives of Auditor as per SA 700

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

Purpose

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

Expression of Unmodified Opinion on Financial Statements

Fair presentation framework

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

Compliance framework

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

Basic Elements of Auditors Report

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

Opinion Section will include :

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

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CHAPTER 8 AUDIT REPORT

SA 700 FORMING AN OPINION & REPORTING ON FINANCIAL STATEMENTS

8. Auditor's Responsibility for Audit of Financial Statements

This section of Auditor's Report Shall

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

Auditor's Responsibility for audit of Financial Statements shall further

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

Auditor's responsibility for Audit of Financial Statements also shall

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

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

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

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

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CHAPTER 8 AUDIT REPORT

SA 701 Communicating Key Audit Matters in Independent Auditors Report

Purpose

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

Key audit matters is not a substitute to following Disclosures (OMG):

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

Applicability

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

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

Determining Key Audit matters –

While considering we should take into account following points

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

Communicating Key Audit Matters

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

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

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CHAPTER 8 AUDIT REPORT

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

Qualified Opinion is Issued When ,

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

Adverse Opinion – Auditor issues

Adverse Opinion when –

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

Disclaimer of Opinion – It is issued when –

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

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

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

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

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

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

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CHAPTER 8 AUDIT REPORT

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

Objective of Auditor

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

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

EMPHASIS OF MATTER

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

OTHER MATTER

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

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

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

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

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CHAPTER 8 AUDIT REPORT

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

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

2 Broad Approaches of Comparative Information Corresponding figures

- For corresponding figures, **auditors opinion on Financial statements** refers to **current period only**
- Previous year is just **given for comparison**

Comparative financial statements

- For comparative financial statements, **auditors opinion** refers to **each period** for which **financial statements** are presented
- Here we have **given opinion for all previous years** for which such Information is given

Audit Procedures regarding Comparative Information

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

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

Audit Reporting Regarding Corresponding Figures

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

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

Comparative Financial statements

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

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CHAPTER 8 AUDIT REPORT

DUTIES OF AUDITORS

Duties of Auditor

- **Duty of Auditor to Inquire on certain matters**
 1. **Whether shares have been allotted for cash and whether adequate cash is received** , if no cash is received , position in B/S is properly stated or not
 2. Whether any Investment in the form of shares , debentures or other securities of company are **sold at price less than cost price , except Banking & Investment Company**
 3. Whether loans & advances made by the company are properly secured & terms are **prejudicial to interest of the company**
 4. Whether **loans & advances made by the company have been shown as Deposits**
 5. Whether **Personal Expenses** are charged to Revenue A/c
 6. **Whether book entry transactions are compromising to the interest of company**
- **Duty to Sign Audit Report**
- **Duty to Comply with Auditing Standards**
- **Duty to Audit Report –**
 - As per Section 143 (3) Auditor shall also state
 1. Whether he has **obtained all Information & Explanation necessary for the purpose of audit** , if not details there of and effect of such Information on FS
 2. Whether proper **books of accounts are maintained & proper returns have been received** from Branches not visited by him
 3. Any **qualification , reservation or adverse remark relating to maintenance of accounts**
 4. Whether **Branch Audit report has been sent to him in case Audit is not done by him & how he has dealt it with**
 5. Whether **Company's B/S & P/L are in agreement with Books of Accounts & returns**
 6. Whether **Financial Statements comply with Accounting Standards**
 7. **Observations of comments of auditors on financial transaction or matters having adverse effect on functioning of the company**
 8. Whether any **Director is Disqualified** from being Appointed
 9. Whether Company has **adequate internal financial control system** in place for financial reporting & operating effectiveness of such controls
- **Duty to report on Frauds**
- **Duty to report on matters reported by Central Govt**
- **Duty of Company's Auditor for Branch Audit**
- **Duty to state reason for Qualification / Negative Report**

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

- One Person Company or
- Small Company or
- Company has turnover of less than 50 crores as per latest audited financial statement &
- Aggregate Borrowings from Banks / Financial Institution or any body corporate less than 25 cr at any point of time during financial year

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COMPANY'S AUDITOR REPORT ORDER (CARO 2020)

COMPANIES AUDITOR REPORT ORDER, 2020

The MCA has notified Companies (Auditor's Report) Order, 2020 on 25 February 2020 (CARO 2020). CARO 2020 has included additional reporting requirements after consultations with the [National Financial Reporting Authority](#) (NFRA)

It shall apply to every company including a Foreign Company

It shall not apply to : **One Person Got his Samsung S8 Insured from Private Bank**

- One Person Company
- Small Company
- Section 8 Company (Not-Profit Company)
- Insurance Company
- Private Limited Company
- Banking Company

CARO APPLICABLE TO PRIVATE LIMITED COMPANY IF –

Main Condition - If it is Holding or Subsidiary of Public co

Other Conditions

- Paid up Share & Reserves more than 1 cr as on B/S Date or
- Total Borrowings more than 1 cr from Bank or Financial Institution at any point of time during the Financial Year or
- Total revenue as disclosed in Schedule III more than 10 cr during the financial year as per financial statements
- This report shall not apply on Consolidated Financial Statements

MATTERS TO BE INCLUDED IN CARO

1. **Fixed Assets** – Maintaining Proper Records, Physically Verified, any material discrepancies if noticed, Title deeds of FA are in name of company
2. **Inventory** – Physical Verification, Material discrepancies & how they are dealt in books of accounts
3. **Loans** – Company has granted any loans to parties covered in register maintained u/s 189, if so, it shall not be compromising to company's interest
4. **Loans, Investments, Guarantees & Security** – Provisions of Section 185 & 186 have been complied & details there of
5. **Public Deposits** – Company has accepted deposits whether directives issued by RBI have been followed
6. **Cost Records** – Maintenance of cost records has been specified, whether such accounts and records are made
7. **Statutory Dues** – Extent of undisputed dues on the last day of financial year, if o/s for a period of more than 6 months
8. **Unrecorded Income** – Whether any transactions not recorded in Books of accounts is disclosed as Income
9. **Repayment of Loans** – If company has made any default, period & amount of default has to be reported, loans are applied for purpose for which it was raised
10. **Usage of Term Loans** – Money raised through IPO, FPO or any other public offer and Term loan is applied for the purpose for which those were raised
11. **Fraud – Notice of Fraud** – Any Fraud by or on company has been reported during the year, amount & nature has to be reported
12. **Nidhi Company** – Whether Nidhi Company has maintained Net Owned Funds to Deposit Ratio of 1:20 to meet out liability & whether it is maintaining 10 % of term deposits to meet out liability
13. **Related Party Transactions** – Whether all related Party Transactions are in compliance with Section 177 & 188 & disclosed as per AS
14. **Internal Audit System** - Whether Internal Audit System is commensurate with size & nature of Business
15. **Non-Cash Transactions** – If the company has entered any non-cash transactions with Directors or persons connected with him & provision of Section 192 are complied with
16. **NBFC** – Whether registration is done as per Act or not. Whether company has done any NBFC Activity without certificate, whether company is CIC, whether it continues to fulfil criteria
17. **Cash Losses** – If company has incurred cash losses in immediate financial year, then amount of such cash losses
18. **Considerations of Issues Raised by Outgoing Auditor** – Whether there is resignation of statutory Auditors, auditor has taken into consideration issued raised by those Auditors
19. **Existence of Material uncertainty as to Company's Ability to Meet Claims** – On basis of financial ratios, whether there is material uncertainty of meeting liabilities within one year of B/S Date
20. **Transfer of Unspent CSR Amount** – Whether company has transferred unspent amount to fund specified under schedule viii of companies act in respect of other than ongoing projects, For ongoing Projects unspent amount is transferred to special account as per Sec 135 (6) of the act
21. **Qualifications or Adverse Remark in CARO Report of Group Companies** – Whether there is adverse remark on CARO report of Group Companies in consolidated financial statements

