

# Background Material for Audit Training Workshops and Seminars

*(A Manual of Presentations on Standards  
on Auditing and Other Engagement Standards)*

**(1st July, 2014)**



**The Institute of Chartered Accountants of India**

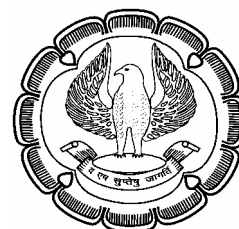
*(Set up by an Act of Parliament)*

**New Delhi**

# Background Material for Audit Training Workshops and Seminars

*(A Manual of Presentations on Standards on Auditing &  
Other Engagement Standards)*

**This Background Material is intended for use at the audit training workshops and seminars/conferences, etc., on auditing organised by the Institute of Chartered Accountants of India.**



**Auditing and Assurance Standards Board**  
**The Institute of Chartered Accountants of India**  
*(Set up by an Act of Parliament)*  
**New Delhi**

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## FOREWORD

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Engagement and Quality Control Standards issued by the Auditing and Assurance Standards Board under the authority of the Council of the Institute of Chartered Accountants of India codify the best practices to be followed by the members in various audits, reviews, and other assurance engagements undertaken by them. These Standards are the performance benchmarks for the members. It is therefore essential that the members understand and implement these Standards appropriately in their engagements.

I am happy that the Auditing and Assurance Standards Board is focusing its efforts not only on developing the Standards but also undertaking various measures to create awareness about these Standards among the members like organizing awareness programs on Standards across the country, issuing Implementation Guides to Standards, conducting E-learning on Standards on Auditing. I am happy that the Board has brought out this Revised 2014 edition of the publication, *'Background Material for Audit Training Workshops and Seminars'*. The simplicity and lucidity with which each of the Standards has been explained by way of power point slides, the technical posers, the case studies, documentation requirements in various standards, make the Background Material a really useful publication..

At this juncture, I wish to place my appreciation for CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board of ICAI for his proactive initiatives to bring out various publications for the guidance of the members.

I urge the members to make fullest use of this Background Material. I am sure that the members will find the publication useful.

June 26, 2014  
New Delhi

**CA. K. Raghu**  
President, ICAI

# PREFACE

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Auditing and other engagement Standards issued by the Auditing and Assurance Standards Board under the authority of the Council of the Institute of Chartered Accountants of India are a codification of the best practices in the field of auditing, review and other assurance engagements undertaken by the members. These Standards are benchmarked against the globally accepted International Standards issued by the International Auditing and Assurance Standards Board (IAASB) of International Federation of Accountants (IFAC). Just as the issuance of such Standards by the Institute is important and inevitable, it is equally important that these Standards, to be able to really contribute to the goal of serving the public interest by the members, are appropriately understood and implemented by them.

Having created a strong knowledge base of more than 40 new/ revised globally benchmarked Standards, taking these Standards to the members and helping them in understanding and implementing these Standards in real practice is obviously the next logical step by the Auditing and Assurance Standards Board. While a number of awareness programmes on auditing Standards are being organised by the Board which are supported by experienced faculties, this Background Material is an important resource material for such programmes.

This Revised 2014 edition of the Background Material contains an overview of Engagement and Quality Control Standards, the structure and numbering pattern of Standards, crisp power point slides on Standards accompanied by notes, a compilation of documentation requirements in various Standards, technical posers and case studies on auditing. The Background Material, therefore, I feel, makes a very useful one stop concise reference point for understanding the Standards though, I may also caution that it is in no way a substitute for the authoritative text of the Standards issued by the Institute.

At this juncture, I wish to express my sincere gratitude to CA. K. Raghu, President, ICAI and CA. Manoj Fadnis, Vice President, ICAI for their constant support to the initiatives undertaken by the Auditing and Assurance Standards Board for creating awareness among the members about auditing standards. I also wish to express my sincere thanks to all my colleagues at the Council as well as the Auditing and Assurance Standards Board who have been taking active interest in and providing a strong support as organisers and speakers for these programmes.

I am sure that like its previous editions, this edition of the Background Material too would prove to be immensely useful.

June 25, 2014  
Kolkata

**CA. Abhijit Bandyopadhyay**  
Chairman,  
Auditing and Assurance Standards Board

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## **NOTE TO THE READERS**

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The contents of this Background Material are not authoritative. Readers are requested to refer the authoritative text of the Standards and/or Guidance Notes, etc., issued by the Institute and referred to in this Background Material. The Institute does not accept any responsibility for any action taken by the readers on the basis of the contents of this Background Material.

**This Background Material is intended for use at the audit training workshops and seminars/conferences, etc., on auditing organised by the Institute of Chartered Accountants of India.**

# Overview of Engagement and Quality Control Standards\*

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## What are Engagement and Quality Control Standards?

1 In the simplest terms, Standards represent a codification of the best practices in the various types of assurance and non-assurance engagements undertaken by the members. Standards, therefore, are the performance benchmarks for the members in public practice. The term "Engagement Standards" is an umbrella term which comprises the following categories of Standards issued by the ICAI:

Standards on Auditing (SAs) : To be applied in audit of historical financial information.

Standards on Review Engagements (SREs) : To be applied in review of historical financial information.

Standards on Assurance Engagements (SAEs) : To be applied in assurance engagements, other than audits and reviews of historical financial information.

Standards on Related Services (SRSs) : To be applied to engagements involving application of agreed upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

Standards on Quality Control issued by ICAI are to be applied (at the firm level) for all the services covered by the Engagement Standards as described above.

2. Engagement Standards, therefore, contain guidance for the members on how they should carry out their engagements, enshrined as the basic principles and essential procedures to apply those basic principles that relates to judgment or behaviour. Standards are framed to ensure integrity and quality in the professionals' work, essential for ensuring the confidence of the society in the financial information being reported by the business enterprises.

## Need for Standards

3. Formulation of Standards, worldwide, including India, entails consideration of important factors such as existing and accepted auditing practices, existing laws and regulations, usage and customs of trade and commerce, fundamental financial reporting principles, expectations of the society from the auditors. Standards therefore play critical role in:

- Ensuring application of accepted financial reporting standards thereby lending credibility and wider acceptability to the financial statements.
- Providing benchmarks against which the performance of the members can be measured and evaluated at global level also.

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\* Earlier known as Auditing and Assurance Standards (AAS).

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- Ensuring compliance with the applicable legislative and regulatory framework.
- Ensuring right approach of the professionals in complex/ emerging areas of engagements.
- Ensuring consistency and quality in the work performed by the professionals.

### **Features of an Effective Standard**

4 A Standard, to be really effective, should be founded on the principles and ground realities, should be easy to understand, should have universal acceptance and should be reasonably flexible to permit application in all types of situations and importantly, amenable to enforcement. In addition, a Standard should not be perceived by the society as being overly protective of the member but as being in the best interests of the users of his/ her services. Hence, the Standards-setting process should be objective and transparent, giving fair representation to the concerned stakeholders.

### **Standard-setting in India**

5 The Engagement and Quality Control Standards in India are formulated by the Auditing and Assurance Standards Board (AASB) of the Institute of Chartered Accountants of India. The Standards formulated by the AASB are issued under the authority of the Council of the Institute and are mandatory in nature. This implies that while carrying out their attest functions, it will be the duty of the members of the Institute to comply with these Standards. If for any reason a member has not been able to perform an audit in accordance with the applicable Standards, his report should draw attention to the material departures therefrom.

### **New Format of Presenting the Standards**

6 In line with the format adopted by the IAASB under its Clarity Project, the Revised Preface provides that instead of a running text, the Standards would now contain two distinct sections, one, the *Requirements* section and, two, the *Application and Other Explanatory Material* section.

### **Requirements Section**

7 The fundamental principles of the Standard are contained in the Requirements section and represented by use of "shall". Hitherto, the word, "should" was used in the Standards, for this purpose. Further, this format also does away with the need to present the principles laid down by the Standard in bold text.

### **Application and Other Explanatory Material**

8 The application and other explanatory material contained in a Standard are its integral part as they provide further explanation of, and guidance for carrying out, the requirements of a Standard, along with the background information on the matters addressed in the Standard. These may include examples of procedures, some of which the auditor may judge to be appropriate in the circumstances. Such guidance is, however, not intended to impose a requirement.

### **Numbering Pattern of Standards**

9 The provisions of the Revised Preface, coupled with the difficulties otherwise being faced by the Board in writing Standards on the conventions followed by the IAASB, necessitated the need to adopt a new numbering pattern for the auditing standards. Prior to 2007, the auditing standards were being allotted sequential numbers

as and when they were issued. Under the Revised Preface, however, these Standards have been categorised on the basis of the specific aspect that they deal with and accordingly allotted the number from that category. These categories are as follows:

<b>Category</b>	<b>Number Series</b>
<b>Standards on Quality Control (SQC)</b>	<b>01–99</b>
<b>Standards on Auditing (SAs)</b>	<b>100-999</b>
Introductory Matters	100 – 199
General Principles and Responsibilities	200 – 299
Risk Assessment and Responses to Assessed Risks	300 – 499
Audit Evidence	500 – 599
Using Work of Others	600 – 699
Audit Conclusions and Reporting	700 – 799
Specialised Areas	800 – 899
<b>Standards on Review Engagements (SREs)</b>	<b>2000–2699</b>
<b>Standards on Assurance Engagements (SAEs)</b>	<b>3000–3699</b>
<b>Standards on Related Services (SRSs)</b>	<b>4000-4699</b>

A list of Standards on Auditing (SAs) issued by AASB is given in **Annexure 1**. Also given in **Annexure 2** is the diagrammatic representation of the structure of Standards issued by AASB.

### List of Standards on Auditing (SAs) issued by AASB

**NOTE:** Effective date means that the SA is effective for audits of the financial statements for periods beginning on or after the specified date

SA number  (100-999)	Title of Standard on Auditing	Published in Journal	Effective Date			
			April 1, 2008	April 1, 2009	April 1, 2010	April 1, 2011
100-199	Introductory Matters					
200-299	General Principles and Responsibilities					
200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	March, 2010			√	
210	Agreeing the Terms of Audit Engagements	September, 2009			√	
220	Quality Control for an Audit of Financial Statements	March, 2010			√	
230	Audit Documentation	January, 2009		√		
240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	December, 2007		√		
250	Consideration of Laws and Regulations in An Audit of Financial Statements	December, 2008		√		
260	Communication with Those Charged with Governance	December, 2008		√		

## Overview of Engagement and Quality Control Standards

265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	September, 2009			√	
299	Responsibility of Joint Auditors	Effective for all audits related to accounting periods beginning on or after April 1, 1996				
300-499	Risk Assessment and Response to Assessed Risks					
300	Planning an Audit of Financial Statements	December, 2007	√			
315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment	February, 2008	√			
320	Materiality in Planning and Performing an Audit	August, 2009			√	
330	The Auditor's Responses to Assessed Risks	February, 2008	√			
402	Audit Considerations Relating to an Entity Using a Service Organisation	August, 2009			√	
450	Evaluation of Misstatements Identified during the Audit	August, 2009			√	
500-599	Audit Evidence					
500	Audit Evidence	April, 2009		√		
501	Audit Evidence - Specific Considerations for Selected Items	March, 2010			√	

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505	External Confirmations	March, 2010			√	
510	Initial Audit Engagements—Opening Balances	March, 2009			√	
520	Analytical Procedures	March, 2010			√	
530	Audit Sampling	February, 2009		√		
540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	February, 2009		√		
550	Related Parties	March, 2009			√	
560	Subsequent Events	January, 2009		√		
570	Going Concern	December, 2008		√		
580	Written Representations	October, 2008		√		
<b>600-699</b>	<b>Using Work of Others</b>					
600	Using the Work of Another Auditor	Effective for all audits related to accounting periods beginning on or after April 1, 2002				
610	Using the Work of Internal Auditors	August, 2009			√	
620	Using the Work of an Auditor's Expert	March, 2010			√	

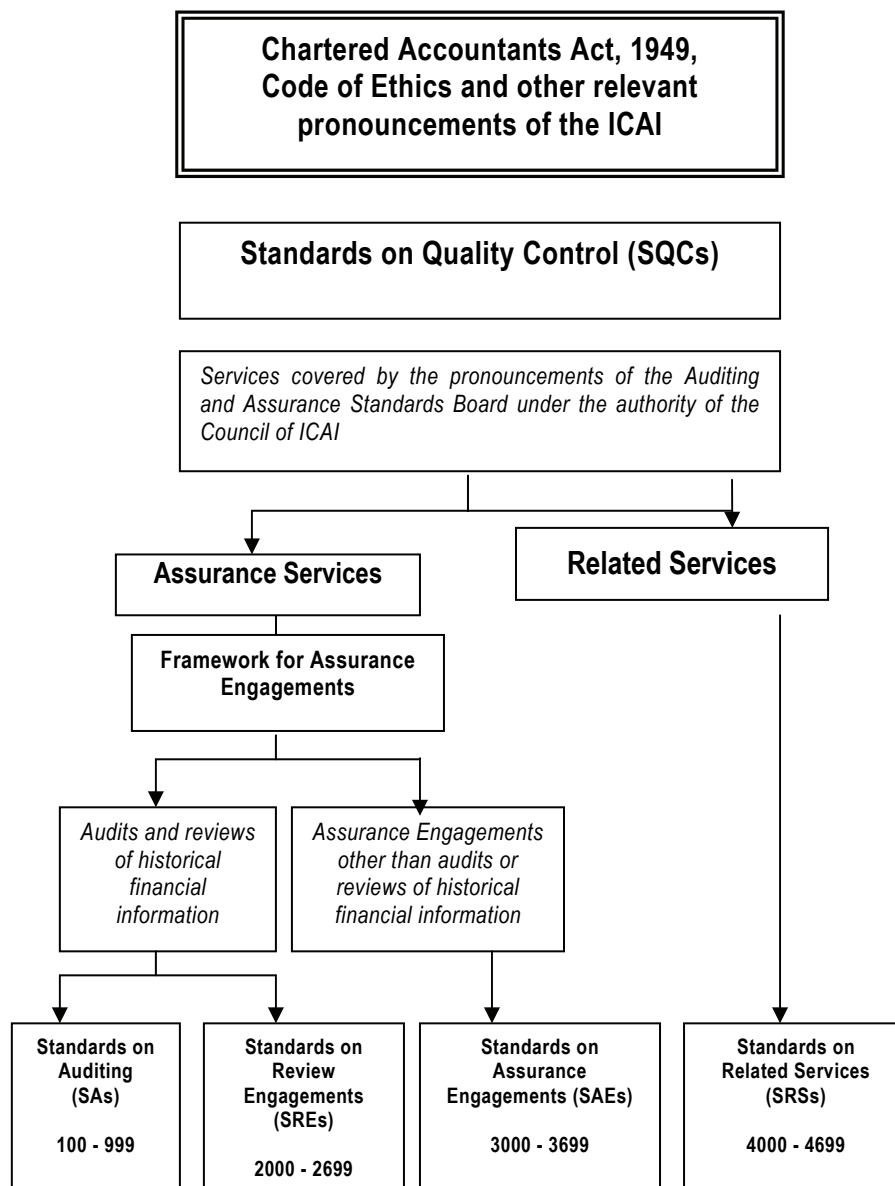
## Overview of Engagement and Quality Control Standards

<b>700-799</b>	<b>Audit Conclusions and Reporting</b>					
700 <sup>1</sup>	Forming an Opinion and Reporting on Financial Statements	February, 2010				√
705	Modifications to the Opinion in the Independent Auditor's Report	February, 2010				√
706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	February, 2010				√
710	Comparative Information - Corresponding Figures and Comparative Financial Statements	April, 2010				√
720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements	April, 2009			√	
<b>800-899</b>	<b>Specialized Areas</b>					
800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework	April, 2010				√
805	Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement	April, 2010				√
810	Engagements to Report on Summary Financial Statements	April, 2010				√

<sup>1</sup> The Council of the ICAI, in partial modification of the decision taken by it at its 291<sup>st</sup> meeting held in December 2009, has decided that the effective date/applicability of the three standards viz SA 700, SA 705 and SA 706 be postponed by one year and consequently the said Standards shall now be effective/applicable for audits of financial statements for periods beginning on or after 1<sup>st</sup> April, 2012 (instead of audits of financial statements for periods beginning on or after 1<sup>st</sup> April, 2011 as was earlier decided).



## Structure of Standards Issued By AASB under the Authority of the Council of ICAI



**Part - I**

**Presentations**

## **An Overview of Engagement and Quality Control Standards**

- ❖ **Standards on Quality Control (SQC)**

- ❖ **Framework for Assurance Engagements**

- ❖ **Engagement Standards**

- 100 – 999 Standards on Auditing(SAs)
  - 100 – 199 : Introductory Matters
  - 200 – 299 : General Principles & Responsibilities
  - 300 – 499 : Risk Assessment & Response to Assessed Risks
  - 500 – 599 : Audit Evidence
  - 600 – 699 : Using Work of Others
  - 700 – 799 : Audit Conclusions & Reporting
  - 800 – 899 : Specialised Areas
- 2000 – 2699 : Standards on Review Engagements (SREs)
- 3000 – 3699 : Standards on Assurance Engagements (SAEs)
- 4000 – 4699 : Standards on Related Services (SRSs)

# **Standards on Quality Control (SQC)**

**Standard on Quality Control (SQC) 1**  
**Quality Control for Firms that Perform Audits & Reviews of**  
**Historical Financial Information, and Other Assurance**  
**& Related Services Engagements**

*Effective for all Engagements relating to accounting period beginning on  
or after April 1, 2009*

**Objective**

- ❖ Firm's responsibility for its system of quality control for:
  - audits and reviews of historical financial information.
  - Other assurance and related services engagements.