CHARTS OF CHAPTER 9

**AUDIT OF DIFFERENT TYPES
OF ENTITIES**

CHAPTER 9 AUDIT OF DIFFERENT TYPES OF ENTITIES

GOVERNMENT AUDIT

COMPTROLLER AND AUDITOR GENERAL OF INDIA

- In India Government audit is done by C & AG through agency of Indian Audit & Accounts Department

Appointment – He shall be appointed by President of India

Resignation – On Ground of Proven misbehaviour or incapacity

- He can be removed when each house of parliament decided to do so by majority of more than 2/3rd of members of house present and voting

Tenure – 6 Years or Max Age 65 Years

Salary – He shall be paid salary equal to judge of supreme court

Duties of C & AG

- **Compiling the accounts & subsidiary accounts and report to**
 1. Central Government – Consolidated fund of India - President
 2. State Government – Consolidated fund of state - Governor
 3. Union Territory – Consolidated fund of union territory – Administrator
- **Audit of Receipts of Union or states**
- **Audit & report on all expenditures from CFI, CFS & CFUT**
- **Audit of Stores & Stocks**
- **Audit of Receipts & Expenditure – Any authority is substantially financed by grants or loans from CFI, CFS, CFUT**
- **Audit of Grants or loans**
- **Audit of Government Companies & Corporations**

Powers of C & AG

- Inspect any office of accounts under control of union or state government
- Demand any document, books, records
- Put such questions to person in charge of office and call for such information
- In carrying out audit, can check any accounts or class of transactions in detail if required

Audit of Expenditure

Audit against Rules & Order

Here we will see rules, regulations and orders issued by executive authorities to see that Expenditure is as per :

1. They are as per provisions of constitution or any laws made there under
2. They are not in conflict with orders or rules made by any higher authority
3. They are as per requirements of audit and accounts as per C & AG
4. In case they are not approved by competent authority, issuing authority possess necessary rule making power

Audit of Sanction

- Expenditure is covered by a sanction &
- Satisfy that authority sanctioning it, is competent for the purpose

Audit against Provision of Funds

- Here we will see that –
 1. Expenditure has been incurred for same purpose for which grant and appropriation had been provided &
 2. Amount of expenditure does not exceed the appropriation made

Propriety Audit

- Many times thou expenditure is sanctioned, provision is made, is as per rules & regulations, but still may be improper, avoidable or not useful expenditure
- Auditor will see wisdom, faithfulness & economy of transactions
- Some General Principles laid down in Audit code are :
 1. Expenditure should not be more than what occasion demands. Even public officer should exercise same vigilance as person of ordinary prudence will exercise in his own money
 2. No authority sanctioning expenditure shall pass order directly or indirectly to its own advantage
 3. Should not be utilised for benefit of particular person or section of community
 4. Amount of allowances should be regulated eg travel, that they are not source of profit to recipient

Performance Audit

Efficiency means

1. Whether schemes and project are done economically
2. Whether they are giving desired results
3. Relationship between goods and services produced and resources used to produce them

Economy looks into

1. Government has acquired financial, human & physical resources in economical manner
2. Whether spending authorities have exercised economy

Effectiveness Audit is - Appraisal of performance of programmes, schemes, projects with targeted objectives

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CHAPTER 9 AUDIT OF DIFFERENT TYPES OF ENTITIES

General Things to be Checked for all Entities

- Review Legal Status of the Entity (Proprietor, Partnership, Trust, HUF, Society, Company)
- Obtain & Study Fundamental Legal Document (MoA, AoA)
- Review the Internal Control System of the entity
- Examine the Powers of members of management committee and other officers
- Study minutes of Board meeting or Governing Body or Managing Committee
- Examine Accounting Policies followed & accounting records maintained
- Check various receipts in the form of organisation in form of fees, rent, income on investments, donations & grants [GRID]
- Check various Expenditure like staff, common expenses, capital exp with approval of authority
- Verification of Assets & Liabilities

Payments

- Verify all PF money of staff has been invested in appropriate securities
- Vouch all Capital Expenditure in usual way, verify same with sanction of committee in minute book
- Vouch establishment expenses (Telephone, stationery, printing etc) and enquire into heavy expenditure
- See if expenditure is more than budgeted as sanctioned by Managing Committee
- Increase in salaries of staff has been sanctioned and minuted by committee

Assets

- Ascertain that system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised before payment
- Verify inventories of furniture, staff, clothing, provision and all equipment.

AUDIT OF EDUCATIONAL INSTITUTE

General

- Examine Trust Deed or Regulations, in case of school and note all provision affecting accounts
- Read minutes of meeting of managing committee or Governing body regarding operation of Bank accounts and sanctioning of expenditure

Receipts

- Fees from Students
- Check name in Students Fee Register with class register and test check amount of fees charged and see there is system of internal check which ensures fees are properly charged
- Check fees by comparing cash book with counterfoils of receipt granted
- Fees paid in advance is carried forward and
- Arrears that are irrecoverable have been written off with sanction of appropriate authority
- Admission fees are credited to Capital fund,
- Free studentship and concessions are granted by person authorised by Managing committee
- Fines or Late Payments are received and properly remitted
- Confirm Hostel Dues are received before students account is closed
- Report old heavy arrears on fees, dormitory rent to Managing committee
- Verify **rental income** with rent agreement (GRID)
- Verify **Interest and Dividend** income from Investment, also inspect securities in respect of Investments held
- Verify any Government or local authority **grant** and if any expense is disallowed under grant and reasons thereof
- See **Donations received** and if any donations are for specific purpose, see money was used for that purpose

Liabilities

- Caution money and deposit paid by students on admission is shown as liability in balance sheet

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AUDIT OF HOSPITALS & HOTELS

AUDIT OF HOSPITALS

Receipts

- **Register of Patients** – Vouch register of patients with copies of bill issued to them to ensure bills are prepared in correct period
 - Also ensure bills have been issued to all patients from whom amount was recoverable
 - Check cash collections as entered in Cashbook with receipts, counterfoils and other evidence
- **Income from Investments, Rent** – See Investment register to see all income from Interest, Dividend, Rent on Property have been collected
- **Donations** – Trace all Subscriptions and Donations from cashbook to respective registers.
 - Reconcile the Subscriptions due with subscription register
 - Donations for Specific purpose are used for that purpose
- **Grants** – Grants received from Government are duly accounted for

Payments

- Vouch all the Purchases and Expenses
- Verify capital expenditure is incurred with sanction of trustees or managing committee
- Increments to staff have been duly authorised
- Check totals of various items of expenditure with amount budgeted for them and report to trustees or managing committee significant variations in them

Assets

- See Depreciation is charged on all assets at appropriate rates
- Inspect bonds, share, scripts, title deeds of properties and compare with those entered in Property and Investment Register
- Obtain Inventories, especially stock and stores and do physical verification, also compare their values with respective ledger balances
- Examine Internal check as regards receipts and issue of stores, medicine, linen, apparatus, clothing, instrument etc, to ensure they are properly recorded in inventory register and are

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AUDIT OF HOTELS

General

Internal Control – Pilfering is one of biggest problems in Hotels, so there should be strong Internal controls

Receipts

Room Sales & Hall Booking – The charge for room sales is normally posted to guest bills by receptionist or in case of large hotels by night auditor

- Check correct no are guests are charged for correct period with Entry register
- Any difference between rates charged and standard rate should be properly authorised
- In many hotels, housekeeper prepares daily occupancy report, see this report to compare with guest register and individuals guest's bill
- Proper records are maintained for booking of halls and other premises for special parties are recovered on basis of tariff

Restaurant Bills - Auditor should check restaurant bills by reference to KOT (Kitchen order tickets), this would help him to see Controls over revenue cycle

Taxes received from client are paid to Government authorities

Travel Agent & Shops – Auditor should ensure money received from travel agents is as per terms of credit allowed

Payments

- Cost of minor repairs and redecoration should be treated as Revenue Expenditure
- Cost of major alterations and additions to Hotel Building should be capitalised
- **Casual Labour** – Hotel depends on large extent on casual labour, see proper records are maintained and ensure there is no fraud by suggesting proper controls to management
- Commission paid to travel agents should be checked with reference to agreement on that behalf

Assets

- See Inventories like silver, cutlery are treated as FA or Inventory, depends on life of asset and nature of treatment followed by Hotel and Inventory exists and definitions are closely followed

CHAPTER 9 AUDIT OF DIFFERENT TYPES OF ENTITIES

AUDIT OF CLUBS & CHARITABLE INSTITUTION

Audit of Clubs

General

- See Financial Powers of secretary and if they have been exceeded, report specific cases to managing committee

Receipts

Entrance Fees – Vouch entrance fees with members register, counterfoils issued to them

Subscriptions – Vouch members subscription with counterfoils issued to them

- Trace receipts with register of members for selected period
- Reconcile total subscriptions with amount due and outstanding
- Arrears are correctly brought forward from last year
- Arrears are adjusted of current year
- See appropriate steps are taken for recovery
- Amount considered irrecoverable is mentioned in audit report
- Advances are properly accounted for

Pricing for Food Items & Amenities –

- Verify internal checks members are charged for foodstuffs, drinks provided to them as well as guests and special services like billiards, tennis etc
- See debits in register of supplies and services to members and see members account is debited

Payments

- Vouch purchase of sports item, crockery, and trace them with inventory
- Verify purchases of food items, cigars, wines and see sale price charged on them to see, appropriate gross profit margin is earned.
- Unsold goods should be in inventory

Assets

Inventories – physical verification & Invt's

Audit of Charitable Institute (Education, religious or any other activity for public interest) Eg – Balmission Charitable Trust

General

- Study Constitution under which it is set up
- Examine trust deed or regulation as laid down
- Verify institute is functioning in a manner as mentioned in law
- Examine system of internal check as regards amount of money collected
- Verify in detail income and amount is deposited to bank regularly

Receipts

Subscriptions & Donations –

- Ascertain changes made in annual or life membership during the year
- Whether official receipts are issued
- Confirm control over unused receipts
- Obtain all receipts book for period under review
- See counterfoil of receipts with cash book
- Verify total subscriptions and donations with any figure mentioned in report by institute
- Examine system of internal check regarding money received from box collection, flag days

Grant –

- Verify amount received with relevant correspondence, receipts and minute books
- Obtain certificate from responsible official showing amount of grant received

Investment Income – Verify interest and dividend with counterfoils

- Check calculation of interest for interest bearing fixed interest
- Ex dividend (Excluding Dividend as after record date) and cum dividend (Including dividend as purchased before record date)
- See schedule of investments to see, dividend is received for all

Rent – Verify rent with counterfoils from receipt book

- Rent agreement, amount of rent and due dates

Special Functions – Concerts, dramas, performance

Income tax refunds – Vouch refund of Income tax if deducted, as they are exempt from tax

Payments

- Vouch payment of grants and grants are paid only according to purpose of charitable institute and no trustee or MC member is benefitted from this
- Verify cash and bank payments

Assets

- Verify schedule of securities held as well as movable and immovable property by inspecting securities, title deeds and physical verification of inventories on test basis

AUDIT OF TRUSTS & SOCIETIES

• 3 Basic Legal forms of charitable entities – Trusts, Societies & Section 8 Companies

1. If charitable institute is Public trust, it will be governed by Public Trust Act in relevant state . However if no trust exists, then applicable legislation would be Indian Trust Act, 1882
2. If charitable institute is formed as society, it will be governed by Societies Registration Act, 1960
3. Charitable Institute can also be formed as non-profit company under Section 8 of Companies Act , 2013

Auditor's Considerations in Case of Societies

- Auditor should ascertain governing legislation of the society i.e Societies Registration Act 1860 or applicable state law
- Objectives of society need to be ascertained from its memorandum of association / byelaws
- Ascertain whether society has obtained registration under Foreign Contribution (Regulation) Act , 2010 in case foreign contributions are received
- Ascertain whether it is registered under relevant provisions of Income Tax Act which make it possible for tax exemption
- Obtain understanding of internal controls in respect of donations & various expenditures
- Evaluation appropriateness of accounting policies with reference to donations & grants
- Some expenses incurred by society are reimbursed by donors, ascertain how they are recognized in financial statements
- Ascertain any inquiry has been held by Registrar under applicable law or financial condition & its implication on Auditor's opinion
- Ascertain cases of irregular, improper expenditure or failure or omission to recover monies or other properties belonging to society or loss or waste of money
- Ascertain such expenditure or waste was caused in consequence of breach of trust or misapplication or misconduct of governing body