**Note:**

**Quality control responsibility of firm personnel for specific engagements set out in other Standards, e.g., SA 220.**

SQC 1

### **Parameters**

- ❖ The Chartered Accountants Act, 1949.
- ❖ Code of Ethics.
- ❖ Other relevant pronouncements of ICAI.
- ❖ Other relevant legal/regulatory requirement.

**Collectively known as “the CODE”.**

**SQC 1**

### **System of Quality Control**

All firms to have system of quality control that provides reasonable assurance that:

- Firm & personnel comply with professional standards, regulatory & legal requirements.
- Reports issued by firm or partners are appropriate in the circumstances.

**SQC 1**

- ❖ SQC applies to all firms.
- ❖ The nature of the policies and procedures developed by individual firms to comply with SQC will depend on various factors:
  - Size and operating characteristics of the firm.
  - Whether it is part of a network.

## Definitions

<ul style="list-style-type: none"> <li>• Engagement documentation</li> <li>• Engagement partner</li> <li>• Engagement quality control review</li> <li>• Engagement quality control reviewer</li> <li>• Engagement team</li> <li>• Firm</li> <li>• Inspection</li> <li>• Listed entity</li> </ul>	<ul style="list-style-type: none"> <li>• Monitoring</li> <li>• Network firm</li> <li>• Network</li> <li>• Partner</li> <li>• Personnel</li> <li>• Professional standards</li> <li>• Reasonable assurance</li> <li>• Staff</li> <li>• Suitably qualified external person</li> </ul>
--	--

**SQC 1**

## Definitions Explained

### **Engagement Documentation:**

Record of:

- work performed.
- results obtained.
- conclusions reached.

*Assembled for each engagement in Engagement File.*

### **Engagement Partner:**

- ❖ Partner or other person in firm.
- ❖ Is a member of ICAI, in full time practice.
- ❖ Is responsible for engagements & its performance.
- ❖ Is responsible for report issued.
- ❖ Or has appropriate authority from professional/ legal/ regulatory body.

**SQC 1**

## **Definition Explained**

### **Engagement QC Review:**

Process:

- **To** provide objective evaluation.
- **Before** report is issued.
- **For** significant judgments & conclusions of engagement team.
- **In** formulating report.

### **Engagement QC Reviewer:**

- ❖ Partner/ other person in firm/ suitably qualified external person/ team.
- ❖ With sufficient & appropriate experience & authority.
- ❖ To objectively evaluate significant judgments/ conclusions of engagement team.
- ❖ Before report is issued.
- ❖ "QC team" to be led by CA, who is a member of ICAI.

**SQC 1**

## **Definition Explained**

### **Engagement Team:**

- ❖ All personnel performing the engagement.
- ❖ Includes outside experts contracted for that engagement.

**Firm:**

- ❖ Sole practitioner.
- ❖ Partnership.
- ❖ Any other such entity of professional accountants permitted by law.

**SQC 1**



## **Definition Explained**

### **Inspection:**

- ❖ For completed engagements.
- ❖ Procedures:
  - Applied on audit engagement team.
  - Evidence of compliance with firm's quality control policies/ procedures.

### **Listed Entity:**

- ❖ Stocks/ shares/ debt quoted on:
  - Recognised stock exchange, or
  - Marketed under regulation of recognised stock exchange/ equivalent body.

**SQC 1**

## **Definition Explained**

### **Monitoring:**

- ❖ *What* – A process.
- ❖ *About* – consideration & evaluation of firm's QC system:
  - Periodic inspection of selected completed engagements.
- ❖ *Why* – get reasonable assurance of operating effectiveness of QC system.

### **Network Firm:**

- ❖ A firm or entity that belongs to a network.

### **Network:**

- ❖ A large structure:
  - Aimed at cooperation, and
  - Clearly aimed at profit/cost-sharing or shares common ownership/control/management etc.

**SQC 1**

### **Definition Explained**

**Partner:**

- ❖ Any individual.
- ❖ Authority to bind the firm w.r.t. performance of professional service engagement.

**Personnel:**

- ❖ Partners.
- ❖ Staff.

**Professional Standards:**

- ❖ Engagement Standards as defined in revised Preface.
- ❖ Relevant ethical requirements.

**SQC 1**

### **Definition Explained**

**Reasonable Assurance:**

- ❖ High but not absolute level of assurance.

**Staff:**

- ❖ Professionals other than partners employed by firm.
- ❖ But includes experts.

**Suitably Qualified External Person:**

- ❖ Individual outside the firm.
- ❖ Capabilities & competence to act as engagement partner.
- ❖ E.g. Partner/ employee of another firm with appropriate experience.

**SQC 1**

## **Elements of SQC**

- ❖ Leadership responsibilities for QC.
- ❖ Ethical requirements.
- ❖ Client acceptance/ continuance.
- ❖ Human resources.
- ❖ Engagement performance.
- ❖ Monitoring.

**SQC 1**

- ❖ Document QC policies & procedures.
- ❖ Communicate to all firm personnel:
  - Description of QC policies.
  - Objectives to be achieved therefrom.
  - All responsible for quality.
  - All expected to comply.
- ❖ Obtain feedback on QC system from personnel.

**SQC 1**

## **I. Leadership Responsibilities for QC**

- ❖ Firm to design policies/ procedures.
- ❖ To promote internal culture:
  - Quality is essential in engagements.
  - Work to comply with professional standards, regulatory/ legal requirements.
  - Issue reports appropriate in circumstances.
- ❖ Require CEO/ managing partner to assume ultimate responsibility for QC.
- ❖ Recognise & reward high quality work.

**SQC 1**

- ❖ Communication, e.g.:
  - Training seminars/ Meetings.
  - Formal/ informal dialogues.
  - Mission statements/ Newsletters.
- ❖ Incorporated in:
  - Firm's internal documentation/training material.
  - Appraisal documents of personnel.
- ❖ Leaders to recognise quality precedes business objectives:
  - Assign management responsibilities appropriately.
  - HR policies to demonstrate firm's QC commitment.
  - Sufficient resources for development, documentation & support of QC policies & procedures.
- ❖ Person delegated the QC responsibility by CEO/ Managing partner to have sufficient appropriate experience & ability, & necessary authority to assume responsibility.

**SQC 1**

- ❖ Person delegated the QC responsibility:
  - Experience—identity, understand QC issues and develop appropriate policies and procedures.
  - Authority—enable implementation of policies.

## II. Ethical Requirements

- ❖ Establish policies & procedures → reasonable assurance.
- ❖ Firm & personnel comply with relevant ethical requirements.
- ❖ Fundamental ethical principles:
  - Integrity.
  - Objectivity.
  - Professional competence & due care.
  - Confidentiality.
  - Professional behaviour.

**SQC 1**

- Fundamental principles enforced by:
  - Leadership of the firm.
  - Education & training.
  - Monitoring.
  - Process for dealing with non-compliance.
- Ethical requirements enshrine **INDEPENDENCE**.

**SQC 1**

## **Independence**

- ❖ Establish policies & procedures → reasonable assurance that:
  - Maintenance of independence by relevant personnel.
  - Firm notified of breaches of independence requirements.
- ❖ Policies & procedures should enable:
  - Communication of independence requirements to personnel & others.
  - Identification & evaluation of circumstances/ relationships threatening independence.
  - Take appropriate action for elimination/ reduction of threats/ withdrawal from engagement.
  - Resolution of breaches of independence.

**SQC 1**

Policies / procedure should require:

Maintenance of independence of personnel	Breach of independence
<ul style="list-style-type: none"> <li>Engagement partners to provide firm with relevant information about client.</li> <li>Prompt notification of threats to independence.</li> <li>Accumulation &amp; communication of relevant information to appropriate personnel.</li> </ul>	<ul style="list-style-type: none"> <li>All subjected to independence to promptly notify breach of independence.</li> <li>Prompt communication of identified breaches.</li> </ul>

### SQC 1

- ❖ **Partners to provide full information to firm about client engagements:**
  - This helps the firm to evaluate overall impact, if any, on independence requirements.
- ❖ **Personnel to promptly notify threats to independence to firm:**
  - This enables the firm to take appropriate action.
- ❖ **Accumulate & communicate relevant information** to appropriate personnel:
  - The firm and its personnel can readily determine whether they satisfy independence requirements;
  - The firm can maintain and update its records relating to independence; and
  - The firm can take appropriate action regarding identified threats to independence.
- ❖ **Prompt communication of identified breaches:**
  - to the **engagement partner** who, with the firm, needs to address the breach;
  - to **other relevant personnel** in the firm and those subject to the independence requirements who need to take appropriate action; and
  - to the **firm**, if necessary, by the engagement partner and the other individuals referred to in the previous bullet of the actions taken to resolve the matter, so that the firm can determine whether it should take further action
- ❖ **Appropriate action:**
  - Applying appropriate safeguards to eliminate the threats to independence or to reduce them to an acceptable level.
  - Withdrawing from the engagement.
  - Independence education to personnel who are required to be independent.

- ❖ Annual written confirmation as to compliance with independence requirements.
- ❖ Familiarity threat:
  - Created by using same senior personnel on assurance engagements.
  - Create policies & procedures:
    - Criteria for need for safeguards to reduce familiarity threat.
    - Audit of FS of listed entities – rotation of engagement partner – at least every 7 years.

**SQC 1**

**Written Confirmations**

- Paper/electronic form.
- If indicating non-compliance, demonstrate the importance of independence to all its personnel.

**Factors to consider in setting criteria:**

- Nature of engagement.
- Public interest involved.
- Length of service of senior personnel on the engagements.

**Examples of safeguards:** rotating senior personnel/ requiring an engagement QC review.

### **III. Client Acceptance & Continuance**

- ❖ Establish policies/ procedures ➔ reasonable assurance that clients are accepted/ continued only where:
  - Client integrity has been considered & no information that would lead to conclude that client lacks integrity:
  - Firm competent to perform engagement – capability, time & **resources**.
  - Can comply with ethical requirements.
- ❖ Document how issues were resolved.

**SQC 1**



Significant matters to consider (examples):

<b><i>Client integrity</i></b>	<b><i>Firm capabilities</i></b>	<b><i>Ethical issues</i></b>
<ul style="list-style-type: none"> <li>• Identity / reputation of owners / key management / related parties.</li> <li>• Nature of operations.</li> <li>• Attitude of owners / governing body towards internal controls.</li> <li>• Aggressive towards maintaining firm's fee as low as possible.</li> <li>• Indication of inappropriate scope limitation.</li> <li>• Indication of inappropriate scope limitation.</li> <li>• Indications of money laundering.</li> <li>• Non continuance of previous auditors.</li> </ul>	<ul style="list-style-type: none"> <li>• Industry knowledge among personnel.</li> <li>• Experience of relevant regulatory/reporting requirements.</li> <li>• Ability to gain necessary skills.</li> <li>• Availability of experts.</li> <li>• Availability of individuals fulfilling the criteria.</li> <li>• Ability to complete engagement within reporting deadline.</li> </ul>	<ul style="list-style-type: none"> <li>• Professional/legal responsibilities applying in circumstances.</li> <li>• Possibility of withdrawal – from engagement and / or client relationship.</li> </ul>

### SQC 1

#### **Client acceptance/ retention – coverage**

- Engagement with a new client.
- Continuing an existing relationship.
- Acceptance of a new engagement for an existing client.

#### **Client integrity – sources of information**

- Communications with existing or previous providers of professional accountancy services to the client in accordance with the Code of Ethics.
- Discussions with other third parties.
- Inquiry of other firm personnel or third parties, such as, bankers, legal counsel and industry peers.
- Background searches of relevant databases.

#### **Accepting engagement from a new/ existing client.**

- Consider whether it gives rise to actual/ perceived conflict of interest?

#### **Client continuance.**

- Consider significant matters arising in current/ previous engagements & their implication for client continuance., e.g, expansion of business to areas where firm does not have expertise/ knowledge.

#### **Ethical issues – additional matters**

- Consider if there is a requirement to report to a regulator or the person/s appointing the auditor.
- Potential conflicts of interest.

## **Withdrawal from Engagement**

- ❖ Policies to address following issues:
- ❖ Discussion with appropriate level of mgt & TCWG.
- ❖ If withdrawal necessary, discuss with mgt & TCWG.
- ❖ Professional/ regulatory requirement to:
  - Not to withdraw, or
  - Report withdrawal from engagement and/ or client relationship.
- ❖ Documentation of significant issues, consultations, conclusions, basis for conclusions.

**SQC 1**

### **Discussion with appropriate level of management**

- So that firm can take appropriate action based on facts & circumstances of the case.

### **If withdrawal necessary**

- Discuss if withdrawal from engagement or both from engagement as well as client relationship needed.

## **IV. Human Resources**

- ❖ Establish policies/ procedures → reasonable assurance:
  - Sufficient personnel with capabilities, competence & commitment to ethical principles
  - Enable firm/ partners to issue reports appropriate in circumstances.
- ❖ Issues to be addressed by HR policies:

• Recruitment	• Career development
• Performance evaluation	• Promotion
• Capabilities	• Compensation
• Competence	• Estimation of personnel needs

**SQC 1**

### **Sufficient personnel**

- Ensures engagements are performed in accordance with professional standards & legal/ regulatory requirements.

- ❖ Capabilities & Competence:
  - Developed through .
  - Professional education.
  - Continuing professional development, training.
  - Work experience.
  - Coaching by more experienced staff.
- ❖ Performance evaluation/ compensation/ promotion:
  - Create awareness among personnel as to firm's expectation wrt performance & ethical principles.
  - Evaluation & counseling wrt performance, progress & career development.
  - Help personnel understand performance quality & adherence to ethics are essential prerequisites for promotion.

**SQC 1**

- ❖ Training/ coaching – suitably qualified external persons may also be used for the purpose.
- ❖ Performance evaluation process affected by firm's size & circumstances e.g. small firms – less formal process.

**Assignment of Engagement Teams**

- ❖ Responsibility for each engagement to be assigned to engagement partner.
- ❖ Policies/ procedures to ensure that:
  - Identity & role of engagement partner communicated to key personnel of client mgt. & TCWG.
  - Engagement partner is capable & competent & has time & authority for engagement.
  - Responsibility of engagement partner clearly defined & communicated to him/ her.

**SQC 1**

- ❖ Firm to have a system to monitor workload of partners to see that they have sufficient time to adequately discharge their responsibilities.

- ❖ Assign appropriate **staff**.
- ❖ Assessment of staff capability & competence – factors considered:
  - Understanding & practical experience of similar type of engagement.
  - Understanding of professional standards, legal/ regulatory requirements.
  - Appropriate technical knowledge.
  - Knowledge of relevant industry.
  - Ability to apply professional judgment.
  - Understanding of firm's QC policies/ procedures.

**SQC 1**

- ❖ Staff – to have appropriate capability & competence & time to perform engagement in accordance with professional standards, legal/ regulatory requirements & to enable partner to issue a report appropriate in circumstances.

## **V. Engagement Performance**

- ❖ **Establish policies/ procedures → reasonable assurance:**
  - Compliance with professional standards.
  - Compliance with laws/ regulations.
  - Engagement partner issues reports appropriate in the circumstances.
- ❖ **Aspects to be addressed by policies:**
  - Briefing engagement teams.
  - Process for complying with engagement standards.
  - Process of supervision, staff training & coaching.

**SQC 1**

### **Policies & Procedures:**

- Bring consistency in engagement performance.
- Form: written or electronic manuals, software tools, other forms of standardised document, industry specific/ general guidance material.

### **Briefing the team**

- All members to understand objectives of the work allotted to them. Team work & training necessary to assist less experienced members.

- Methods of reviewing work, judgments, form of reports.
- Appropriate documentation of work performed & of timing & extent of review.
- Processes to keep all policies/ procedures current.
- ❖ Important aspects of engagement performance:
  - Supervision.
  - Review.
  - Consultation.
  - Differences of opinion.
  - Engagement QC review:
    - Nature, timing & extent of EQC review.
    - Eligibility criteria for EQC reviewer.
    - Documentation of EQC review.
  - Engagement documentation:
    - Assembly of final audit file.
    - Confidentiality, safe custody, accessibility of engagement documentation.
    - Documentation retention.
    - Documentation ownership.

**SQC 1**

**Considering capabilities, competence of individuals on team**

- Whether they have sufficient time, understand instructions. Whether work being carried out by planned approach to the engagement

**Addressing issues arising during the engagement**

- Considering their significance & appropriately modifying the planned approach.

**A. Supervision**

- ❖ Tracking the process of engagement.
- ❖ Considering capabilities, competence of individuals on team.
- ❖ Addressing issues arising during the engagement.
- ❖ Identifying matters for consultation & consideration by experienced members of team.

**SQC 1**

## **B. Review**

- ❖ Matters considered by reviewer:
  - Performance of work in accordance with standards & legal/ regulatory requirements.
  - Significant matters raised for further consideration.
  - Consultations undertaken & results documented & implemented.
  - Need to revise nature, timing & extent of work performed.
  - Work supports conclusions reached & appropriate documentation.
  - Sufficiency & appropriateness of evidence – supports the report.
  - Achievement of engagement objectives.

**SQC 1**

## **C. Consultation**

- ❖ Establish policy/ procedures → reasonable assurance:
  - Appropriate consultation takes place on difficult or contentious matters;
  - Sufficient resources are available to enable appropriate consultation to take place;
  - The nature and scope of such consultations are documented; and
  - Conclusions resulting from consultations are documented and implemented.

**SQC 1**

### **Consultation**

- Promotes quality & improves application of professional judgment.
- Includes discussion at appropriate level – experts inside or outside the firm.
- Establish & encourage culture of consultation.

❖ **Consultation procedures to require:**

- Consultation with appropriate personnel:
  - Knowledge.
  - Seniority.
  - Experience.
- Documentation & implementation of decisions of consultation.

❖ **External consultation:**

- Other firms.
- Professional & regulatory bodies.
- Commercial organisations that provide relevant quality control services.

**SQC 1**

- ❖ **Documentation – sufficiently complete & detailed:**
  - Issues on which consultation was sought.
  - Results of consultation:
    - Basis of decisions.
    - Basis for decisions.
    - How implemented.
- ❖ **Differences of Opinion.**
- ❖ **Policies & procedures for dealing/ resolving differences of opinion:**
  - With in engagement team.
  - With Consultants – internal/ external.
  - Engagement partner *vis a vis* QC reviewer.
- ❖ **Document the conclusions reached & their implementation.**
- ❖ **Report not to be issued until matter is resolved.**

**SQC 1**

**Consultation documentation**

- The documentation of consultations with other professionals that involve difficult or contentious matters is agreed by both the individual seeking consultation and the individual consulted.

**Differences of opinion**

**Benefits:**

- Encourages identification of differences of opinion at an early stage.
- Provides clear guidelines as to the successive steps to be taken thereafter.
- Requires documentation regarding the resolution of the differences and the implementation of the conclusions reached.



## **D. Engagement QC Review**

- ❖ Essentials of these policies/ procedures:
  - Require QC review for all audits of financial statements of listed companies.
    - Nature, timing & extent of review.
    - Eligibility criteria for QC reviewer.
    - Documentation requirements.
  - Establish criteria for QC review of all other audits/ reviews of historical financial information & other assurance & related service engagements.

**SQC 1**

**QC review of all other audits/ reviews – criteria for deciding:**

- The nature of the engagement, including the extent to which it involves a matter of public interest.
- The identification of unusual circumstances or risks in an engagement or class of engagements.
- Whether laws or regulations require an engagement quality control review.

- Require QC for engagements covered by criteria above.
- Require completion of engagement before QC review.
- Provide for replacement of QC reviewer if his ability to perform objective review is impaired.

***Nature, timing & extent of QC review:***

- Review involves.
- Discussion with engagement partner.
- Review of financial statements & report.
- Review of selected working papers – significant judgments & conclusions of team.
- Extent of review depends upon complexity of engagement & risk of inappropriate report in the circumstances.
- Review does not reduce responsibility of engagement partner.

**SQC 1**

- Review of audit of FS of listed companies – *considerations*:
  - Team's evaluation of the firm's independence in relation to the specific engagement.
  - Significant risks identified during the engagement and the responses thereto.
  - Judgments made especially wrt materiality and significant risk.
  - Consultation has taken place on significant/ contentious matters and the conclusions arising therefrom.
  - Significance and disposition of corrected and uncorrected misstatements identified during the engagement.
  - Matters to be communicated to mgt and TCWG and, where applicable, other parties.
  - Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.
  - The appropriateness of the report to be issued.

**SQC 1**

- ❖ All or a combination of these considerations to be seen, depending upon facts of each case.
- ❖ The engagement quality control reviewer conducts the review in a timely manner at appropriate stages during the engagement so that significant matters may be promptly resolved to the reviewer's satisfaction before the report is issued.

**Eligibility criteria for QC reviewer**

- ❖ Policies/ procedures to address.
- ❖ Appointment of QC reviewer.
- ❖ Establish eligibility:
  - Technical qualifications required – experience & authority.
  - Degree to which QC reviewer can be consulted on engagement without compromising his objectivity.
- ❖ Maintaining QC reviewer's objectivity:
  - QC reviewer not selected by engagement partner.
  - No participation in engagement during period of review.
  - Does not make decisions for engagement team.
  - Not subject to conditions threatening his/ her objectivity.

**SQC 1**

- ❖ For listed companies, QC reviewer should be one who is otherwise capable of being appointed as an audit engagement partner for audit of FS.
- ❖ The engagement partner may consult the engagement quality control reviewer during the engagement. Such consultation need not compromise the engagement quality control reviewer's eligibility to perform the role. Where the nature and extent of the consultations become significant, however, care is taken by both the engagement team and the reviewer to maintain the reviewer's objectivity. Where this is not possible, another individual within the firm or a suitably qualified external person is appointed to take on the role of either the engagement quality control reviewer or the person to be consulted on the engagement. The firm's policies provide for the replacement of the engagement quality control reviewer where the ability to perform an objective review may be impaired.
- ❖ **Sole proprietor/ small firms** – use suitably qualified external persons. Alternatively, use other firms to facilitate engagement quality control reviews.

**Documentation of QC review**

❖ **Policies/ procedures to require:**

- Procedures on engagement QC review have been performed;
- QC review has been completed before the report is issued; and
- Reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

SQC 1

**E. Engagement Documentation**

**Assembly of Files**

- ❖ Policies/procedures for completion of final engagement files on a timely basis after finalisation of engagement reports.
- ❖ Two or more reports on same subject, time limit for final file assembly to be applied for each report separately.
- ❖ Time limit may be prescribed by law. If not, firm to establish time limits appropriate to nature of engagement – not more than 60 days in case of audit.

SQC 1

- ❖ Confidentiality, safe custody, accessibility of engagement documentation.
- ❖ Policies/ procedures to maintain confidentiality, safe custody, integrity, accessibility & retrievability of documentation.
- ❖ Confidentiality subject to:
  - Specific client authority.
  - Legal/ regulatory requirement.
  - Professional requirement.
- ❖ Adequate controls needed to:
  - Enable the determination of when and by whom engagement documentation was created, changed or reviewed;
  - Protect the integrity of the information at all stages of the engagement;
  - Prevent unauthorised changes to the engagement documentation; and
  - Allow access to the engagement documentation by the engagement team and other authorised parties.

**SQC 1**

- ❖ Protection of document integrity-especially when the information is shared within the engagement team or transmitted to other parties via Internet.

- ❖ **Examples of controls:**
  - The use of a password.
  - Appropriate back-up routines for electronic documentation.
  - Procedures for properly distributing documentation at the start of engagement, processing it during engagement, and collating it at the end of engagement.
  - Procedures for restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation.

**SQC 1**

- ❖ For practical reasons, original paper documentation may be electronically scanned for inclusion in engagement files. In that case, the firm implements appropriate procedures requiring engagement teams to:
  - Generate scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;
  - Integrate the scanned copies into the engagement files, including indexing and signing off the scanned copies as necessary; and
  - Enable the scanned copies to be retrieved and printed as necessary.

The firm considers whether to retain original paper documentation that has been scanned for legal, regulatory or other reasons.

**Retention of engagement documentation**

- ❖ Policies/ procedures for retention of engagement documentation for period sufficient to meet needs of firm/ laws & regulations. Depends upon:
  - Nature of engagement.
  - Firm's circumstances.
  - Laws/ regulations.

In the specific case of audit engagements, the retention period ordinarily is **no shorter than seven years** from the date of the auditor's report, or, if later, the date of the group auditor's report.

**Ownership of documentation**

- ❖ Property of the firm unless specified by law.
- ❖ Firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided:
  - disclosure does not undermine the validity of the work performed, or
  - in the case of assurance engagements, the independence of the firm or its personnel.

**SQC 1**

- ❖ Procedures that the firm adopts for retention of engagement documentation include those that:
  - Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation since the underlying technology may be upgraded or changed over time.
  - Provide, where necessary, a record of changes made to engagement documentation after the engagement files have been completed.
  - Enable authorised external parties to access and review specific engagement documentation for quality control or other purposes.

## **VI. Monitoring**

- ❖ Policies & procedures → reasonable assurance that QC policies/ procedures are:
  - Relevant.
  - Adequate.
  - Operating effectively.
  - Complied with in practice.
- ❖ Involves on going consideration & evaluation of QC system, includes periodic inspection of completed assignments.

**SQC 1**

- ❖ Benefits – evaluation of:
  - Adherence to professional standards, regulatory requirements.
  - QC appropriately designed & effectively implemented.
  - QC has led to reports appropriate in the circumstances.
- ❖ Responsibility of monitoring is on partners/ other persons with sufficient appropriate experience & authority in the firm.
- ❖ Ongoing evaluation of QC system includes:
  - Analysis of:
    - New professional/ legal developments & how reflected in firm's policies/ procedures.
    - Compliance with independence requirements.
    - Continuing Professional Development.
    - Decisions on client acceptance/ continuance.

**SQC 1**

- Determination of corrective action wrt QC system.
- Communication of weaknesses to appropriate personnel in firm.
- Follow up.
- ❖ Selection of completed engagements:
  - Cyclical.
  - One engagement of each partner in a cycle.
  - **Cycle not to exceed three years.**
  - Factors to consider:
    - Size of firm.
    - Number & location of offices.
    - Results of previous inspection.
    - Degree of authority of personnel & office.
    - Nature & complexity of practice & organisation.
    - Risks associated with clients & specific engagements.
  - May be without prior notice.
  - Inspectors not to act as QC reviewer or part of engagement team.
  - **Independent external inspection not a substitute for internal monitoring program.**

**SQC 1**

- ❖ Small firms and sole practitioners may wish to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures. Alternatively, they may wish to establish arrangements to share resources with other appropriate organisations to facilitate monitoring activities.

- ❖ Evaluate effect of deficiencies:
  - Are they one off instances ?
  - Are they systemic, repetitive or significant deficiencies requiring prompt corrective action?
- ❖ Recommendations may include, one/ more of following:
  - appropriate remedial action in relation to an individual engagement or member of personnel;
  - communication of the findings to those responsible for training and professional development;
  - Changes to the quality control policies and procedures; and
  - Disciplinary action against errant.
- ❖ If monitoring results indicate inappropriate report/ omitted procedures, firm to consider further action required, including obtaining legal advice.

**SQC 1**

- ❖ The firm should evaluate the effect of deficiencies noted as a result of the monitoring process and should determine whether they are either:
  - Instances that do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with professional standards and regulatory and legal requirements, and that the reports issued by the firm or engagement partners are appropriate in the circumstances; or
  - Systemic, repetitive or other significant deficiencies that require prompt corrective action.

- ❖ Communicate results of monitoring to engagement partners, CEO, managing partner & other appropriate individuals **at least annually**.
  - Also communicate recommendations for remedial action.
- ❖ Communication to include:
  - A description of the monitoring procedures performed.
  - The conclusions drawn from the monitoring procedures.
  - Where relevant, a description of systemic, repetitive or other significant deficiencies and of the actions taken to resolve or amend those deficiencies.

**SQC 1**

- ❖ Identification of the specific engagements concerned not normally required, unless such identification is necessary for the proper discharge of the responsibilities of the individuals other than the engagement partners.



❖ For network firms:

- Monitoring system to be in accordance with SQC;
- At least annually, the network communicates the overall scope, extent and results of the monitoring process to appropriate individuals within the network firms;
- The network communicates promptly any identified deficiencies in the quality control system to appropriate individuals within the relevant network firm or firms so that the necessary action can be taken; and
- Engagement partners in the network firms are entitled to rely on the results of the monitoring process implemented within the network, unless the firms or the network advises otherwise.

**SQC 1**

❖ Documentation relating to monitoring:

- Sets out monitoring procedures, including selection procedure;
- Records the evaluation of:
  - Adherence to professional standards and regulatory and legal requirements;
  - Whether the QC system has been appropriately designed and effectively implemented; and
  - Whether the firm's QC policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.
- Identifies the deficiencies noted, evaluates their effect, and sets out the basis for determining whether and what further action is necessary.

**SQC 1**

### **Complaints & allegations**

- Establish policies/ procedures → reasonable assurance that following complaints/ allegations are appropriately dealt:
  - firm's work not in compliance with legal/ regulatory requirements/ professional standards.
  - Non compliance with firm's QC system.
- Establish clearly defined channels for firm personnel to raise concerns – no fear of reprisal.
- Investigate – done by independent partner & a legal counsel (if necessary).
- Document complaints/ allegations & responses thereto.
- Result of investigation:
  - Deficiency in design/ operation of QC system, or
  - Non compliance with QC system
    - Take appropriate action

#### **SQC 1**

- ❖ Does not include complaints/ allegations that are clearly frivolous.
- ❖ **Investigation in small firms** – suitably qualified external person/ other firm.

## **VII. Documentation**

- Policies/ procedures for documentation to provide evidence of operation of each element of QC system.
- **Form & content** – factors to consider:
  - Size of the firm and the number of offices.
  - Degree of authority both personnel and offices have.
  - Nature and complexity of the firm's practice and organization.
- **Retention:**
  - Time period sufficient to permit evaluation of firm's compliance with QC system.
  - Longer period, if required by law.

#### **SQC 1**

- ❖ How matters are documented is firm's decision. For example, large firms may use electronic databases to document matters, such as, independence confirmations, performance evaluations and the results of monitoring inspections. Smaller firms may use more informal methods, such as, manual notes, checklists and forms.

**Framework for Assurance  
Engagements  
Effective from April 1, 2008**

## **What this Framework Defines**

- ❖ Elements of Assurance Engagements.
- ❖ Objectives of Assurance Engagements.
- ❖ Engagements to which Framework applies.

**Framework**

## **Why this Framework**

Useful for:

- ❖ Professional Accountants in Public Practice.
- ❖ Users of assurance reports and responsible parties.
- ❖ AASB – Engagement Standards to be consistent with the Framework.

**Framework**

- ❖ Professional accountants who are neither in public practice nor in the public sector are encouraged to consider the Framework when performing assurance engagements.
- ❖ The term “professional accountant” refers to the member of the Institute of Chartered Accountants of India. Further, the term “professional accountant in public practice (practitioner)” refers to the member of the Institute of Chartered Accountants of India who is in practice in terms of section 2 of the Chartered Accountants Act, 1949. The term is also used to refer to a firm of chartered accountants in public practice.
- ❖ Does not cover engagements covered by Standards on Related Services (SRSs) since the members do not express any assurance on the financial information or any other subject matter of their report.

## **Overview of the Framework**

- ❖ Introduction.
- ❖ Definition and objective of Assurance Engagements.
- ❖ Scope of framework.
- ❖ Engagement acceptance → criteria.
- ❖ Elements of assurance engagements.
- ❖ Inappropriate use of practitioner's name.

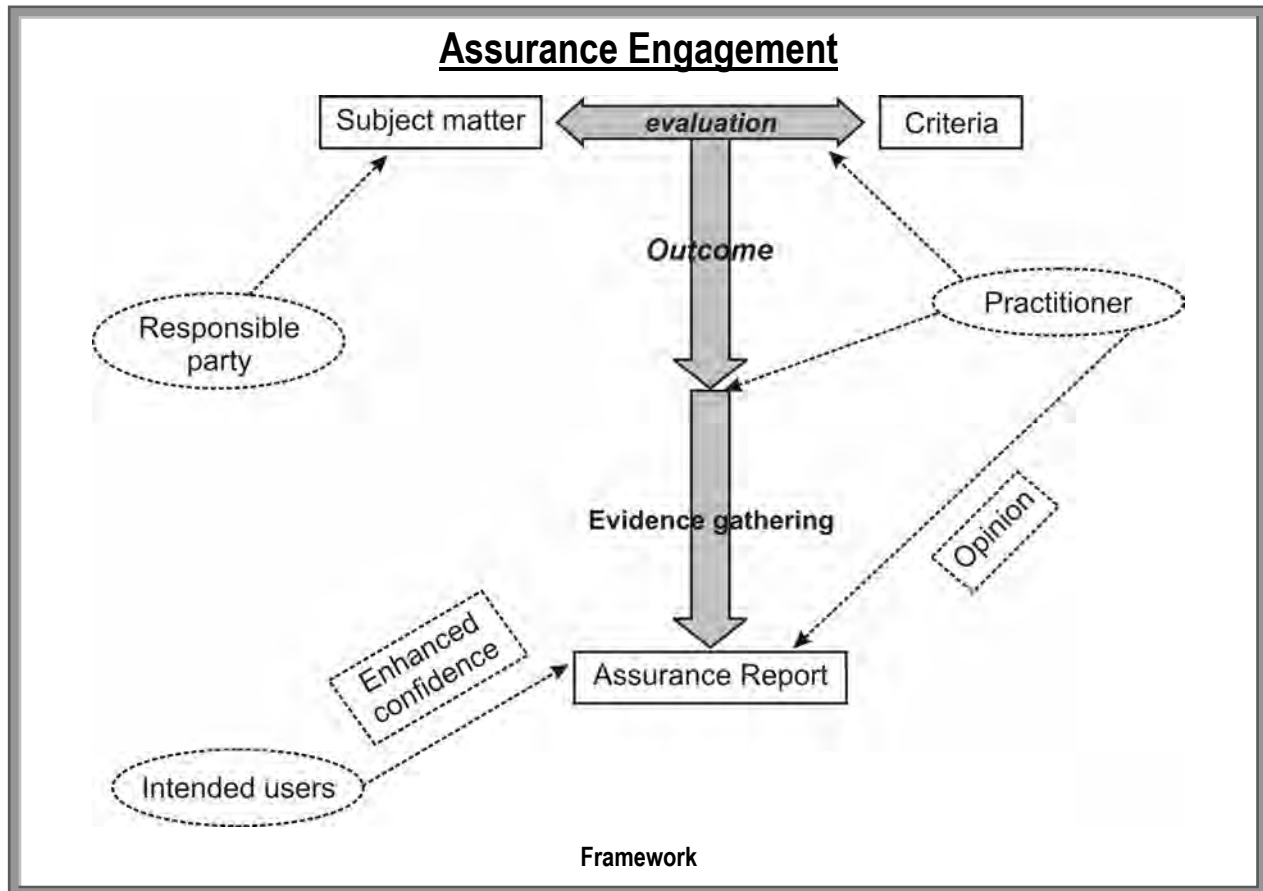
**Framework**

## **Governance Parameters**

- ❖ The Chartered Accountants Act, 1949.
- ❖ The Code of Ethics issued by ICAI.
- ❖ Other relevant pronouncements of ICAI.
- ❖ Standards on Quality Control.