Auditor Considerations in Trusts

- Whether accounts are maintained as per applicable act & rules
- Whether receipts & disbursements are proper & money received in form of donations is applied as per objects of the trust
- Whether cash balance & vouchers are in custody of manager or trustee are in agreement with accounts
- Whether register of movable & immovable properties is maintained , the changes are communicated from time to time & inaccuracies mentioned in previous report are rectified
- Whether property of funds of trust are applied for purpose other than object or purpose of the trust
- Amounts of outstanding for more than one year & amounts written off , if any
- Whether any money has been invested contrary to provisions of applicable act of trust
- All cases of improper , illegal or improper expenditure or any misconduct on the part of the trustees
- Whether max & min trustees are maintained
- Meetings are held regularly as provided in such instrument
- Whether any of the trustees have any interest in investment of the trust
- Whether any of the trustees is debtor or creditor of the trust
- Whether any anonymous donations received are properly accounted for & donations in cash are not above limits of the trust
- Any special matter auditor thinks necessary to bring to notice of deputy or assistant charity commissioner

CHAPTER 9 AUDIT OF DIFFERENT TYPES OF ENTITIES

AUDIT OF LOCAL BODY & HIRE PURCHASE

Audit of Local Body

Income

- Property taxes & Octroi
- Other municipal taxes are profession tax ,
- Taxes on advertisement , tolls , show tax , parking auctions

Grants –

- **General Purpose** – Grants given to bridge gap between needs & resources of local bodies
- **Specific Purpose Grant** – For provision of certain services or performance of certain tasks
- **Statutory & Compensatory Grant** – Loss of any revenue on taking over tax by state government from local government

Expenses

They are endowed with specific functions covering

- Regulatory
- Maintenance & Development activities
- Expenditure covered by them are classified in following heads

General Administration & revenue collection

- Public Health
- Public safety
- Education
- Public works &

Others such as interest payment

Auditor should Understand Financial Administration of Local Bodies .

Some Aspects are :

Budgetary Procedure – This is done to see Financial accountability and control of expenditure

Main objective is to ensure funds are raised and money is spent as per rules and regulations and within limits of sanction

Expenditure Control – Here audit is done by state government as it is only way of controlling municipal expenditure

Accounting System – Municipal accounting and budget format have been criticized as neither simple nor comprehensible , sometimes providing inadequate information or excessive . Both these situations are not conducive to proper system of management information

Audit Programme for Local Body

1. Local audit wing of state government is in charge of municipal accounts . Sometimes bigger municipal corporations like Delhi , Mumai have power to appoint their own auditors.
2. Auditor should report on fairness of contents and presentation of Financial statements . System of financial control and adherence to legal or administrative requirements
3. Expenditure conforms to relevant provisions of the law and is as per rules and regulations framed by competent authority
4. Expenditure is as per provision of funds
5. All types of sanction either special or general by competent authority
6. Different schemes , programmes and projects where large expenditure is incurred are running economically and getting expected results (Value for Investment)

Audit of Hire Purchase

- Hire Purchase agreement is in writing and is signed by all parties
- Hire Purchase agreement specifies clearly –
 1. Hire purchase price of goods
 2. Cash price of goods ,price at which goods may be purchased for cash by hirer
 3. Date on which agreement shall be deemed to have commenced
 4. No of installments & amount of each installment , Date & Place of Payment
 5. Good to which agreement relates
- Ensure payments are received regularly as per terms of agreement

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AUDIT OF LEASING COMPANY & LLP

Leasing Company –

- See Object clause of leasing company to determine the goods like capital goods, consumer durables in respect on which company can undertake such activities
- Further whether company can undertake financing activities or not
- Whether there exists a procedure to ascertain credit analysis of lessee like lessee's ability to meet commitment under lease, past credit record, capital strength, collateral security etc
- Lease agreement will be seen and following points may be noted –
 1. Description of lessor, lessee, equipment and location where equipment is to be kept
 2. Amount of tenure of lease, dates of payment, late charges, deposits or advances
 3. Whether equipment shall be returned to lessor on termination of agreement and cost shall be borne by lessee
 4. Whether agreement prohibits lessee from assigning the subletting the equipment and authorizes lessor to do so
- Examine lease proposal form submitted by lessee requesting lessor to provide him equipment on lease
- Examine acceptance letter from lessee indicating equipment has been received in order and is acceptable to lessee
- See Board resolution authorizing a particular director to execute lease agreement
- Ensure invoice is retained safely as lease is long term contract
- See that copies of insurance policies have been obtained by lessor for his records

Feature of LLP

- LLP shall file "Statement of Accounts & Solvency" in prescribed Form 8 with Registrar every year within 30 days from end of financial year to which it relates
- Every LLP also should file annual return in Form 11 within 60 days of close of Financial year
- Accounts shall be audited in accordance with Rule 24 of LLP, Rules 2009

Exemption –

- Turnover does not exceed 40 lakh rupees or
- Contribution does not exceed 25 lacs rupees
- However partners of such LLP decide to get accounts of such LLP audited, then they can
- Registrar would have power to obtain information from designated partner, partner or employee of LLP
- He can summon any designated partner, partner or employee of LLP in case info is not furnished or registrar is not satisfied with information furnished

Auditor will be appointed by designated partners of LLP –

- At any point of time for first financial year, but before end of first financial year
- At least thirty days prior to end of each financial year (other than first FY)
- Casual vacancy will also be filled by designated partners
- If designated partners fail, then partner will appoint auditor

Advantages of Audit of LLP

- Helps in detecting errors & frauds & verification of financial statements
- Disputes, if any between partners in matters of accounts will be solved with help of audited accounts
- Settling accounts between partners at time of admission, death, retirement, insolvency, insanity
- Banks & Financial Institutions will lend money to firms only on basis of audited accounts
- Periodical visits and suggestions by auditor will help in improving management of LLP

Auditors Duty in case of LLP

- Auditor should get definite instructions in writing as to work to be performed by him
- Auditor should mention
 1. Whether records of the firm appear to be correct & reliable
 2. Whether he has obtained all information & explanation necessary for his work
 3. Whether any restriction was imposed on him
- If partners maintain minute book, he shall refer any resolution passed regarding accounts
- Auditor should read LLP agreement and note following provisions – Nature of business, capital contributed by each partner, Interest for capital contributed, Drawings, Salary to partner, Borrowing powers, Rights and duties of partners, loans advanced to partners, Profit sharing ratio etc

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CHAPTER 9 AUDIT OF DIFFERENT TYPES OF ENTITIES

AUDIT OF NGO

AUDIT OF NGO

General

- Knowledge of NGO , its mission , vision, areas of operation and environment in which it operate
- Knowledge of all relevant statutes with regard to amendments , circulars
- Legal form of organisation
- NGO's Organisation chart , financial and administrative manuals , Project and programme guidelines
- Examination of minutes of Board /MC / Governing body
- Study accounting system and internal control & Internal check
- Setting materiality levels for audit purpose
- Nature and timing of reports
- Involvement of experts
- Review of previous years report

Receipts

Grant for Projects – Agreement with donors and grant letters to ensure funds are accounted for

Fund Raising Program – Internal controls and person who are responsible for collection of funds , and collections are deposited in Bank daily

Membership fees – Fees received with membership register . Ensure proper classification is made between entrance fees and annual fees and life membership fees .