**Framework**

- ❖ The Code of Ethics sets out the fundamental ethical principles that all professional accountants are required to observe, including:
  - Integrity;
  - Objectivity;
  - Professional competence and due care;
  - Confidentiality; and
  - Professional behaviour.



- ❖ The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to the subject matter. For example:
  - The recognition, measurement, presentation and disclosure represented in the financial statements (outcome) result from applying a financial reporting framework for recognition, measurement, presentation and disclosure, such as, the Accounting Standards, (criteria) to an entity's financial position, financial performance and cash flows (subject matter).
  - An assertion about the effectiveness of internal control (outcome) results from applying a framework for evaluating the effectiveness of internal control, (criteria) to internal control, a process (subject matter).
  - In the remainder of this Framework, the term "subject matter information" will be used to mean the outcome of the evaluation or measurement of a subject matter. It is the subject matter information about which the practitioner gathers sufficient appropriate evidence to provide a reasonable basis for expressing a conclusion in an assurance report.
- ❖ Subject matter information can fail to be properly expressed in the context of the subject matter and the criteria, and can therefore be misstated, potentially to a material extent.
- ❖ In some assurance engagements, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users. These engagements are called "assertion-based engagements". In other assurance engagements, the practitioner either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report. These engagements are called "direct reporting engagements".
- ❖ Two types of assurance engagements:
  - *A reasonable assurance engagement* - The objective is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion.
  - *A limited assurance engagement* - The objective is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

## **Engagement Circumstances**

- ❖ Terms of engagement.
- ❖ Characteristic of subject matter.
- ❖ Criteria.
- ❖ Needs of intended users.
- ❖ Characteristics of Responsible Party.
- ❖ Environment of Relevant Party.
- ❖ Other matters:
  - Events.
  - Transactions.
  - Conditions.
  - Practices.

**Framework**

## **Scope**

### **Framework Does Not Apply to**

- ❖ All non-assurance engagements.
- ❖ Agreed-upon Procedures.
- ❖ Compilation.
- ❖ Preparation of Tax returns.
- ❖ Consulting engagements - Management or Tax Consulting.

**Framework**

## **Assurance vs. Consulting**

### **What is Consulting?**

#### **Analytical process**

- ❖ Activities involved:
  - Objective setting.
  - Fact finding.
  - Definition of problems/ opportunities.
  - Evaluation of alternatives.
  - Development of recommendations.
  - Communication of results.
  - Implementation and follow up.

Framework

- Reports – long form/ narrative.
- Only for benefit of client.
- Nature and scope determined by client and practitioner.

**But any engagements meeting criteria of assurance engagement is an assurance engagement not consulting.**

Framework



## **Exceptions**

- ❖ Engagements meeting the definition but not governed by this Framework:
- ❖ Testifying in legal proceedings on accounting, auditing, taxation & other matters.
- ❖ Engagements including professional opinion if all the following conditions are met:
  - Opinion incidental to overall engagement.
  - Express restriction on use by user identified in report.
  - Agreement with intended user that engagement is not an assurance engagement.
  - Engagement not represented as assurance engagement in report.

### **Framework**

- ❖ An assurance engagement may be part of a larger engagement, for example, when a business acquisition consulting engagement includes a requirement to convey assurance regarding historical or prospective financial information. In such circumstances, this Framework is relevant only to the assurance portion of the engagement.

- ❖ Engagement report **not** to:
  - Imply compliance with Framework, SAs, SREs or SAEs.
  - Inappropriately use words “assurance”, “audit”, “review”.
  - Include a statement that can be mistaken to enhance users’ confidence about outcome.

### **Framework**

- ❖ The practitioner and the responsible party may agree to apply the principles of this Framework to an engagement when there are no intended users other than the responsible party but where all other requirements of the SAs, SREs or SAEs are met. In such cases, the practitioner’s report includes a statement restricting the use of the report to the responsible party.

## Engagement Acceptance

- ❖ Accept **only** when:
  - Relevant ethical requirements will be met
  - Engagement exhibits all the following:
    - Subject matter is appropriate
    - Criteria is suitable
    - Criteria is available to intended users
    - Practitioner has access to SAAE
    - Written report is to be issued
    - Practitioner satisfied as to rational purpose of engagement
- ❖ Any additional requirements of applicable SA, SRE, SAE.

Framework

## If Engagement Does Not Meet These Criteria ?

- ❖ If original criteria not suitable then:
  - Engaging party may identify a new aspect of subject matter for which the criteria may be suitable
  - Select/ develop alternative suitable criteria
- ❖ Engaging party may request a consulting/ agreed upon procedures engagement

**Once assurance engagement is accepted, cannot convert it into a lower/ non assurance engagement without reasonable justification.**

Framework

- ❖ A change in circumstances that affects the intended users' requirements, or a misunderstanding concerning the nature of the engagement, ordinarily will justify a request for a change in the engagement. If such a change is made, the practitioner does not disregard evidence that was obtained prior to the change.

## **Elements of Assurance Engagement**

- ❖ Three party relationship.
- ❖ Appropriate subject matter.
- ❖ Suitable criteria.
- ❖ Sufficient appropriate evidence.
- ❖ Written assurance report.

**Framework**

## **I. Three Party Relationship**

The three parties:

- ❖ Practitioner
- ❖ Responsible party
- ❖ Intended user

**Framework**

- ❖ The responsible party and the intended users may be from different entities or the same entity. The relationship between the responsible party and the intended users needs to be viewed within the context of a specific engagement and may differ from more traditionally defined lines of responsibility.

## **I.1 Practitioner**

- ❖ May require specialised knowledge & skills.
- ❖ Not to accept engagement if ethical requirements would be breached.
- ❖ Can use work of experts if practitioner is:
  - Satisfied about their knowledge & skills.
  - Adequately involved in engagement.
  - Understands the work for which expert is used.

### **Framework**

- ❖ The term “practitioner” as used in this Framework is broader than the term “auditor” as used in SAs and SREs, which relates only to practitioners performing audit or review engagements with respect to historical financial information.

## **I.2 Responsible Party**

- ❖ Responsible for subject matter (in direct reporting engagement).
- ❖ Responsible for subject matter information, i.e., assertion (in assertion based engagement). May also be responsible for subject matter.
- ❖ May or may not be the engaging party.
- ❖ Provides practitioner with written representation evaluating subject matter against criteria (this representation not available where engaging party is different from responsible party).

### **Framework**

### **I.3 Intended Users**

- ❖ Persons for whom assurance report is prepared.
- ❖ Responsible party can be one of the intended users.
- ❖ Assurance report addressed to all intended users.
- ❖ Practitioner may not identify all intended users.
- ❖ Involvement of intended users with the practitioner and engagement party, the practitioner is:
  - Responsible for determining the nature/timing/extent of procedures .
  - Pursue any matter the practitioner becomes aware, leads to question whether a material modification should be made to the subject matter information.

#### **Framework**

- ❖ In some cases, intended users (for example, bankers and regulators) impose a requirement on, or request the responsible party (or the engaging party, if different) to arrange for, an assurance engagement to be performed for a specific purpose. When engagements are designed for specified intended users or a specific purpose, the practitioner considers including a restriction in the assurance report that limits its use to those users or that purpose.

## **II. Subject Matter**

- ❖ Forms:
  - Financial performance/ conditions.
  - Non-financial performance/ conditions.
  - Physical characteristics.
  - Systems and processes.
  - Behaviour.
- ❖ Characteristics:
  - Qualitative/ quantitative.
  - Objective/ subjective.
  - Historical/ prospective.
  - Point in time/ covers a period.
  - Characteristics affect precision in evaluation against criteria and persuasiveness of audit evidence.

### **Framework**

- ❖ The subject matter, and subject matter information, of an assurance engagement can take many forms, such as:
  - Financial performance or conditions (for example, historical or prospective financial position, financial performance and cash flows) for which the subject matter information may be the recognition, measurement, presentation and disclosure represented in financial statements.
  - Non-financial performance or conditions (for example, performance of an entity) for which the subject matter information may be key indicators of efficiency and effectiveness.
  - Physical characteristics (for example, capacity of a facility) for which the subject matter information may be a specifications document.
  - Systems and processes (for example, an entity's internal control or IT system) for which the subject matter information may be an assertion about effectiveness.
  - Behaviour (for example, corporate governance, compliance with regulation, human resource practices) for which the subject matter information may be a statement of compliance or a statement of effectiveness.

## **Appropriate Subject Matter?**

- ❖ Identifiable.
- ❖ Capable of consistent evaluation against criteria.
- ❖ Information about it can be subjected to procedures for gathering evidence to support assurance.

### **Framework**

### III. Suitable Criteria

- ❖ Are **benchmarks** used for evaluation.
- ❖ May be **formal**, e.g.:
  - Accounting Standards issued by ICAI.
  - Internal control framework/ objective specifically designed for engagement.
  - Applicable law/regulation or contract.
- ❖ May be **less formal**, e.g.:
  - Internally developed code of conduct.
- ❖ Required for **consistent evaluation**- Otherwise conclusion is open to the individual interpretation.
- ❖ Are **context sensitive** - Relevant to Engagement circumstances.

Framework

### Suitable Criteria - Characteristics

- ❖ Relevance.
- ❖ Completeness.
- ❖ Reliability.
- ❖ Neutrality.
- ❖ Understandability:
- ❖ Evaluation based on practitioner's own judgments, expectations, experiences DO NOT constitute suitable criteria.
- ❖ Practitioner to assess suitability of criteria.

Framework

- ❖ Criteria can either be established or specifically developed. Established criteria are those embodied in laws or regulations, or issued by authorised or recognised bodies of experts that follow a transparent due process. Specifically developed criteria are those designed for the purpose of the engagement, whether affects the work of the practitioner to assess their suitability for a particular engagement.

- ❖ Criteria need to be available to intended users:
  - Publicity.
  - Inclusion in a clear manner in the presentation of subject matter information.
  - Inclusion clearly in assurance report.
  - General understanding.
- ❖ May be available only to specific intended users.

**Framework**

## **IV. Evidence**

- ❖ Professional skepticism in gathering SAAE.
- ❖ Whether subject matter information is free of material misstatement.
- ❖ Considerations in planning/ performing engagement:
  - Materiality.
  - Engagement risk.
  - Quantity of evidence.
  - Quality of evidence.

**Framework**



## **IV.1 Professional Skepticism**

- ❖ Critical assessment, with questioning mind, as to validity of evidence obtained.
- ❖ Alertness to contradictory evidence.
- ❖ RARELY involves authentication of documents. Practitioner not trained/ expected to be expert in authentication.
- ❖ But consider reliability of evidence like faxes, photocopies, electronic documents, etc., and control over their preparation and maintenance.

**Framework**

## **IV.2 Sufficient Appropriate Evidence**

- ❖ Sufficiency – quantity of evidence.
- ❖ Appropriateness – quality of evidence – reliability & relevance.
- ❖ Sufficiency affected by:
  - Risk of material misstatement.
  - Quality of evidence.
- **Increased quantity CANNOT substitute poor quality of evidence.**
- Reliability influenced by:
  - Source.
  - Nature.
  - Circumstances under which obtained.

**Framework**

### **Some Generalisations on Evidence**

- ❖ Externally generated evidence from independent sources is more reliable.
- ❖ Internally generated evidence more reliable when related controls are effective.
- ❖ Evidence directly obtained by practitioner more reliable than that by inference.
- ❖ Documentary evidence more reliable.
- ❖ Original documents more reliable than photocopies/ faxes.
- ❖ More assurance from consistent evidence from different sources/ different nature.
- ❖ Difficult to obtain evidence for subject matter covering a period of time than that relating to a point in time.
- ❖ Consider cost of obtaining evidence *vis-a-vis* usefulness of evidence.  
But cost/ difficulty does not exonerate from evidence gathering procedures.

**Framework**

### **IV.3 Materiality**

- ❖ Relevant in:
  - ❖ Deciding nature, timing & extent of evidence gathering procedures.
  - ❖ Assessing whether outcome is free of material misstatements.
- ❖ Understand and assess factors that might affect decisions of intended users.
- ❖ Quantitative/ qualitative characteristics to be considered.

**Framework**

- ❖ Materiality is considered in the context of quantitative and qualitative factors, such as, relative magnitude, the nature and extent of the effect of these factors on the evaluation or measurement of the subject matter, and the interests of the intended users.

## IV.4 Assurance Engagement Risk

Expression of inappropriate conclusion when outcome is materially misstated.

	<b>Reasonable Assurance</b>	<b>Limited Assurance</b>
<b>Objective</b>	Reduce Engagement risk to acceptable level	Reduce engagement risk (but higher than that in reasonable assurance)
<b>Reporting</b>	Positive assertion	Negative assertion

**Framework**

## **Components of Engagement Risk**

- ❖ Risk of material misstatement in outcome:
  - **Inherent risk:** susceptibility of material misstatement assuming no controls.
  - **Control risk:** material misstatement will not be prevented/ detected and corrected on a timely basis by internal controls (control risk cannot be zero because of inherent limitations of internal controls).
- ❖ **Detection risk:** Practitioner will not detect a material misstatement.

**Framework**

## **Can Engagement Risk be Zero?**

NO, because of following reasons:

- ❖ Selective testing.
- ❖ Inherent limitations of internal controls.
- ❖ Persuasive nature of evidence.
- ❖ Use of judgment in gathering & evaluating evidence.
- ❖ Characteristics of subject matter.

**Framework**

## **IV. 5 Nature, Timing & Extent of Evidence Gathering Procedures**

- ❖ Reasonable assurance engagements:
  - Understand subject matter information, engagement circumstances, internal controls.
  - Assess risk of material misstatement.
  - Respond to assess risk.
  - Perform further procedures.
  - Evaluate sufficiency, appropriateness of evidence.
- ❖ Limited assurance engagement:
  - Procedures deliberately limited *vis-a-vis* reasonable assurance engagement:
    - Analytical procedures.
    - Inquiries.

### **Framework**

- ❖ "Reasonable assurance" is a concept relating to accumulating evidence necessary for the practitioner to conclude in relation to the subject matter information taken as a whole. To be in a position to express a conclusion in the positive form required in a reasonable assurance engagement, it is necessary for the practitioner to obtain sufficient appropriate evidence as part of an iterative, systematic engagement process.
- ❖ Performing further procedures clearly linked to the identified risks, using a combination of inspection, observation, confirmation, recalculation, re-performance, analytical procedures and inquiry. Such further procedures involve substantive procedures including, where applicable, obtaining corroborating information from sources independent of the responsible party, and depending on the nature of the subject matter, tests of the operating effectiveness of controls.
- ❖ "Reasonable assurance" is less than absolute assurance. Reducing assurance engagement risk to zero is very rarely attainable or cost beneficial as a result of factors such as the following:
  - The use of selective testing.
  - The inherent limitations of internal control.
  - The fact that much of the evidence available to the practitioner is persuasive rather than conclusive.
  - The use of judgment in gathering and evaluating evidence and forming conclusions based on that evidence.
  - In some cases, the characteristics of the subject matter when evaluated or measured against the identified criteria.

## **IV.6 Quantity & Quality of Evidence**

Affected by:

- ❖ Characteristics of subject matter and subject matter information.
- ❖ Engagement circumstances.

Framework

## **Material Scope Limitation**

- ❖ Circumstances prevent obtaining the evidence, or
- ❖ Responsible party/ engaging party imposes restriction that prevents obtaining evidence.

### **IMPLYING:**

- ❖ Engagement risk cannot be reduced to appropriate level.
- ❖ Unqualified report cannot be issued.

Framework

## **V. Assurance Report**

- ❖ Written report.
- ❖ Contains conclusions.
- ❖ Assurance obtained about subject matter information.
- ❖ Standards establish principles regarding elements of report.
- ❖ Consider reporting responsibilities to others.

**Framework**

## **Other than Unqualified Reports**

- ❖ Material scope limitation on work.
- ❖ Responsible party's assertion is not fairly stated in all material respects (in assertion-based engagements).
- ❖ Outcome is materially misstated (in direct reporting engagements).
- ❖ Post acceptance, it is found that criteria is unsuitable/ subject matter not appropriate for assurance engagement.

**Some circumstances may call for withdrawal.**

**Framework**

### **Inappropriate Use of Practitioner's Name**

- ❖ Association only when:
  - Practitioner reports on information about subject matter, or
  - Consents to use of practitioner's name in professional connection with the subject matter.
- ❖ Practitioner comes to know of inappropriate use:
  - Requires the party to cease doing so.
  - Considers other steps including seeking legal advice.

**Framework**



# **Engagement Standards**

## **Standards on Auditing**

### **❖ 100-999 : Standards on Auditing (SAs) (37 Standards):**

- 200-299: General Principles & Responsibilities (9 Standards).
- 300-499: Risk Assessment and Response to Assessed Risks (6 Standards).
- 500-599: Audit Evidence (11 Standards).
- 600-699: Using Work of Others (3 Standards).
- 700-799: Audit Conclusions & Reporting (5 Standards).
- 800-899: Specialised Areas (3 Standards).

## **200-299 : General Principles & Responsibilities**

- ❖ SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" (April 1, 2010).
- ❖ SA 210, "Agreeing the Terms of Audit Engagements" (April 1, 2010).
- ❖ SA 220, "Quality Control for an Audit of Financial Statements" (April 1, 2010).
- ❖ SA 230, "Audit Documentation" (April 1, 2009).
- ❖ SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" (April 1, 2009).
- ❖ SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements" (April 1, 2009).
- ❖ SA 260, "Communication with Those Charged with Governance" (April 1, 2009).
- ❖ SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance & Management" (April 1, 2010).
- ❖ SA 299, "Responsibility of Joint Auditors" (April 1, 1996).