- Reconcile fees received with fees to be received during the year

Subscriptions – Check with subscription register and receipts issued .

- Reconcile subscriptions with report in magazine
- Check rates of subscription schedule

Interest and Dividend – Check with investments

Payments

- **Programme and Project Expenses** – Verify agreement with donor / contributor supporting particular programme or project with respect to conditions
- In case projects involving contracts . Ensure income tax is deducted , deposited , returns and filed and verify terms of contract
- **Establishment Expenses** – Verify PF , Life insurance premium , ESIC are deducted and deposited within time .
- Check expenses like postage , stationery , travelling etc
- Check requirements for Earmarked funds and see they are used for that purpose
- Vouch disbursements and expenditure as per agreement with donors for each of the balances

Assets

Fixed Assets – Vouch all Acquisition / sale or disposal of assets including depreciation and authorisation for same.

- Check Donor's agreement for the grant
- In case of immovable property check title etc

Investments – Check investment register and investments physically ensuring they are in name of NGO

- See Interest is received or not
- Verify Investments and disinvestments are for approval by appropriate authority

Cash in hand – Physically verify cash in hand at close of year and whether it tallies with books of tallies with books of accounts

Bank Balance – Check BRS and ascertain details of old and outstanding and unadjusted amounts

Inventory – Verify inventory in hand and obtain certificate from management for quantity and valuation of the same

Liabilities

- **Corpus Fund** – Contribution / Grants in corpus fund should be vouched with letter from donor
- **Reserves** – Vouch transfers from Project / programmes with donor letters and board resolution of NGO .

CHAPTER 9 AUDIT OF DIFFERENT TYPES OF ENTITIES

AUDIT OF COOPERATIVE SOCIETY

Audit as per Sec 17 of Co-operative Societies Act, 1912

Registrar shall audit or person authorised by him by general or special order in writing shall audit accounts of every registered society once at least in every year

Qualification of Auditor

1. CA or
2. Person holding diploma in cooperative accounts or
3. Auditor in cooperative department of government

Audit Concerns

1. **Restrictions on Shareholding** – No member can hold shares which exceed 20 % of total no of shares or of value of shareholding to Rs 1,000
2. **Loans** – Can't make loan to any person other than member
 - With special sanction of registrar, we can give loan to another registered society. State government may further put restrictions as it may think fit
3. **Borrowings** – may accept loans and deposits from its members subject to restrictions and limit of byelaws of society
4. **Appropriation of Profits** – Section 33 – 25 % of Profits should be transferred to Reserve fund, before distribution of dividend or bonus to members.
 - However registrar can reduce percentage, but now below 10 %
 - Section 34 – With sanction of registrar may contribute an amount not exceeding 10 % of net profits after to reserve fund as Contribution to charitable purpose
 - Contribution to Education Fund – It is charge on profits and not appropriation
 - According to certain state acts, transfers to Dividend Equalization reserve and Share Capital Redemption fund are stated as charges against profit

Audit Classification by Society

After judgement of an over-all performance of society, auditor will award a class to society based on criteria specified by registrar

If management is not satisfied about award of audit class, it can appeal to registrar

Registrar may direct to review the audit classification

Discussion of Draft Audit Report with MC

On conclusion of audit, auditor should ask secretary to convene meeting with MC to discuss draft audit report

Some state acts provide that society may use Reserve Fund –

- In Business of society as working capital
- May invest as per provisions of act
- May be used for some public purpose likely to promote objectives of society

Investment of Funds

A society may invest its funds in any one or more –

1. In central or state cooperative bank
2. In any other cooperative bank, other than central or state as approved by registrar
3. In shares, securities, bonds or debenture of any other society with limited liability
4. In any of securities specified in Sec 20 of Indian Trust Act, 1882
5. In any other money permitted by Central or State Government

Special Features of Cooperative Audit

- **Examination of Overdue Debts** – 6 Months to 5 years and more than 5 years will have to be classified and reported to auditor
- **Overdue Interest** – Interest should be excluded from interest outstanding and accrued
- **Certification of Bad Debts** – When they are written off only when certified as bad by auditor, where not certified, managing committee of society must authorize write off
- **Valuation of Assets & Liabilities** – Refer provisions of AS 2 & AS 10
- **Adherence to Cooperative Principles** –
 - Check whether objects of cooperative organization have been achieved in course of its working
 - Not in terms of profits, but in terms of providing benefit to members
 - Expenses are economically incurred
 - There is no wastage of funds
 - Middlemen, commissions are avoided
- **Verification of members register and examination of their pass book** – Examine entries in members book regarding loans given and repayments and confirmation of loan balances in person

Special Reporting to Registrar

If auditor notices there are serious irregularities. He will special matters to registrar

The registrar on receipt of special report may take necessary legal action

In following cases, special reporting is necessary : (FM DP)

1. Detection of **fraud** relating to expenses, purchases, stores
2. **Mis-Management** – Decisions against cooperative principles
3. **Disproportionate advances** to vested interest groups such as relatives of management
4. **Advances without adequate security** and proper safeguards for judging credit worthiness of party
5. **Personal Profiteering by members** of managing committee

CHAPTER 9 AUDIT OF DIFFERENT TYPES OF ENTITIES

AUDIT OF MULTI-STATE COOPERATIVE SOCIETY

Applies to Cooperative Society who objects are not confined to one state
Funds of multi-state cooperative society cannot be utilized for any political purpose

Qualifications of Auditor

- CA as per CA Act, 1949

Disqualifications

1. Body Corporate
2. Officer or employee of multi-state cooperative society
3. Person who is member or is in employment of officer or employee of multi-state cooperative society
4. Person who is indebted to multi-state cooperative society or who has given guarantee or security regarding third person of more than 1000 Rs

Powers & Duties of Auditor

- Right to access at all times books accounts and voucher kept at head office or elsewhere
- Shall be entitled to officer or explanation of such information as he may think necessary for performance of his duties as auditor

Powers of Central Government to Direct Special Audit in certain cases

Under Section 77 where Central Government is of opinion that (SSS) –

- Affairs of any multistate cooperative society are not managed in **sound business principles** or
- Managed in a manner that is likely to cause **serious injury or damage to interest of trade, industry or business to which it pertains**
- Endanger its **solvency**

C.Govt may direct special audit for such period or periods as specified in order

Additional Condition – Central Government shall order for special audit only if Government or State Government wither by itself or both hold 51 % or more of paid up share capital in such multi-state cooperative society

- Special auditor shall make report to Central Government
- On receipt of report central government may take action
- If Central Government, does not take action within 4 months from date of receipt, Government shall send to multi-state cooperative society full or extract of report and circulate it to members or read before members in meeting
- Expenses shall be determined by Central Government
- It shall be paid by multi-state cooperative society, if they fail, it shall be recoverable as arrear of land revenue