# **SA 200**

## **Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing**

*Effective for audits of financial statements for periods beginning  
on or after April 1, 2010*

## **Overview**

- ❖ **Introduction:**
  - Scope
  - An audit of financial statements (FS)
  - Effective date
- ❖ **Overall Objectives of the Auditor.**
- ❖ **Definitions.**
- ❖ **Requirements & Application:**
  - Ethical requirements Relating to Audit of FS.
  - Professional skepticism.
  - Professional judgment.
  - Sufficient and Appropriate Audit Evidence (SAAE).
  - Conduct of an Audit in Accordance with SAs.

**SA 200**

## **Scope**

- ❖ Establishes independent auditor's overall responsibilities when conducting an audit of FS:
  - Overall objective of auditor.
  - Nature & scope of audit designed to meet those objectives.
- ❖ Explains Scope, authority & structure of SAs.
- ❖ Sets out General responsibilities of the auditor.
- ❖ Obligation to comply with SAs.

**SA 200**

## An Audit of Financial Statements

- ❖ Audit enhances degree of confidence in FS.
- ❖ Expression of opinion on preparation of FS in accordance with applicable FRF.
- ❖ Does not ensure:
  - Future viability of entity.
  - Efficiency & effectiveness of management.
- ❖ SAs do not:
  - Impose responsibilities on management/TCWG.
  - Override L&R.

### SA 200

- ❖ An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form the opinion.
- ❖ L & R may require auditor to opine on Internal Controls. SAs may provide guidance to the extent of forming an opinion but the auditor will have to undertake additional procedures if he had additional reporting responsibilities.
- ❖ FS (General Purpose FS or Special Purpose FS) are prepared and presented by the mgt. with oversight of TCWG.
- ❖ Audit is conducted on a premise that management/TCWG have responsibility that are fundamental to an audit. **(SA 580) (SA 210)**  
The audit of the financial statements does not relieve management or those charged with governance of those responsibilities. The Responsibilities of the Mgt. and TCWG are:
  - Identification of FRF (General Purpose FS or Special Purpose FS).
  - Preparation of FS in acc with FRF, exercise of judgment.
  - Accounting Standards by:
    - Standard setting authority;
    - L&R;
    - Both by Standard setting authority and L&R;
    - The legal and ethical environment, including statutes, regulations, court decisions, and professional ethical obligations in relation to accounting matters;
    - Published accounting interpretations of varying authority issued by standards setting, professional or regulatory organisations;
    - Published views on accounting issues;
    - General/industry practices; and
    - Accounting literature. **(Highest Authority source prevails in case of conflict about the application of FRF)**
  - Adequate description of FRF in FS.
  - Design, implementation & maintenance of ICs relevant to preparation & presentation of FS free of material misstatement.
  - Access to all information & records/ dox relevant to preparation & presentation of FS.
  - Any additional info requested by auditor.
  - Unrestricted access to those within the entity.
  - FS meet common financial info needs of wide range of users/ special purpose.
- ❖ The requirements of the applicable FRF (Fair Presentation Framework or Compliance Framework) determine:
  - The form and content of the FS.
  - What constitutes a complete set of FS.
- ❖ Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

## **Reasonable Assurance**

- ❖ SAs require auditor to obtain reasonable assurance:
  - Obtained SAAE to reduce audit risk to an acceptably low level.
- ❖ Absolute assurance not possible because of inherent limitations of audit.
- ❖ Materiality to be applied at planning as well as performance.

### **SA 200**

- ❖ **SAAE:**
  - **Sufficiency, appropriateness of audit evidence** (interrelated) **(SA 500)**
    - Primarily obtained from the audit procedures performed.
    - Previous Audits.
    - Firm's QCs procedures.
    - Entity's accounting records.
    - Evidence from the experts (internal or external) engaged
    - Absence of info. ( Refusal by mgt to provide WR.)
- ❖ **Audit Risk:**
  - Assessment is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit.
  - Matter of professional judgment.
  - Does not include the insignificant risk.
  - Does not refer to the auditor's business risks.
- ❖ **Risk of Material Misstatements (RMM) (SA 240, SA 315, SA 320, SA 330, SA 450, SA 210)**
  - Two levels:
    - The overall financial statement level; and
    - The assertion level for classes of transactions, account balances, and disclosures. (two components: inherent + Control risk)
  - Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. External circumstances giving rise to business risks may also influence inherent risk. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion.
  - Control risk is a function of the effectiveness of the design, implementation and maintenance of IC by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's FS. Can only reduce, but not eliminate, RMM in the FS, because of the inherent limitations of IC.
  - Detection risk – this is the only SA which describes Detection Risk. It does not find mention in any other SA.
    - Relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level.
    - A function of the effectiveness of an audit procedure and of its application by the auditor.
- ❖ **Inherent limitation of audit – causes:**
  - Nature of financial reporting.
  - Nature of audit procedures.
  - Need for audit to be conducted within a reasonable period of time and at a reasonable cost.
  - In case of certain assertions/ subject matters the potential effects of the inherent limitations on the auditor's ability to detect misstatement can be significant:
    - Frauds, particularly senior management frauds.
    - Existence & completeness of related party transactions.
    - Occurrence of non-compliance with L&R.
    - Future events/ conditions that may cause entity to cease to continue as a going concern.
- ❖ Subsequent discovery of a material misstatement of the FS resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence.

### **Practical & legal limitations on ability to obtain audit evidence**

- ❖ Management & others do not provide complete info intentionally/ unintentionally.
- ❖ Audit procedures used to gather audit evidence may be ineffective against fraud detection.
- ❖ Audit is not an official investigation into alleged wrongdoings:
  - Auditor does not have specific legal powers such as power of search.

**SA 200**

- ❖ This aspect has been discussed explicitly in a Standard for the first time.

### **Balance between benefit & costs**

- ❖ Matter of difficulty.
- ❖ Time.
- ❖ Cost involved.

Not valid reasons for auditor to omit audit procedure for which there is no alternative or to be satisfied with less persuasive audit evidence.

**SA 200**

- ❖ Concept of balance between benefit & costs is being discussed for the first time in a Standard.

### **Objective of SAs**

- ❖ Designed to support the auditor in obtaining reasonable assurance.
- ❖ Expectations from auditor:
  - Exercise professional judgment.
  - Maintain professional skepticism.
  - Identify & assess risk of material misstatement.
  - Obtain SAAE about material misstatement.
  - Design & implement appropriate responses to assessed risks.
  - Form opinion on the FS based on audit evidence obtained.

#### **SA 200**

- ❖ The form of opinion expressed by the auditor will depend upon the applicable FRF and any applicable L & R.
- ❖ The auditor may also have certain other communication and reporting responsibilities to users, management, TCWG, or parties outside the entity, in relation to matters arising from the audit. These may be established by the SAs or by applicable L & R.

### **Overall Objective of the Auditor**

- ❖ Obtain reasonable assurance whether FS as a whole are free from material misstatement whether due to fraud/ error.
- ❖ Report on FS and communicate as required by SAs.

#### **SA 200**

- ❖ In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the SAs require that the auditor disclaim an opinion or withdraw from the engagement, where withdrawal is legally permitted.



## Definitions

- ❖ **Applicable FRF** – adopted by management/TCWG in the preparation and presentation of FS:
  - That is acceptable in view of the nature of the entity,
  - Objective of the FS, and
  - Required by L & R.
- ❖ **Fair presentation framework** – FRF that requires compliance with the requirements of the framework and:
  - Acknowledges explicitly or implicitly that, to achieve fair presentation of the FS; or
  - Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of FS. **(In extremely rare circumstances)**
- ❖ **Compliance framework** – FRF that requires compliance with the requirements of the framework, but does not contain the acknowledgements as required in case of fair presentation framework.

SA 200

## Definitions

- ❖ **Audit evidence** – Info used by the auditor:
  - In arriving at the conclusions.
  - On which the auditor's opinion is based.
  - Includes:
    - Both info contained in the accounting records underlying the financial statements, and
    - Other information.
- ❖ **Sufficiency** – measure of the quantity of audit evidence.
- ❖ **Appropriateness** – measure of the quality of audit evidence.
- ❖ **Audit risk** – The risk that:
  - The auditor expresses an inappropriate audit opinion.
  - When the financial statements are materially misstated.
  - Audit risk is a function of the risks of material misstatement and detection risk.

SA 200

## **Definitions**

- ❖ **Auditor** – Person(s) conducting the audit:
  - Engagement partner.
  - Other members of the engagement team, or, as applicable, the firm.
  - Where an SA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, use the term “engagement partner”.
- ❖ **Detection risk** – The risk that:
  - Procedures will not detect a misstatement that exists; and
  - That could be material, either individually or when aggregated with other misstatements.
- ❖ **Financial statements** – A structured representation of historical financial information:
  - Including related notes, ordinarily comprise a summary of significant accounting policies and other explanatory information,
  - Intended to communicate an entity’s economic resources or obligations at a point in time, or
  - The changes therein for a period of time in accordance with a FRF.

**SA 200**

## **Definitions**

- ❖ **Historical financial information:**
  - Info expressed in financial terms in relation to a particular entity,
  - Derived primarily from that entity’s accounting system,
  - About economic events occurring in past time periods, or
  - About economic conditions or circumstances at points in time in the past.
- ❖ **Management:**
  - Person(s) with executive responsibility for the conduct of the entity’s operations.
  - For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

**SA 200**

## Definitions

- ❖ **Misstatement** – A difference between:
  - Amount, classification, presentation, or disclosure of a reported FS item; and
  - Amount, classification, presentation, or disclosure that is required for the item to be in accordance with FRF.
  - Can arise from error or fraud.
  - In case of fair presentation framework, also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the FS to be presented fairly, in all material respects, or to give a true and fair view.
- ❖ **Premise, relating to the responsibilities of management/TCWG on which an audit is conducted** – management/TCWG have the following fundamental responsibilities:
  - Preparation and presentation of FS in accordance with the applicable FRF – this includes
    - Design, implementation and maintenance of IC; and
  - To provide the auditor with:
    - All relevant info for the preparation and presentation of the FS;
    - Any additional info requested by the auditor; and
    - Unrestricted access to within the entity.
  - Applies to fair presentation framework.
  - May also be referred to as the "premise".

**SA 200**

## Definitions

- ❖ **Professional judgment:**
  - Application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards,
  - In making informed decisions about the courses of action,
  - That are appropriate in the circumstances of the audit engagement.
- ❖ **Professional skepticism:**
  - An attitude that includes:
    - A questioning mind, being alert to conditions which may indicate:
      - Possible misstatement due to error or fraud, and
      - A critical assessment of audit evidence.
- ❖ **Reasonable assurance** – In the context of an audit of financial statements, a high, but not absolute, level of assurance.

**SA 200**

## **Definitions**

- ❖ **Risk of material misstatement** – The risk that:
  - FS are materially misstated prior to audit.
  - Consists of two components at the assertion level:
    - Inherent risk – The susceptibility of an assertion that could be material, either individually or in aggregate, before consideration of any related ICs.
    - Control risk – The risk that a misstatement that could occur in an assertion that could be material, either individually or in aggregate, will not be prevented, or detected and corrected, on a timely basis by the entity's IC.
- ❖ **Those charged with governance:**
  - Person(s) or organisation(s) (e.g., a corporate trustee).
  - With responsibility for overseeing the strategic direction of the entity; and
  - Obligations related to the accountability of the entity.
  - Includes overseeing the financial reporting process.
  - For some entities in some jurisdictions, include management personnel, e.g, executive members of a governance board of a private or public sector entity, or an owner-manager.

**SA 200**

## **I. Ethical requirements relating to an audit of FS**

- ❖ Comply with relevant ethical requirements relating to an audit of FS including Independence.
- ❖ Independence:
  - Of mind.
  - In appearance.
- ❖ Safeguards auditor's ability to form opinion without being influenced by compromising factors.
- ❖ Enhances ability to act with integrity.
- ❖ Be objective.
- ❖ Maintain professional skepticism.

### **SA 200**

- ❖ Relevant ethical requirements ordinarily comprise the Code of Ethics issued by the Institute of Chartered Accountants of India. The fundamental principles are:
  - Integrity;
  - Objectivity;
  - Professional competence and due care;
  - Confidentiality; and
  - Professional behavior.
- ❖ SQC 1 and SA 220 contain independence requirements.
- ❖ SA 220 entitles the engagement team to rely on firm's system in meeting its responsibilities wrt QC applicable to individual engagement unless information provided by firm/ other parties suggest otherwise.

## **II. Professional Skepticism**

- ❖ Plan and perform audit with professional Skepticism.
- ❖ Necessary for critical assessment of audit evidence.
- ❖ Reduces risk of:
  - Overlooking unusual circumstances.
  - Overgeneralising when drawing conclusions from audit observations.
  - Using inappropriate assumptions in determining nature, timing & extent of audit procedures & evaluating the results thereof.

### **SA 200**

- ❖ Professional skepticism in simple words means having a questioning and alert mind.
- ❖ Being alert to:
  - Contradictory audit evidence.
  - Questions on reliability of documents.
  - Conditions indicating possible frauds.
  - Circumstances suggesting need for audit procedures in addition to those suggested in SAs.
- ❖ The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and TCWG. Nevertheless, a belief that management and TCWG are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

### **III. Professional Judgment**

- ❖ Exercise in planning and performing an audit.
- ❖ Expectations from auditor:
  - It is exercised by an auditor.
  - Whose training, knowledge & experience have assisted.
  - In developing the necessary competencies.
  - To achieve reasonable judgments.
- ❖ Its exercise depends on facts & circumstances known to the auditor.

**SA 200**

1. Dealt for the first time in an SA.
2. Important when deciding about:
  - Materiality & audit risk.
  - NTE of audit procedures.
  - Evaluating sufficiency & appropriateness of audit procedures.
  - Evaluating mgt judgment in applying applicable FRF.
  - Drawing conclusions based on audit evidence.

- ❖ Can be evaluated based on whether the judgment reached:
  - Reflects a competent application of auditing & accounting principles.
  - Is appropriate in the light of & consistent with the facts & circumstances that were known to auditor till the date of audit report.
- ❖ To be exercised throughout audit.
- ❖ To be appropriately documented.
- ❖ Cannot be used to justify decisions that are not otherwise supported by facts & circumstances of engagement or SAAE.

**SA 200**

## IV. SAAE & Audit Risk

- ❖ See Slides 5 to 7 of SA 200.

SA 200

## V. Conduct of Audit in Accordance with SAs

- ❖ Complying with SAs relevant to audit:
  - Comply with all SAs relevant to audit.
    - SA is relevant when:
      - That SA is in effect, &
      - Circumstances addressed by SA exist.
  - Have an understanding of the entire text of SA.
  - Do not represent compliance with SAs in audit report unless auditor complies with SA 200 & other SAs relevant to audit.

SA 200

- ❖ SAs taken together provide standards for auditor's work in fulfilling the overall objectives of the auditor.
- ❖ They deal with:
  - The general responsibilities of the auditor.
  - Further considerations relevant to application of those responsibilities to specific topics.
- ❖ Do not override L&R. **Audit only in accordance with L&R does not automatically comply with SA.**
- ❖ Contents of the SAs:
  - **Introduction:** The 'Introduction' section deals the purpose and scope of the Standard, subject matter of the Standard, responsibility of auditor and effective date of the Standard.
  - **Objectives:** The 'Objectives' section provides the reference in which the Requirements are elaborated in the Standard. The aim of the auditor is to achieve the Objectives as specified in all Standards of Auditing (SAs). Each SA contains one or more objectives which provide a link between the requirements and the overall objectives of the auditor. The objectives in individual SAs serve to focus the auditor on the desired outcome of the SA, while being specific enough to assist the auditor in:
    - Understanding what needs to be accomplished and, where necessary, the appropriate means of doing so; and
    - Deciding whether more needs to be done to achieve them in the particular circumstances of the audit.*The requirements of the SAs are designed to enable the auditor to achieve the objectives specified in the SAs, and thereby the overall objectives of the auditor.*
  - **Definitions:** The 'Definitions' section deals with the meaning attributed to certain expressions for the purpose of SAs. The aim is to assist the auditors to ensure consistent application of the Standards.
  - **Requirements:** The fundamental principles of the Standard are contained in the Requirements section and presented by use of "shall".
  - **Application and Other Explanatory Material:** The 'Application and Other Explanatory Material' contained in an SA is an integral part of the SA as it provides further explanation of, and guidance for carrying out, the requirements of an SA, along with the background information on the matters addressed in the SA. It may include examples of procedures that may be appropriate in the circumstances. Such guidance is, however, not intended to impose a requirement. Appendices form part of Application and Other Explanatory Material. The purpose and intended use of an appendix are explained in the body of the related SA or within the title and introduction of the appendix itself.
  - **Public Sector perspective.**
  - **Small Entities considerations.**



- Objective stated in each SA:
  - Use this objective to achieve overall objectives.
  - Have regard to interrelationship between SAs:
    - Determine if any audit procedure in addition to that required by SAs is necessary.
    - Evaluate, SAE has been obtained.
- ❖ Complying with relevant requirements:
  - Unless:
    - Entire SA is not relevant.
    - Requirement is not relevant because it is conditional & condition does not exist.
    - Departure from requirement in exceptional circumstances – perform alternative procedures to achieve aim of requirement.

**SA 200**

- ❖ Failure to achieve an objective:
  - Evaluate if the failure:
    - Prevents auditor from achieving the overall objectives of the auditor.
    - Necessitates modified audit opinion.
  - It is a significant matter for documentation.

**SA 200**

# SA 210

## Agreeing the Terms of Audit Engagements

*Effective for audits of financial statements for  
periods beginning on or after April 1, 2010*

### Overview of SA 210

- ❖ **Introduction:**
  - Scope
  - Effective Date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements:**
  - Preconditions for an Audit.
  - Agreement on Audit Engagement Terms.
  - Recurring Audits.
  - Acceptance of a Change in the Terms of the Audit Engagement.
  - Additional considerations in Engagement Acceptance.
- ❖ **Application and Other Explanatory Material on these aspects.**
- ❖ **Appendices.**

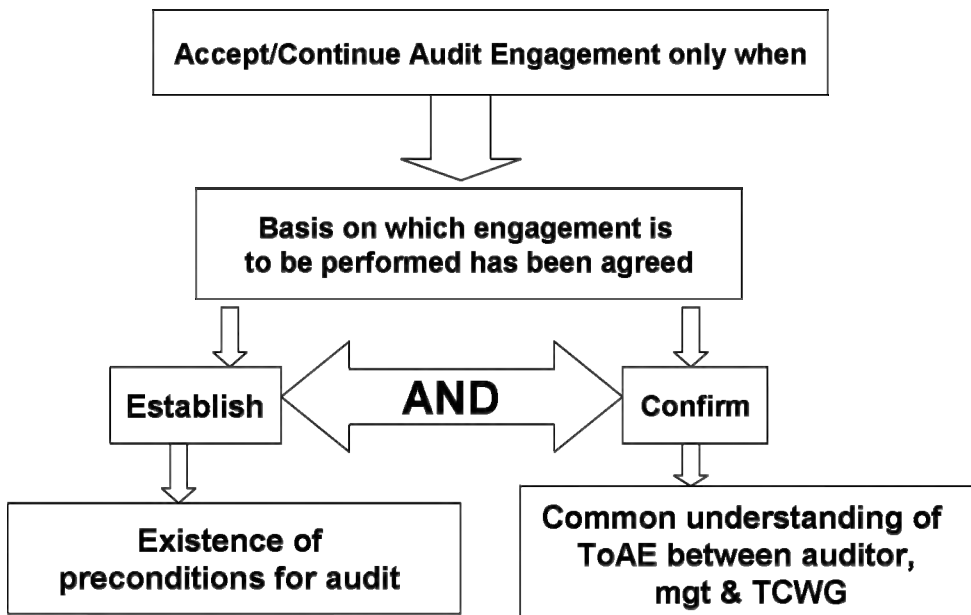
SA 210

## Scope

- ❖ Auditor's responsibilities in agreeing the terms of audit engagement (ToAE) with mgt & TCWG:
  - Includes establishing that preconditions for audit are present.

SA 210

## Auditor's Objective



SA 210

## Definitions

### **Preconditions for An Audit:**

- ❖ Mgt uses acceptable FRF in preparation of FS, and
- ❖ Agreement with Mgt/ TCWG on basic premise on which audit is conducted.

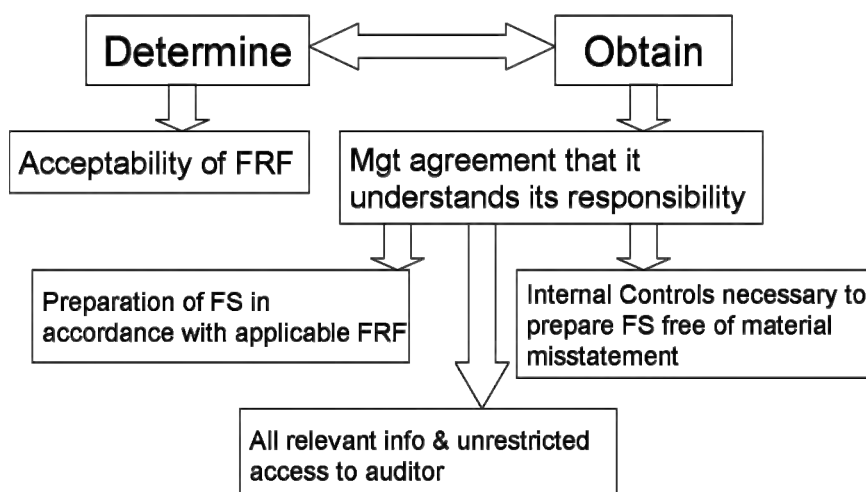
SA 210

### **Premise on which audit is conducted**

As per SA 200, the *Premise on which an Audit is conducted* or *Premise* means that Management is responsible for:

- Design, implementation & maintenance of Internal Controls on financial reporting so that FS are free of material misstatements.
- Providing to the auditor:
  - \* All relevant records, documents, other relevant information.
  - \* Additional info requested by auditor.
  - \* Unrestricted access to those in the entity from whom necessary evidence can be obtained.

## **Preconditions for Audit – I** **Establishing Existence**



SA 210

## **Preconditions for Audit – II**

### **Acceptability of FRF**

❖ **Factors for determining Acceptability:**

- The nature of the entity;
- The purpose of the FS;
- The nature of the FS; and
- Whether FRF prescribed by Law/ Regulation.

❖ Deficiencies in applicable FRF may be encountered after engagement acceptance. In such cases, mgt may decide to use another FRF. This will become new ToAE.

**SA 210**

❖ **Determining Acceptability of FRF:**

Following factors are relevant for such determination.

- The nature of the entity (for example, whether it is a business enterprise, a public sector entity or a not-for-profit organisation);
  - The purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users or the financial information needs of specific users);
  - The nature of the financial statements (for example, whether the financial statements are a complete set of financial statements or a single financial statement); and
  - Whether law or regulation prescribes the applicable FRF.
- ❖ Financial Statements prepared in accordance with the FRF designed to meet the information needs of specific users is covered by the 800 series of Standards.

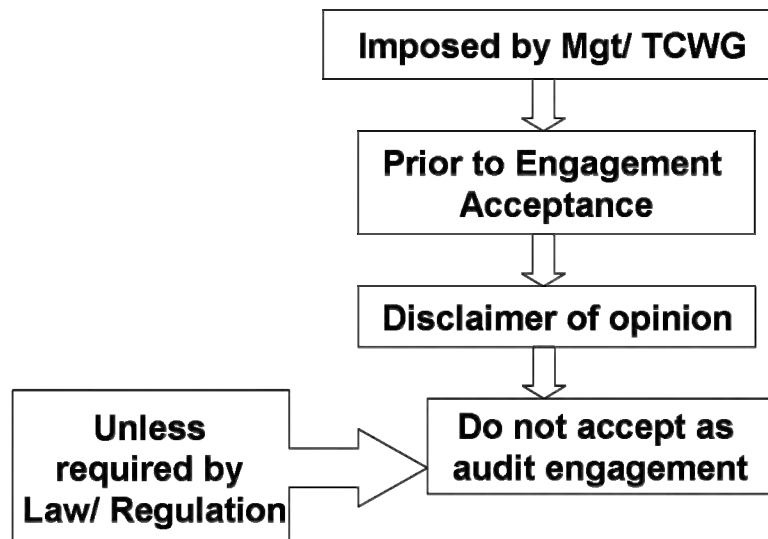
### **Preconditions for Audit – III** **Management Responsibility**

- ❖ **Independent audit means:**
  - Auditor not to be involved in:
    - Preparation of FS or entity's related internal controls.
  - Auditor has reasonable expectation of obtaining info necessary for audit.
- ❖ If mgt does not acknowledge its responsibilities or agree to provide written representations:
  - Auditor will be unable to obtain SAAE.
  - Do not accept engagement unless required by L & R.
  - If auditor is required to accept engagement:
    - Explain to mgt importance of these matters & impact on AR.

SA 210

- ❖ ICs provide only reasonable assurance about achieving entity's financial reporting objectives due to its inherent limitations.
- ❖ Independent audit is not a substitute for maintenance of ICs hence the need for mgt agreement. But agreement does not imply that auditor will find the ICs maintained by mgt have achieved its purpose are free of deficiencies.
- ❖ Includes responsibility for preparation & maintenance of accounting records – whether or not specifically required by law.

### **Preconditions for Audit – IV** **Scope Limitation**



SA 210

## Agreement on Audit Engagement Terms

- ❖ Agree the ToAE with Mgt/TCWG.
- ❖ Agreed ToAE shall include:
  - Objective & scope of audit of FS.
  - Auditor's responsibilities.
  - Management's responsibilities.
  - Identification of applicable FRF.
  - Expected form & content of report.
  - A statement that these may undergo change due to circumstances.
- ❖ If L & R prescribe ToAE in details:
  - Written Engagement Letter may not be necessary for above.

### SA 210

- ❖ **Send Audit Engagement Letter (AEL) before commencement of audit to avoid misunderstandings wrt audit.**
- ❖ **AEL may make reference to, for example:**
  - Elaboration of scope of audit, including reference to applicable legislation, regulations, SAs, and ethical and other pronouncements of professional bodies to which auditor adheres.
  - The form of any other communication of results of the audit engagement.
  - Fact that because of inherent limitations of audit, together with inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though audit is properly planned and performed in accordance with SAs.
  - Arrangements regarding planning and performance of audit, including composition of audit team.
  - The expectation that management will provide written representations.
  - The agreement of management to make available to auditor draft FS and any accompanying other information in time to allow auditor to complete audit in accordance with proposed timetable.
  - The agreement of management to inform auditor of facts that may affect the FS, of which management may become aware during the period from the date of AR to date the FS are issued.
  - The basis on which fees are computed and any billing arrangements.
  - A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein.
- ❖ **When relevant, the following points could also be made in the AEL:**
  - Arrangements concerning involvement of other auditors and experts in some aspects of the audit.
  - Arrangements concerning the involvement of internal auditors and other staff of the entity.
  - Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
  - Any restriction of the auditor's liability when such possibility exists.
  - A reference to any further agreements between the auditor and the entity.
  - Any obligations to provide audit working papers to other parties.

## **Recurring Audits**

- ❖ Assess whether:
  - Circumstances require revision in ToAE, and
  - Need to remind the entity re existing ToAE.

**SA 210**

- ❖ Following factors may make it appropriate to revise the terms or to remind the existing terms to the entity:
  - Any indication that the entity misunderstands objective and scope of the audit.
  - Any revised or special terms of the audit engagement.
  - A recent change of senior management.
  - A significant change in ownership.
  - A significant change in nature or size of the entity's business.
  - A change in legal or regulatory requirements.
  - A change in the FRF adopted in the preparation of the FS.
  - A change in other reporting requirements.

## **Acceptance of Change in Terms**

- ❖ Do not agree to change if no reasonable justification for it.
- ❖ If unable to agree with changed ToAE AND not permitted by mgt to continue:
  - Withdraw if permitted under L & R; and
  - Determine need to report to other parties such as TCWG/ regulators/ owners.
- ❖ If ToAE are changed:
  - Auditor and mgt shall agree on new terms, and
  - Record new terms in engagement letter or other suitable form of written agreement.

**SA 210**

- ❖ **Reasonable Justification:**
  - Change in circumstances affecting entity's requirements.
  - Misunderstanding as to nature of audit.
- ❖ **Unreasonable Justification:**
  - Incorrect/ incomplete/unsatisfactory information.
  - If, before completing audit engagement, auditor is requested to change audit engagement to an engagement that conveys a lower level of assurance, auditor shall determine whether there is reasonable justification for doing so.



## Additional Considerations in Engagement Acceptance – I Financial Reporting Standards supplemented by L&R

- ❖ Determine if conflicts exist between **standards** and **additional requirements**.
- ❖ If conflicts exist:
  - Discuss with mgt the additional requirements, and
  - Agree whether:
    - Additional requirements can be met through additional disclosures in the FS;  
OR
    - Description of FRF in FS can be amended accordingly.
    - If neither possible, consider effect on audit opinion.

SA 210

## Additional Considerations in Engagement Acceptance - II FRF Given by Law not Acceptable

### Accept engagement only if:

- ❖ Mgt agrees to provide additional disclosures in FS to avoid the FS being misleading; **and**
- ❖ It is recognised in ToAE that:
  - AR will include Emphasis of Matter paragraph, **and**
  - Unless auditor required by L&R to use phrases "present fairly, in all material respects" or "give a true and fair view"
    - auditor's opinion on the FS will not include such phrases.

### Above conditions not met:

- ❖ If above conditions not met and L&R require auditor to undertake engagement:
  - Evaluate effect of misleading nature of FS on auditor's report, and
  - Include appropriate reference to this matter in ToAE.

SA 210

## **Additional Considerations in Engagement Acceptance- III**

### **Auditor's Report Prescribed by L&R**

- ❖ Evaluate:
  - Whether users might misunderstand the assurance obtained from audit of the FS and, if so,
  - Whether additional explanation in the AR can mitigate possible misunderstanding.
- ❖ If additional explanation cannot mitigate possible misunderstanding:
  - Do not accept audit engagement unless required by L&R.
  - This audit, if conducted, does not comply with SAs.
  - Audit report cannot state the audit as having been conducted in accordance with SAs.

**SA 210**

## **SA 220**

### **Quality Control for an Audit of Financial Statements**

*Effective for Audits of financial statements for  
periods beginning on or after April 1, 2010*

## **Overview of SA 220**

- ❖ **Introduction**
  - Scope.
  - Effective date.
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements & Application**
  - Leadership responsibilities for quality on audits.
  - Relevant ethical requirements.
  - Acceptance & continuance of client relationship & audit engagements.
  - Assignment of engagement teams.
  - Engagement performance.
  - Monitoring.
  - Documentation.

**SA 220**

## **Scope**

- ❖ Deals with:
  - Specific responsibilities of the auditor re QC procedures for an audit of FS.
  - Responsibilities of engagement QC reviewer.
- ❖ Read in conjunction with relevant ethical requirements.
- ❖ SA 220 presumes firm is applying SQC 1.

**SA 220**

## **QC System & Role of Engagement Team**

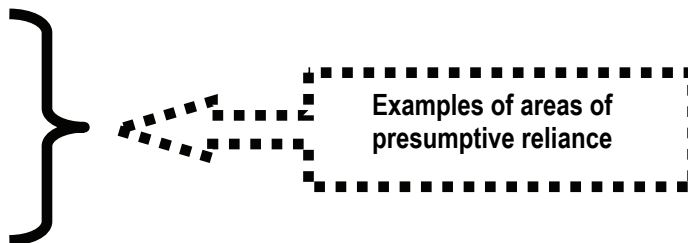
- ❖ Responsibility of Audit Firm:
  - Implement QC system that provides reasonable assurance:
    - Firm & its personnel comply with professional standards & regulatory & legal requirements.
    - Reports issued by firm/ engagement partners are appropriate in the circumstances.
- ❖ Responsibility of Engagement Team:
  - Implement applicable QC procedures.
  - Provide firm with relevant info wrt QC re Independence.

**SA 220**

- ❖ **Aspects to be addressed by QC system for each engagement:**
  - Leadership responsibilities for quality within firm.
  - Relevant ethical requirements.
  - Acceptance & continuance of client relationship & specific engagements.
  - Human resources.
  - Engagement performance.
  - Monitoring .

- ❖ Engagement Team entitled to rely on firm's QC unless info provided by firm or other parties suggests otherwise:

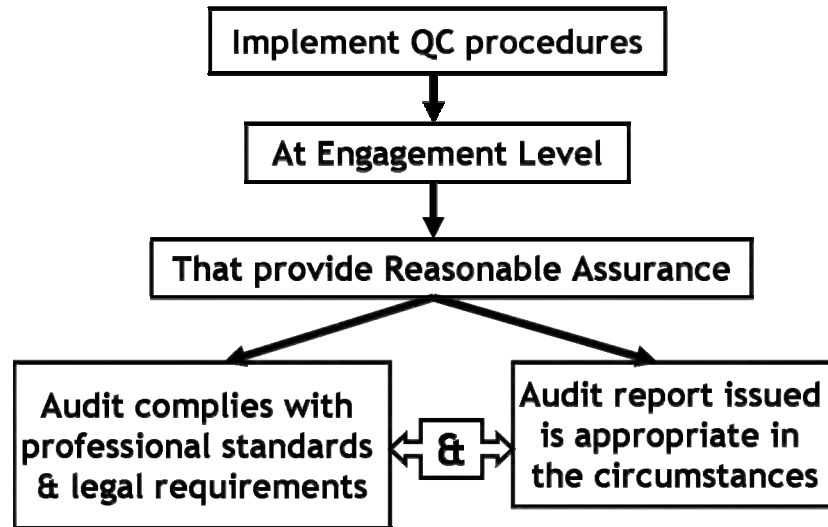
- Competence
- Independence
- Maintenance of client relationships
- Adhere to L&R



**SA 220**

- ❖ The engagement team may rely on the firm's system of quality control in relation to, for example:
  - Competence of personnel through their recruitment and formal training.
  - Independence through the accumulation and communication of relevant independence information.
  - Maintenance of client relationships through acceptance and continuance systems.
  - Adherence to regulatory and legal requirements through the monitoring process.

### Auditor's Objective



SA 220

### Definitions

▪ Engagement Partner	▪ Network Firm
▪ Engagement QC Review	▪ Network
▪ Engagement QC Reviewer	▪ Partner
▪ Engagement Team	▪ Personnel
▪ Firm	▪ Professional Standards
▪ Inspection	▪ Relevant Ethical Requirements
▪ Listed Entity	▪ Staff
▪ Monitoring	▪ Suitably Qualified External Person

SA 220

## **Definitions Explained**

### **Engagement Partner**

- ❖ Partner or other person in firm.
- ❖ Is a member of ICAI, in full time practice.
- ❖ Is responsible for engagements & its performance.
- ❖ Is responsible for report issued.
- ❖ Or has appropriate authority from professional/ legal/ regulatory body.

**SA 220**

## **Definition Explained**

### **Engagement QC Review**

- ❖ Process:
  - *To* provide objective evaluation.
  - *Before* report is issued.
  - *For* significant judgments & conclusions of engagement team.
  - *In* formulating report.

### **Engagement QC Reviewer**

- ❖ Partner/ other person in firm/ suitably qualified external person/ team.
- ❖ With sufficient & appropriate experience & authority.
- ❖ To objectively evaluate significant judgments/ conclusions of engagement team.
- ❖ Before report is issued.
- ❖ "QC team" to be led by CA, who is a member of ICAI.