Inquiry / Inspection by Central Registrar

- It may on request from –
 1. Federal cooperative to which multi state cooperative society is affiliated or
 2. Creditor or
 3. 1/3rd of members of board or
 4. 1/5th of total no of members of multi state cooperative society
- Hold an inquiry / inspection or direct some other person to hold an inquiry into working and financial condition
- However before holding such inquiry / inspection, 15 days notice must be given to multi state cooperative society

Powers of Person holding Inquiry

- He shall access books, accounts, documents, securities, cash and other properties
- He may tell officers of society to hold general meeting by giving notice of atleast 7 days before meeting, if officers fail, he can call meeting
- Summon any person who is knowledge of affairs of multi state cooperative society to appear before him at any place at headquarters of society or any branch

Communication of Inquiry

- Central Registrar shall within period of 3 months of date of receipt of report, communicate report of inquiry to multi-state cooperative society

CHARTS OF CHAPTER 10

BANK AUDIT

CHAPTER 10 BANK AUDIT

APPOINTMENT & REMUNERATION OF AUDITOR

Appointment of Auditor

1. **Banking Company** – Appointed at the AGM by Shareholders, but prior approval of RBI is needed
2. **Nationalised Bank** – Appointed by BOD of the Bank, but prior approval of RBI is needed
3. **State Bank of India** – Appointed by Comptroller & Auditor General of India in consultation with Central Government
4. **Subsidiaries of SBI** – Appointed by SBI
5. **Regional Rural Banks** – Appointed by Banks concerned with approval of central government

Remuneration of Auditors

In accordance with provisions of Section 142 of Companies Act, 2013

Nationalised Banks & SBI –

Fixed by RBI in consultation with the Central Government

Long Form Audit Report

1. Terms of Appointment of auditors of public sector banks, private sector banks & foreign banks require auditors to furnish a long form audit report.
2. Matters which are to be included in LFAR are specified by RBI
3. LFAR is submitted before 30th June Every Year

Mode of Creation of Security

1. **Mortgage** – It is of 2 types Registered & Equitable Mortgage
2. **Pledge** – Bailment or delivery of goods by borrower to lender bank
3. **Hypotheciation** – Borrower holds possession of goods
4. **Assignment** – Transfer existing / future debt to another person
5. **Set-off** – Combine 2 Accounts of 1 person
6. **Lien** – Gives right to lender to seize and dispose / liquidate asset

Conducting an Audit – Audit of Banks / Branches Involve Following Stages :

1. Initial Consideration by Statutory Auditor

- Declaration of Indebtedness
- Internal Assignments in Banks by Statutory Auditor
- Communication with previous auditor

2. Identifying & Assessing Risk of Material Misstatements

3. Understanding the Bank & its environment including its Internal Control

4. Understand the Bank's Accounting Process

5. Understanding the Risk Management Process

- Oversight & involvement in control process by those charged with Governance

- Identification, measurement and monitoring of risks

- Control Activities

- Monitoring Activities

- Reliable Information System

6. Engagement Team Discussions

7. Establish Overall Audit Strategy

8. Develop Audit Plan

9. Audit Planning Memorandum

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 Assessed Risks

16. Stress Testing

17. Basel III Framework

18. Reliance on / review of other Reports

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CHAPTER 10 BANK AUDIT

BANK AUDIT BASICS

Regulatory Framework

- *Banking Regulation Act , 1949*
- *RBI Act , 1934*
- *Companies Act , 2013*
- *State Bank of India Act , 1955*
- *State Bank of India (Subsidiaries Bank , 1959)*
- *Banking Companies (Acquisition & Transfer of Undertakings) Act , 1970*
- *Regional Rural Banks 1976 ,*
- *IT Act , 2000*
- *Prevention of Money Laundering Act , 2002*
- *Securitization & Reconstruction of Financial Assets & Enforcement of Securities Interest Act , 2002 (SARFAESI)*
- *Credit Information Companies Regulation Act , 2005*
- *Payment & Settlement System Act , 2007*

Peculiarities involved in Bank Audit are :

- Wide Geographical spread of Banks Network
- Huge volumes & complexity of transactions
- Large range of products & services offered
- Extensive use of technology
- Strict vigilance by Banking Regulator

TYPES OF AUDIT REPORTS TO BE ISSUED

1. Statutory Audit Report (SA 700 , 701 , 705 , 706)
2. Long Form Audit Report as per requirements of RBI Schedule
3. Tax Audit Report as per Income Tax Act 1961

Bank Audit Approach

Based on nature and thrust of operations , nature of adverse features , level of compliance of previous reports , and audit risk based on breach of internal controls , audit plan should be drawn out

Following questions should be kept in mind while undertaking / performing control activities

Who

1. Who Performs the control
2. Does the above person have requisite knowledge & authority to perform the control

What

1. What evidence is generated to prove that control is performed

When

1. When & with what frequency is control performed
2. Is frequency enough to prevent or detect and correct Risk of Material Misstatements

Where

1. Where is evidence of control retained
2. How long is it retained
3. Is it available for audit

Why

1. Why is control performed
2. What type of errors are prevented or detected through performance of control

How

1. How is control performed
2. What are control activities
3. Can these activities be bypassed
4. Can the bypass be detected
5. How are deviations handled
6. What is time frame for resolving deviations

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CHAPTER 10 AUDIT OF BANKS

AUDIT OF CLUBS & CHARITABLE INSTITUTION

Audit of Clubs

General

- See Financial Powers of secretary and if they have been exceeded, report specific cases to managing committee

Receipts

Entrance Fees – Vouch entrance fees with members register, counterfoils issued to them

Subscriptions – Vouch members subscription with counterfoils issued to them

- Trace receipts with register of members for selected period
- Reconcile total subscriptions with amount due and outstanding
- Arrears are correctly brought forward from last year
- Arrears are adjusted of current year
- See appropriate steps are taken for recovery
- Amount considered irrecoverable is mentioned in audit report
- Advance are properly accounted for

Pricing for Food Items & Amenities –

- Verify internal checks members are charged for foodstuffs, drinks provided to them as well as guests and special services like billiards, tennis etc
- See debits in register of supplies and services to members and see members account is debited

Payments

- Vouch purchase of sports item, crockery, and trace them with inventory
- Verify purchases of food items, cigars, wines and see sale price charged on them to see, appropriate gross profit margin is earned.
- Unsold goods should be in inventory

Auditor should examine efficiency of internal controls over advances to determine nature, timing & extent of his substantive procedures

- Advance is given after **credit worthiness of borrower** and **sanction from appropriate authority from bank**
- All the **necessary documents** should be there
- **Compliance with terms of sanction & end use of funds**
- **Sufficient margin is there** & it is to be checked at regular intervals by banks
- Securities like **share, debenture** should be **transferred in name of bank**
- All securities **requiring registration** are registered in **name of bank**
- In case of goods in **possession of bank**, **contents of goods** should be **test checked** at time of receipt
- **Drawing power register** should be **updated** monthly based of **value of securities hypothecated**
- Accounts should be within **drawing power & sanctioned limit**