**SA 220**

## **Definition Explained**

### **Engagement Team**

- ❖ All personnel performing the engagement.
- ❖ Includes outside experts contracted for that engagement.

### **Firm**

- ❖ Sole practitioner.
- ❖ Partnership.
- ❖ Any other such entity of professional accountants permitted by law.

SA 220

## **Definition Explained**

### **Inspection**

- ❖ For completed engagements
- ❖ Procedures
  - Applied on audit engagement team.
  - Evidence of compliance with firm's quality control policies/ procedures.

### **Listed Entity**

- ❖ Stocks/ shares/ debt quoted on:
  - Recognised stock exchange.
  - Traded under regulation of recognised stock exchange/ equivalent body.

SA 220

## **Definition Explained**

### **Monitoring**

- ❖ What – *A process.*
- ❖ *About* – ongoing consideration & evaluation of firm's QC system:
  - Periodic inspection of selected completed engagements.
- ❖ *Why* – get reasonable assurance of operating effectiveness of QC system.

### **Network Firm**

- ❖ A firm or entity that belongs to a network.

### **Network**

- ❖ A large structure:
  - Aimed at cooperation, and
  - Clearly aimed at profit/cost-sharing or shares common ownership/control/management/QC policies/business strategy/brand name/professional resources etc.

**SA 220**

## **Definition Explained**

### **Partner**

- ❖ Any individual.
- ❖ Authority to bind the firm w.r.t. performance of professional service engagement.

### **Personnel**

- ❖ Partners.
- ❖ Staff.

### **Professional Standards**

- ❖ Engagement Standards as defined in revised Preface.
- ❖ Relevant ethical requirements.

### **Relevant Ethical Requirements**

- ❖ As contained in the Code of Ethics of ICAI.

**SA 220**



## Definition Explained

### Staff

- ❖ Professionals other than partners employed by firm.
- ❖ But includes experts.

### Suitably Qualified External Person

- ❖ Individual outside the firm.
- ❖ Capabilities & competence to act as engagement partner:
  - E.g. Partner/employee of another firm with appropriate experience.

SA 220

## Leadership Responsibilities for Quality in Audits

- ❖ Engagement Partner (EP) to take responsibility of overall quality on each audit engagement assigned to him/ her.
- ❖ Actions of/ messages from EP to ET to emphasise importance of:
  - Compliance with professional Standards, L&R.
  - Compliance with firm's applicable QC policies.
  - Issuance of appropriate audit report.
  - Ability to raise concerns without fear.
  - Quality is quintessential & indispensable in engagement performance.

SA 220

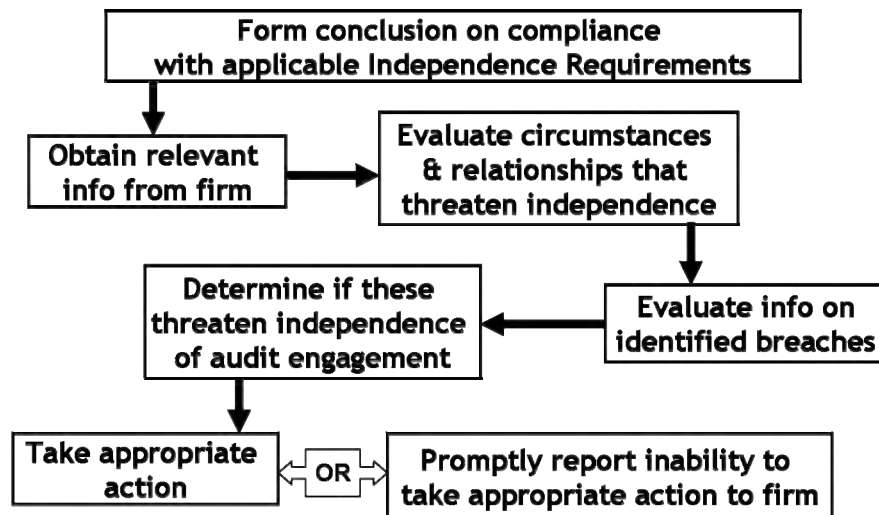
## Relevant Ethical Requirements

- ❖ EP to remain alert to evidence of non-compliance by ET:
  - Inquiry.
  - Observation.
- ❖ Actual/ indications of non-compliance, EP should:
  - Consult others in the firm.
  - Determine appropriate action.

SA 220

- ❖ Fundamental principles of professional ethics (as given in ICAI Code of Ethics)
  - Integrity;
  - Objectivity;
  - Professional competence and due care;
  - Confidentiality; and
  - Professional behaviour.

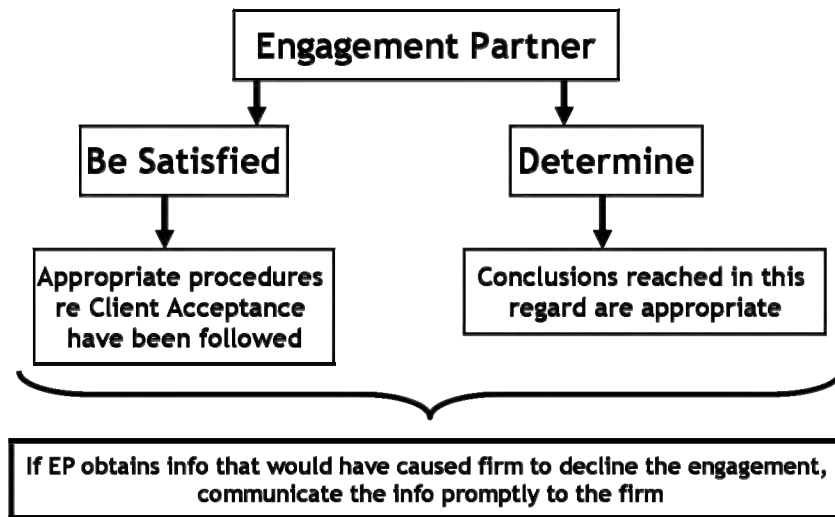
## EP's Responsibility wrt Independence Requirements



SA 220

- ❖ “Firm” includes “Network Firm”.
- ❖ **Appropriate action:**
  - Eliminate such threats or reduce them to an acceptable level by applying safeguards, OR
  - If considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation.

## Acceptance/ Continuation of Client Relationships & Audit Engagements



SA 220

- ❖ Relevant info about client to assess appropriateness of client acceptance/ continuance: **(SQC 1)**
  - The integrity of the principal owners, key management and those charged with governance of the entity;
  - Whether the ET is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
  - Whether the firm and ET can comply with relevant ethical requirements; and
  - Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

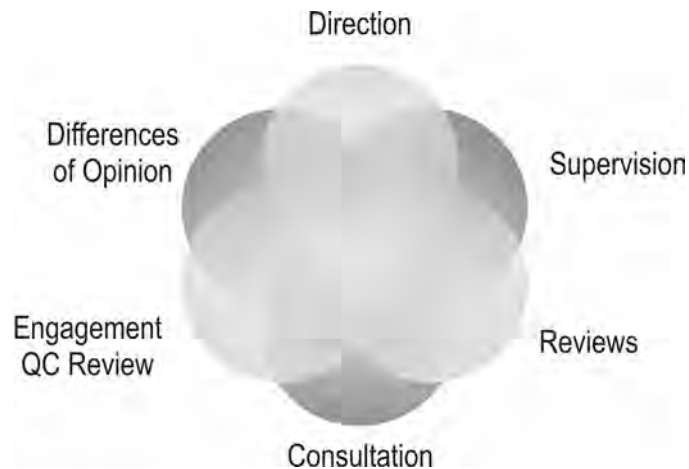
## **Assignment of Engagement Team**

- ❖ EP to be satisfied that ET & Auditor's Expert not part of ET have appropriate competence & capabilities:
  - Perform audit engagement in accordance with professional standards and L&R.
- AND
- Enable an auditor's report that is appropriate in the circumstances.

**SA 220**

- ❖ Matters to consider when assessing Competence and Capabilities:
  - Understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
  - Understanding of professional standards and regulatory and legal requirements.
  - Technical expertise, including expertise with relevant information technology and specialised areas of accounting or auditing.
  - Knowledge of relevant industries in which the client operates.
  - Ability to apply professional judgment.
  - Understanding of the firm's quality control policies and procedures.

## **Engagement Performance** **Responsibilities of EP**



**SA 220**

### **Direction**

- ❖ EP's responsibility:
  - Direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements; and
  - Auditor's report being appropriate in the circumstances.

**SA 220**

### **Direction**

- ❖ Involves informing ET members re:
  - Responsibilities:
    - Compliance with ethical requirements.
    - Professional skepticism in audit planning & performance.
    - Respective partners where more than one partner is involved in engagement.
  - Objective of work to be performed.
  - Nature of entity's business.
  - Risk-related issues.
  - Problems that may arise.
  - Detailed approach to engagement performance.

**SA 220**

- ❖ Discussion among members of the engagement team allows less experienced team members to raise questions with more experienced team members so that appropriate communication can occur within the engagement team.
- ❖ Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

## **Supervision**

- ❖ Tracking progress of audit.
- ❖ Considering competence and capabilities of individual members of ET:
  - Sufficient time to carry out work.
  - Proper understanding of instructions.
  - Work is being carried out as planned.
- ❖ Addressing significant matters arising during audit:
  - Significance & need to modify audit plan.
- ❖ Identifying matters for consultation & consideration by more experienced ET members.

**SA 220**

## **Reviews**

- ❖ EP's responsibility:
  - Reviews are being performed in accordance with firm's review policies and procedures.
  - Be satisfied that SAAE has been obtained to support the conclusions reached and audit report to be issued:
    - Review of audit documentation.
    - Discussion with engagement team.

**SA 220**

### **Issues to address**

- ❖ Work has been performed in accordance with professional standards & L&R.
- ❖ Significant matters raised for further consideration.
- ❖ Appropriate consultation has taken place & resulting conclusion documented & implemented.
- ❖ Need to revise Nature, Timing and Extent of work performed.
- ❖ Work performed supports conclusions reached & appropriately documented.
- ❖ Evidence obtained is sufficient & appropriate to support audit report.
- ❖ Objectives of engagement procedures have been achieved.

**SA 220**

- ❖ EP responsible for reviews being performed in accordance with firm's review policies and procedures:
  - Work of less experienced to be reviewed by more experienced ET member.

### **EP to review following critical areas during engagement for their timely resolution**

- ❖ Critical areas of judgment:
  - Difficult/ contentious matters identified during audit.
- ❖ Significant risks.
- ❖ Other areas considered important by EP.

**SA 220**

- ❖ Where a member of the ET with expertise in a specialised area of accounting or auditing is used, direction, supervision and review of that engagement team member's work may include matters such as:
  - Agreeing with that member the nature, scope and objectives of that member's work; and the respective roles of, and the nature, timing and extent of communication between that member and other members of the engagement team.
  - Evaluating the adequacy of that member's work including the relevance and reasonableness of that member's findings or conclusions and their consistency with other audit evidence.

## **Consultation**

- ❖ EP shall:
  - Take responsibility for ET undertaking consultation on difficult/ contentious issues.
  - Be satisfied that members of ET have undertaken such consultation.
  - Be satisfied that nature & scope and conclusions of such consultations are agreed with consultant.
  - Determine that conclusions resulting from such conclusions have been implemented.

**SA 220**

### ***Consultation***

- ❖ To achieve effective consultation:
  - Consultants are given all the relevant facts that will enable them to provide informed advice; and
  - Consultants have appropriate knowledge, seniority and experience.
- ❖ It may be appropriate for the engagement team to consult outside the firm, for example, where the firm lacks appropriate internal resources. They may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organisations that provide relevant quality control services.

## **Engagement QC Review**

- ❖ For listed companies.
- ❖ For other audit engagements for which firm has determined EQCR is required.

### **EP shall:**

- ❖ Determine that an EQC Reviewer had been appointed.
- ❖ Discuss significant matters arising during audit engagement with EQC reviewer.
- ❖ Not date the audit report until completion of EQC Review.

**SA 220**

- ❖ SA 700 requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the auditor's opinion on the financial statements.
- ❖ In cases of an audit of financial statements of listed entities or when an engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.



- ❖ EQC Reviewer shall perform objective evaluation of:
  - Significant judgments made by ET.
  - Conclusions reached in formulating audit report.
- ❖ Evaluation involves:
  - Discussion of significant matters with ET.
  - Review of FS & proposed audit report.
  - Review of selected audit documentation re significant judgments & conclusions of ET.
  - Evaluation of conclusions reached.
  - Considering whether proposed audit report is appropriate.

**SA 220**

- ❖ EP to remain alert for changes in circumstances in which an engagement quality control review is necessary, even though at the start of the engagement, such a review was not required.
- ❖ The extent of EQC Review may depend, among other things:
  - Complexity of the audit engagement,
  - Whether the entity is a listed entity, and
  - Risk that the auditor's report might not be appropriate in the circumstances.
- ❖ The performance of an engagement quality control review does not reduce the responsibilities of the engagement partner for the audit engagement and its performance.

**EQC Review – Additional Considerations for Listed Entities**

- ❖ ET's evaluation of firm's independence in relation to audit engagement:
  - Whether appropriate consultation has taken place on matters involving differences of opinion/ difficult matters & conclusions arising from consultations.
  - Whether audit documentation selected for review reflects the work performed wrt significant judgments made & supports the conclusions reached.

**SA 220**

- ❖ Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review of a listed entity include:
  - Significant risks identified during the engagement in accordance with SA 315, and the responses to those risks in accordance with SA 330, including the engagement team's assessment of, and response to, the risk of fraud in accordance with SA 240.
  - Judgments made, particularly with respect to materiality and significant risks.
  - The significance and disposition of corrected and uncorrected misstatements identified during the audit.
  - The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.
- ❖ These other matters, depending on the circumstances, may also be applicable for engagement quality control reviews for audits of FS of other entities.

## **Differences of Opinion**

- ❖ Differences of opinion may arise:
  - Within the ET,
  - With those consulted, or
  - Between the EP and EQC Reviewer.
- ❖ ET shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

**SA 220**

## **Monitoring**

- ❖ EP shall consider:
  - Results of firm's monitoring process as evidenced in latest info circulated by firm/ network firms.
  - Whether deficiencies noted in the info may affect the audit engagement.

**SA 220**

- ❖ Monitoring process provides the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively.
- ❖ In considering deficiencies that may affect the audit engagement, the engagement partner may have regard to measures the firm took to rectify the situation that the engagement partner considers are sufficient in the context of that audit.
- ❖ A deficiency in the firm's system of quality control does not necessarily indicate that a particular audit engagement was not performed in accordance with professional standards and regulatory and legal requirements, or that the auditor's report was not appropriate.

### **Documentation - Auditor**

- ❖ Issues identified wrt compliance with relevant ethical requirements and how they were resolved.
- ❖ Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.
- ❖ Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.
- ❖ The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement.

**SA 220**

- ❖ Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to understanding of:
  - The issue on which consultation was sought; and
  - The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

### **Documentation – EQC Reviewer**

- ❖ Procedures required by the firm's policies on engagement quality control review have been performed;
- ❖ ECQR has been completed on or before the date of the auditor's report; and
- ❖ The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

**SA 220**

# SA 230

## Audit Documentation

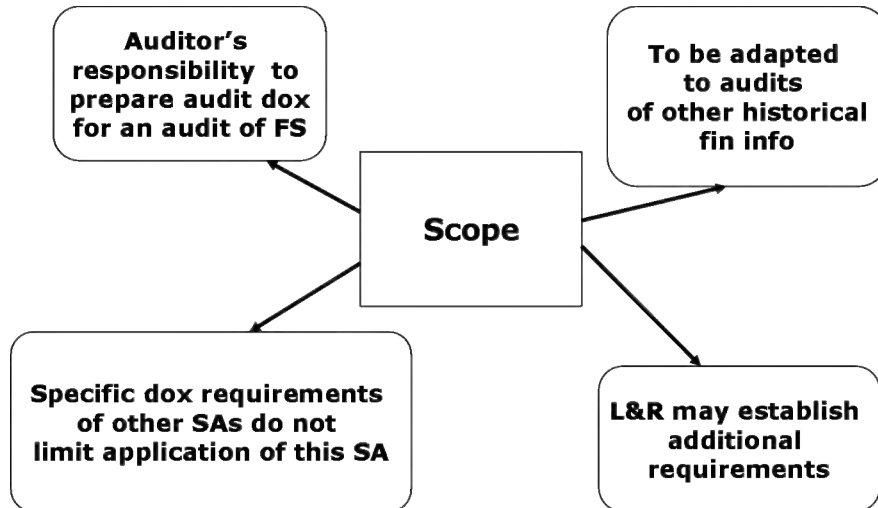
*Effective for audits of financial statements for periods  
beginning on or after April 1, 2009*

## Overview of SA 230

- ❖ **Introduction**
  - Scope
  - Effective Date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements**
  - Timely Preparation of Audit Documentation
  - Documentation of the Audit Procedures Performed and Audit Evidence Obtained
  - Assembly of the Final Audit File
- ❖ **Application and Other Explanatory Material on these Aspects**

SA 230

## Scope



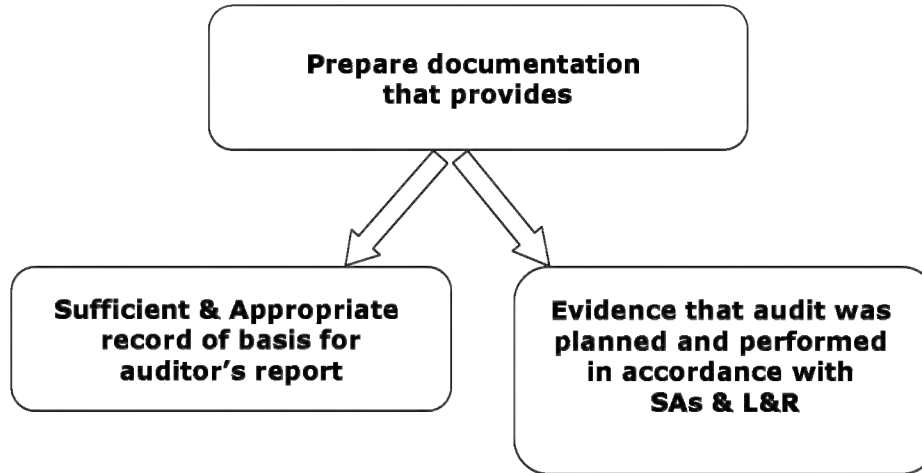
SA 230

## Nature & Purpose



SA 230

## Objective



SA 230

## Definitions

### **Audit Documentation**

- ❖ Record of:
    - audit procedures performed,
    - relevant audit evidence obtained and
    - conclusions reached.
- Also known as "working papers", "work papers".