Categories of NPA

1. **Substandard Assets** – Would be one which has remained NPA for a period less than or equal to 12 months – 15 % of Total Amount O/S
2. **Doubtful Assets** – Would be one which has remained in substandard for a period of 12 months

Sub-categories	Secured	Unsecured
• Doubtful upto 1 year	25 %	100 %
• Doubtful 1 to 3 years	40 %	100 %
• Doubtful more than 3 years	100 %	100 %

3. **Loss Asset** – Which has been identified by Bank or external auditors or RBI inspection, but amount has not been written off wholly – 100 % of Total Amount O/S

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CHAPTER 10 BANK AUDIT

AUDIT OF ADVANCES – PART 2

Non-Performing Assets

- An Asset becomes NPA when it ceases to generate income for Bank.
 - NPA is an loan or advance when –
1. Interest &/ or Instalment of principal remain overdue for a period of more than 90 days in respect of term loan
 2. In respect of CC / OD when it is out of order for more than 90 days
 3. Bill remains overdue for a period of more than 90 days in case of bills purchased & discounted

When is it out of order ?

1. When amount withdrawn is more than sanctioned limit / drawing power or
2. When there are no credits or
3. When credits are not enough to cover the Interest debited during same period

Computation of Drawing Power

- Accounts which exceed drawing power & sanctioned limit should be brought to notice of management / head office regularly
- Drawing power is arrived based on current stock statement
- However large borrowers, don't submit stock statements regularly, so their stock statement should not be older than 3 months.
- If account is based on drawing power calculated from stock statements older than 3 month it deemed as irregular

NPA for Agricultural Advances – Crop season is time taken from sowing to harvesting

Short Duration Crops

- Crop Season is less than 1 year
- It is NPA, if Instalment or Principal is overdue for more than 2 crop seasons

Long Duration Crops

- Crop Season is more than 1 year
- It is NPA, if Instalment or principal is overdue for more than 1 crop season

Accounts where there is Erosion in Value of Security / Frauds done

- If value of security falls less than 50 % of value assessed by bank, such NPA's may be straight away classified under **doubtful category** & provisioning should be made as applicable to doubtful assets
- If realisable value of security falls less than 10 %, it will be classified as **loss asset**. It may be **written off** or **fully provided for by banks**

ACCOUNTS REGULARISED NEAR ABOUT B/S DATE

- Asset classification of borrower **where few credits are recorded before B/S Date should be handled with care** & account should be **deemed as NPA**
- Central Government Advances where guarantee is not revoked / repudiated would be classified as Standard Assets, but their income of those Advances will still be booked on cash basis, though these are standard assets. Because these are treated as standard assets because of guarantee by central government

Advances against term Deposits . NSC , KVP , IVP etc

- Advances against all these eligible for surrender & life policies need **not to be treated as NPAs**, **provided adequate margin is available** on accounts. After margin is not available it will be treated as NPA's

Advances Against Consortium –

It should be based on record of recovery of individual member banks, if all money is paid to lead bank and lead banks do not pay to member banks.

Advances to Bank Staff

- ✓ Classification of NPA is based on record of recovery
- ✓ Availability of security or net worth of borrower should not be considered for NPA
- ✓ Asset Classification should be borrower wise and not facility wise

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Stock audit shld be carried out by bank for all A/c's if exposure is greater than 5 crore
CC/OD

AUDIT APPROACH & PROCEDURES FOR INCOME ACCOUNTS

Audit Approach and Procedures for Income Accounts

- **Reasonable Assurance** – In carrying out audit of income, **auditor is primarily concerned with obtaining reasonable assurance that income** took place from transactions in relevant period, income is recorded in proper amount, period and proper account
- **Accrual Basis** – RBI has advised any income exceeds –
 1. 1 % of **total income of the banks**, it **income is taken on gross basis or**
 2. 1 % of **net profit**, if income is taken **net of costs**, should be considered as per AS 9
- **Cash Basis** – Any income other than above norms, may be **recognised when it is received or accrual**
- **Income on NPA** – It is **not recognised until it is actually received**
- **Reversal of Income** – When a credit facility became NPA for the 1ST Time, all Interest accrued and credited for previous period should be reversed. It will also apply to Government Guaranteed accounts also
- **Advances against Term Deposit, KVP, IVP, Life Policies** – May be taken to **income account till adequate margin is available**
- **Bills Purchased** – **Outstanding at close of year**, the discount received thereon should be apportioned between the years
- **Bills for Collection** – Only commission should be **booked after paying to customer on whose behalf money was collected**
- **Re-negotiation** – **Fees and commission** should be recognised on **accrual basis** over period of time
- **Test checks Interest earned** by Banks for sample items in respect of all loans

Schedules of income & expense accounts

- *Schedule 13 Interest Earned*
- *Schedule 14 Other Income*
- *Schedule 15 Interest Expended*
- *Schedule 16 Operation Expenses*

Partial Recoveries in NPA's

- Whenever Partial recoveries are there, we will recognise **income as per AS – 9 and for past period amount not recognised will be accounted.**
- However **we need to ensure credits are not out of fresh / additional facilities sanctioned to borrowers**
- **Memorandum Account** – On NPA, bank will reverse all Interest, but still may keep record in Memorandum account for their control purpose

AUDIT APPROACH FOR EXPENSE ACCOUNTS

Audit Approach for Expenses

- In carrying out audit of Interest Expense auditor is concerned with **overall reasonableness of interest expense** by **analysing ratios of interest paid of different types of deposits** and borrowings to average quantum of liabilities during the year
- Analyse various types of deposits O/S at year end , auditor may **carry out weighted average interest rate** and see and **compare Interest with Actual interest** and inquire into difference , if material
- Auditor should **compare Average rate of interest paid with corresponding deposits for previous years to analyse material differences**. He can also compare Interest month wise
- Auditor should **test check on reasonable basis :**
 1. Interest is provided on all **deposits upto date of the B/S** , and verify whether there is any excess or short credit of material amount
 2. **Interest rates are in accordance with bank's internal regulations** of the RBI directives
 3. In case of FD , **Interest rate is as per FD Certificate**
 4. **Interest on savings Account should be test checked** in accordance with rules framed by bank in this behalf
 5. Interest **on inter-branch balances** have been provided at the **rates prescribed by head office**
 6. Interest on **overdue / matured deposits** are provided for

For Audit of Operating Expenses

1. Auditor should **evaluate system of internal control relating to expenses** to determine nature , timing and extent of other audit procedures
2. Auditor should see **Trends in respect of major items of expenditure**
3. Expenses should also be analysed on **month on month basis**
4. Verify **expenses with documents evidencing purchase / debit note received**
5. Compare **reasonableness of expenses by comparing it with previous period**

Disclosure of Prior Period items

- In format of P/L it does not specifically provide for disclosure of Prior Period items in current years profit and loss , such disclosures should be done if needed

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CHARTS OF CHAPTER 11

ETHICS & TERMS OF ENGAGEMENT

CHAPTER 11 ETHICS & TERMS OF ENGAGEMENT

ELEMENTS OF SYSTEM OF QUALITY CONTROL

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

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

Leadership Responsibilities for Quality of Audit

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

The Fact that quality is essential in performing audit engagements

Ethical Requirements relating to an Audit of Financial Statements

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

Integrity

Confidentiality

Objectivity

Professional Competence & Due Care

Professional Behaviour

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

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

Threats to Independence (SAIF)

Self Interest Threat – Occur when firm , its partner or associate could benefit from financial Interest in client .

Self Review Threat – Review of any Judgement or conclusion reached in previous audit .

Advocacy Threats – Promoting Client's opinion to a point , where people believe objectivity is getting compromised

Intimidation Threat – Threat of replacement over disagreements with application of accounting principles or reduce work in response to reduced fees

Familiarity Threat – Auditors are too sympathetic to client's interests

Safeguards to Independence

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

Acceptance & continuance of client relationships & audit engagements

SQC 1 requires that firm obtains information before accepting Engagement

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

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

CHAPTER 11 ETHICS & TERMS OF AUDIT ENGAGEMENT

ELEMENTS OF SYSTEM OF QUALITY CONTROL – Part 2

Engagement Performance

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

Through Policies & Procedures –

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

Human Resources

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

Policies & Procedures should Address Following Personnel Issues

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

Monitoring

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

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

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

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CHAPTER 11 ETHICS & TERMS OF ENGAGEMENT

SA-210 Agreeing the Terms of Engagement

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

The terms of Audit Engagement shall include –

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

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

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

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

Limitation on Scope Prior to Audit Engagement Acceptance

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

Acceptance of a change in engagement

Auditor before completion of Engagement is requested to change the Engagement

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

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

Recurring Audits

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

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

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

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SQC 1 QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS & REVIEWS OF HISTORICAL FINANCIAL INFORMATION

DIFFERENCE BETWEEN SQC 1 & SA 220 Firms System of Quality Control

SQC 1

- Deals with all Engagements including Audit , reviews & other assurance & related service engagements
- Applies to Entire Firm

SA 220

- Applies to Audit Engagements Only
- Applies to Particular Audit Engagement

Firm should Establish System of Quality Control to provide with reasonable assurance that firm comply with Professional Standards & legal & regulatory requirements

It includes –

- Leadership Responsibilities for Quality Within the Firm
- Ethical Requirements
- Acceptance & Continuance of Client Relationships & Specific Engagements
- Human Resources
- Engagement Performance
- Monitoring

Leadership Responsibilities for Quality within the Firm

- SQC 1 requires firm should establish Policies & Procedures to promote an internal culture based on recognition that quality is essential in performing engagements
- Managing Partner is responsible for Firm's System of Quality Control
- Further Persons assigned operational responsibilities within firm should have experience , ability & necessary authority to assume that responsibility

Monitoring

The firm should ensure that **policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with** in practice. Such policies and procedures should include an **ongoing consideration and evaluation of the firm's system of quality control**, including a periodic inspection of a selection of completed engagements.

Ethical Requirements

Firm should establish Policies & Procedures so firm & its team comply with ethical requirements contained in code of ethics issued by ICAI

Such Policies & Procedures enable firm to –

1. Communicate its Independence Requirements to its personnel
2. Identify & Evaluate Relationships that create threats to Independence and take appropriate action to eliminate threats or reduce them to acceptable level by applying safeguards

- Atleast Annually firm should take written confirmation from it's team regarding compliance with policies & procedures on Independence

Acceptance & Continuance of Client Relationship & Audit Engagement

If there is any conflict between firm & client , it should be properly resolved before accepting engagement

Policies & Procedures should include consideration of –

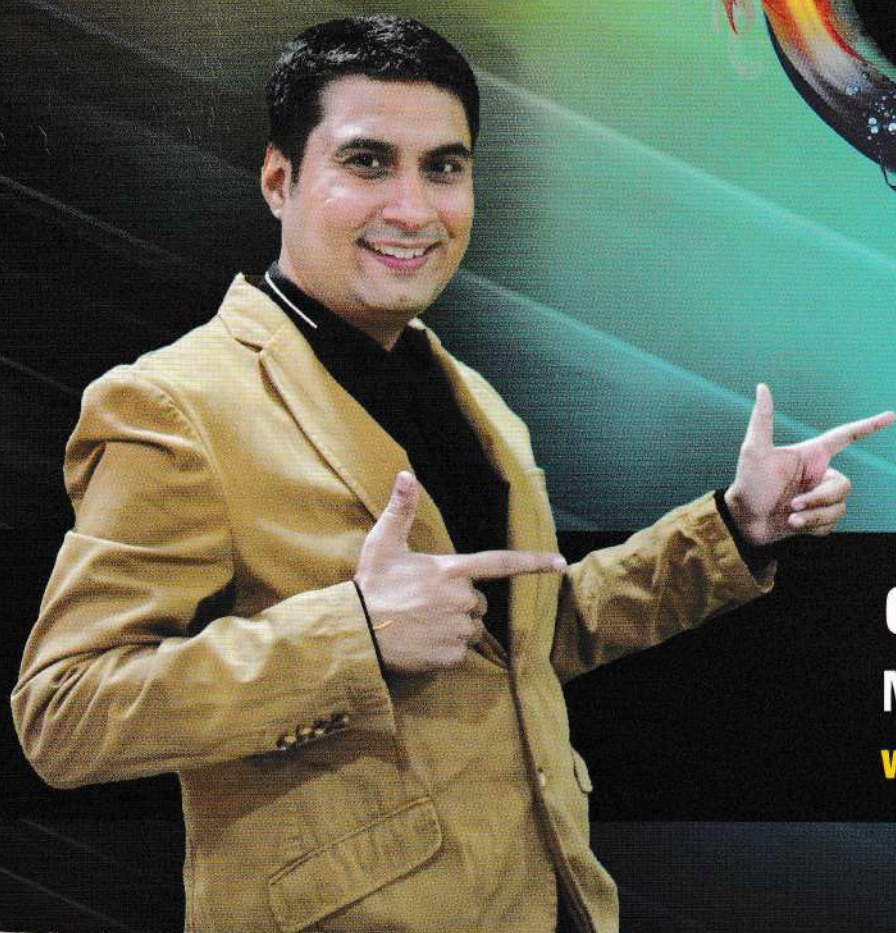
1. Professional & Legal responsibilities that apply to the circumstances , including whether there is requirement for firm to report to persons or person who made the appointment &
2. Possibility of withdrawing from the Engagement or from both the engagement & client relationship

Human Resources –

Firm should establish Policies & Procedures to provide reasonable assurance , that it has personnel with capability , competence & commitment to ethical principles necessary to perform its engagements

Such Policies & Procedures include –

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



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