### **Audit File**

- ❖ One or more folders or other storage media.
- ❖ In physical or electronic form.
- ❖ Containing records that comprise audit documentation for a specific engagement.

SA 230

## **Definitions**

### **Experienced Auditor**

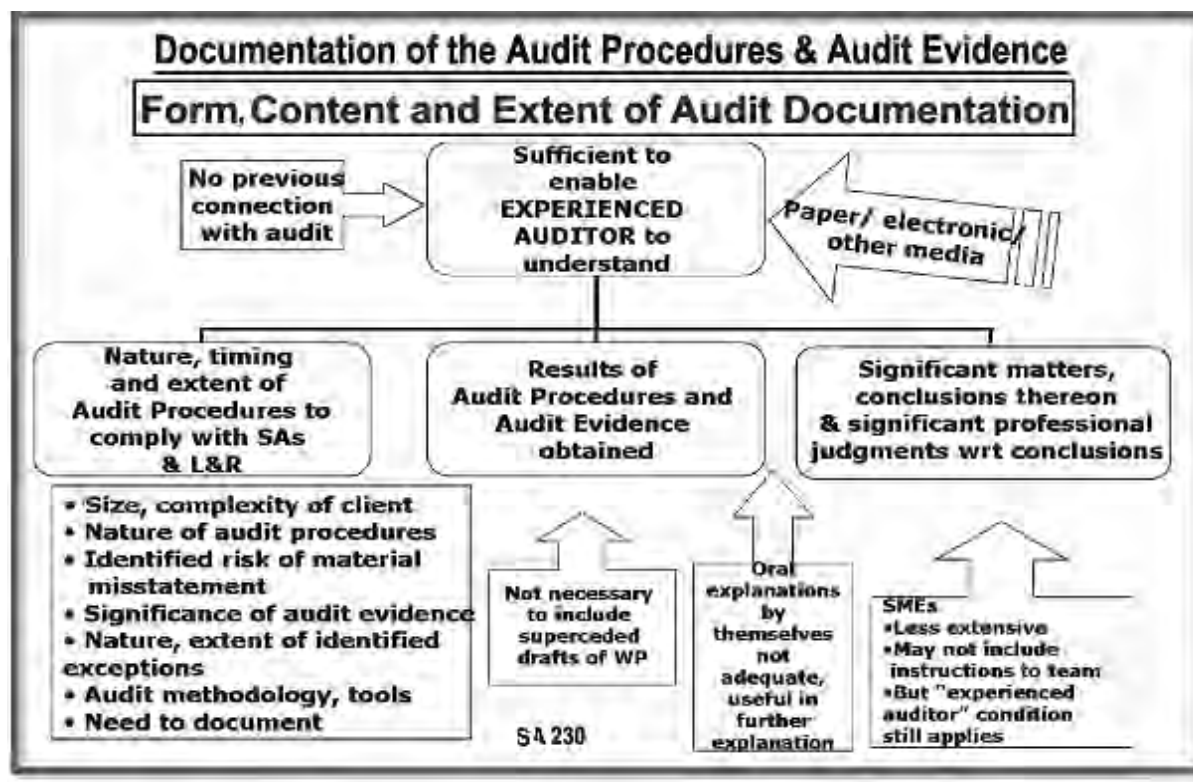
- ❖ An individual (whether internal or external to firm) having practical audit experience, and a reasonable understanding of:
  - Audit processes;
  - SAs and applicable L&R requirements;
  - Business environment ; and
  - Auditing and financial reporting issues.

SA 230

## **Timely Preparation of Audit Documentation**

- ❖ Prepare Sufficient Appropriate audit dox on a timely basis:
  - Enhances quality of audit.
  - Facilitates effective review & evaluation of :
    - Audit evidence
    - Conclusions reachedbefore report is finalised
  - Dox prepared after audit is less accurate.

SA 230



- ❖ Examples of audit documentation include:
  - Audit programmes.
  - Analyses.
  - Issues memoranda.
  - Summaries of significant matters.
  - Letters of confirmation and representation.
  - Checklists.
  - Correspondence (including e-mail) concerning significant matters.
- ❖ The auditor may include abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) as part of audit documentation. Audit documentation, however, is not a substitute for the entity's accounting records.



## **Compliance with SAs and L&R**

- ❖ Compliance with SA 230 normally results in sufficient appropriate audit dox.
- ❖ Absence of specific dox requirements in an SA does not necessarily mean NIL dox wrt that SA.
- ❖ Not necessary/practicable to document every matter.
- ❖ Professional skepticism cannot be documented but demonstrated through dox.

### **SA 230**

- ❖ It is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:
  - The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
  - The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management, or where appropriate, those charged with governance.
  - An auditor's report containing an appropriately qualified opinion demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the SAs.
  - In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
    - For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with SAs. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.
    - Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the SAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussion required by SA 315.

## **Resolution of Significant Matters**

- ❖ Judgment requires objective analysis of facts & circumstances e.g.
  - Give rise to significant risks.
  - Audit procedures:
    - Indicate material misstatement of FS.
    - Need to revise risk assessment.
  - Circumstances leading to difficulty in applying audit procedures.
  - Possible situations for modifications to audit opinion.

**SA 230**

## **Resolution of Significant Matters – Documenting Professional Judgment-I**

- ❖ Rationale for auditor's conclusion where SA mandates consideration of aspect and that aspect is significant to audit.
- ❖ Basis of conclusion on reasonableness of areas of subjective judgment.
- ❖ Basis for conclusion re authenticity of a document when authenticity is in doubt.

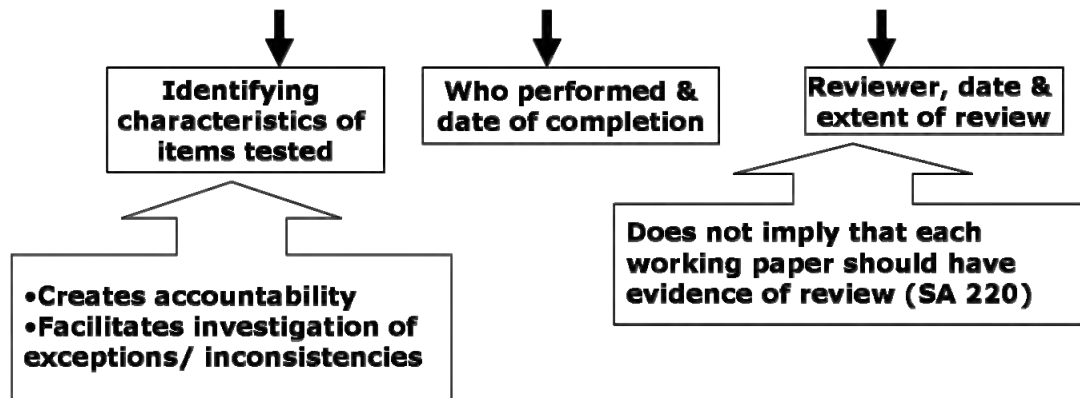
**SA 230**

## **Resolution of Significant Matters – Documenting Professional Judgment-II**

- ❖ May also maintain completion memorandum:
  - Significant matters identified
  - How addressed
  - Cross references to other supporting audit dox
- ❖ It is especially useful in large & complex audits. Helps in:
  - Effective, efficient reviews of dox
  - Consideration of significant matters
  - Identifying whether objective of any SA has not been met, impact on overall objective

**SA 230**

## Nature, Timing & Extent of Audit Procedures - Documentation



### SA 230

- ❖ Identifying characteristics will vary with the nature of the audit procedure and the item or matter tested. For example:
  - For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers.
  - For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register).
  - For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point and the sampling interval (for example, a systematic sample of shipping reports selected from the shipping log for the period from April 1 to September 30, starting with report number 12345 and selecting every 125th report).
  - For a procedure requiring inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of the entity personnel.
  - For an observation procedure, the auditor may record the process or matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

### **Discussions with Management, TCWG, Others**

- ❖ Document discussion on significant matters:
  - Nature of significant matter discussed
  - Time
  - Discussants.
- ❖ Not restricted to records prepared by auditor:
  - Minutes prepared by client & agreed by auditor.

**SA 230**

- ❖ Others with whom the auditor may discuss significant matters may include other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

### **Inconsistency vis-a-vis Final Conclusion**

- ❖ Document how the inconsistency was addressed.
- ❖ No need to retain incorrect/ superseded dox.

**SA 230**

## **Departure from Relevant Requirement**

- ❖ Departure happens in exceptional circumstances only.
- ❖ Document:
  - How alternative audit procedures achieve aim of the requirement.
  - Reasons for departure
  - Report to draw attention to the departure.

**SA 230**

- ❖ The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant only in the cases where:
  - The entire SA is not relevant [for example, if an entity does not have an internal audit function, nothing in SA 610 is relevant]; or
  - The requirement is conditional and the condition does not exist (for example, the requirement to modify auditor's opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

## **Matters Arising After Date of Audit Report**

- ❖ In exceptional circumstances, auditor performs additional procedures / draws new conclusions, document:
  - Circumstances encountered.
  - New/ additional audit procedures performed.
  - Audit evidence obtained.
  - Conclusions reached.
  - Effect on auditor's report.
  - Who made/review audit documentation.

**SA 230**

## **Assembly of Final Audit File**

- ❖ **Timely basis after date of audit report:**
  - Set policy in terms of SQC 1.
  - Within 60 days (SQC 1).
- ❖ **Changes permitted:**
  - Deleted/ discarding superseded dox.
  - Sorting, collating, cross referencing working papers.
  - Signing off on completion checklists re file assembly.
  - Documentation of discussion with engagement team before date of audit report.

**SA 230**

- ❖ No deletion/ discarding permitted after final assembly except for example to clarify existing dox arising from internal/ external inspections:
  - Document specific reasons for making them.
  - When & by whom made/ reviewed.
- ❖ Retention period–7 years from date of audit report.

**SA 230**

## **Ownership of Documentation**

- ❖ **Unless otherwise specified by law or regulation, audit documentation is the property of the Auditor.**
- ❖ **May at his discretion, make portions of, or extracts from, audit documentation available to clients, provided:**
  - Such disclosure does not undermine the validity of the work performed, or
  - in the case of assurance engagements, does not undermine the independence of the auditor or of his personnel.

**SA 230**



# SA 240

## **The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements**

*Effective for audits of financial statements for periods beginning  
on or after 1st April, 2009*

### **Overview of SA 240**

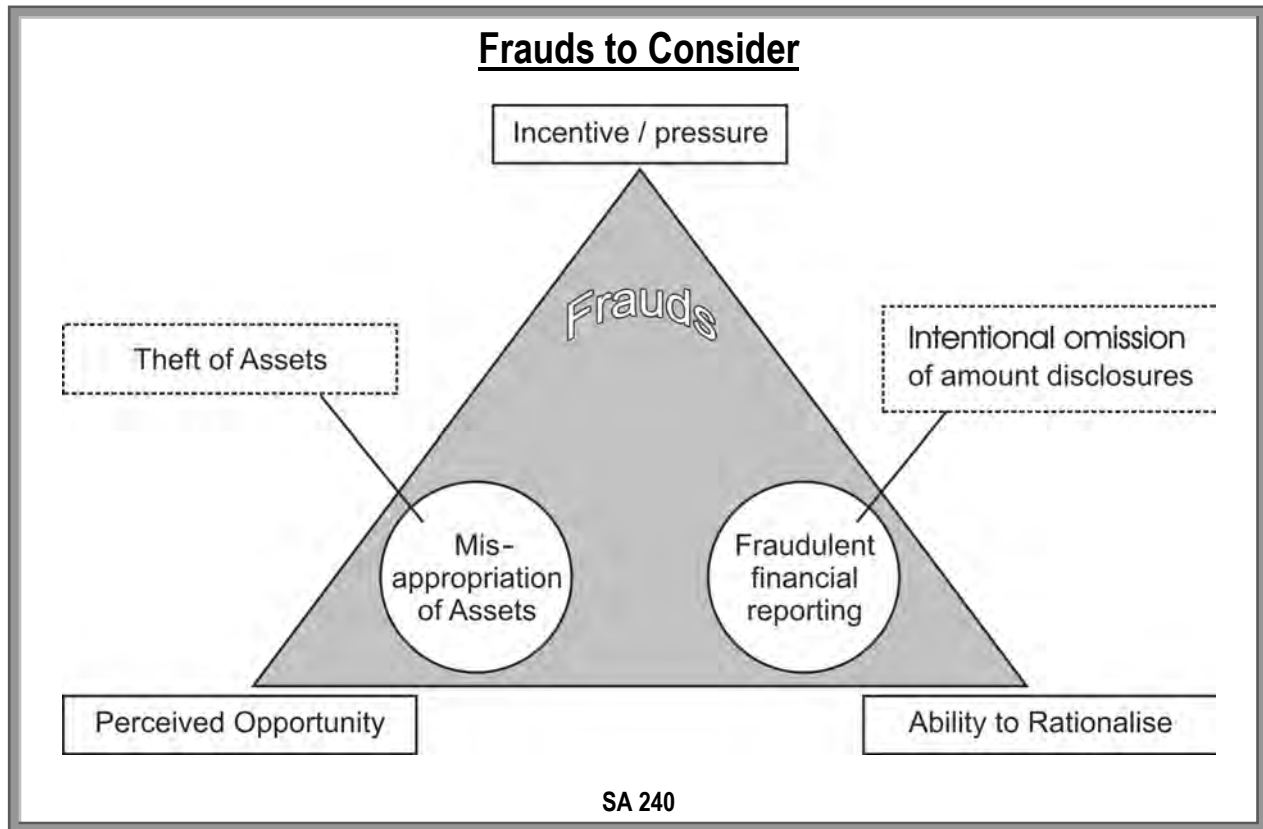
- ❖ **Introduction**
  - Scope
  - Effective Date
- ❖ **Objectives**
- ❖ **Definitions**
- ❖ **Requirements**
  - Professional skepticism
  - Discussion among the Engagement Team
  - Risk assessment procedures and related activities
  - Identification and Assessment of Risks of material misstatement due to fraud
  - Responses to the Assessed Risks of material misstatement due to fraud
  - Evaluation of audit evidence
  - Auditor unable to continue the engagement
  - Management Representations
  - Communication with those charged with governance and management
  - Communications to Regulatory and Enforcement authorities
  - Documentation
- ❖ **Application and Other Explanatory Material on these aspects.**
- ❖ **Appendices.**

SA 240

## **Scope**

- ❖ Deals with auditor's responsibilities relating to fraud in audit of financial statements.
- ❖ Expands on how SA 315 and SA 330, are to be applied in relation to risks of material misstatement due to fraud.

**SA 240**



- ❖ Misstatements:
  - Fraud – Intentional.
  - Error- Unintentional.
- ❖ Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.
- ❖ Fraudulent financial reporting may be accomplished by the following:
  - Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation.
  - Misrepresentation in, or intentional omission.
  - Intentional misapplication of accounting principles.

*Often involves management override of controls which are otherwise working effectively.*
- ❖ Misappropriation of assets can be accomplished in a variety of ways including:
  - Embezzling receipts.
  - Stealing physical assets or intellectual property.
  - Causing an entity to pay for goods and services not received.
  - Using an entity's assets for personal use.

*Often accompanied by false or misleading records.*
- ❖ Sometimes, the auditor's responsibilities may not be limited to consideration of risks of material misstatement of the financial statements, but may also include a broader responsibility to consider risks of fraud, e.g., requirements of N L Mitra Committee.

## **Responsibility for Fraud Prevention & Detection**

- ❖ Those charged with governance:
  - Oversight of management policies.
  - Consider potential for management override of controls.
  - Consider potential for management's inappropriate influence on financial reporting.
- ❖ Management:
  - Establish proper policies.
  - Emphasis on ethics and honesty.

**SA 240**

## **Responsibility of Auditor**

- ❖ Obtain reasonable assurance that financial statements are free of material misstatements.
  - Subjected to:
    - Inherent limitations of audit.
    - Fraud – deliberately concealed so difficult to detect.
  - But exercise **Professional Skepticism**.

**SA 240**

- ❖ The auditor's ability to detect a fraud depends on factors such as:
  - Skillfulness of the perpetrator.
  - Frequency and extent of manipulation.
  - Degree of collusion involved.
  - Relative size of individual amounts manipulated.
  - Seniority of those individuals involved.

### **Auditor's Objectives**

- ❖ Identify and assess risks of material misstatements due to fraud.
- ❖ Obtain SAAE about assessed risks.
- ❖ Respond appropriately to identified/ suspected fraud.

**SA 240**

- ❖ To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses.

### **Definitions**

- ❖ Fraud:
  - Intentional act.
  - One or more persons.
  - Use of deception.
  - Obtain unjust advantage.
- ❖ Fraud Risk factors – indicate:
  - Incentive/ pressure to commit fraud.
  - Provide opportunity for fraud.

**SA 240**

- ❖ Fraud — An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.
- ❖ Fraud risk factors - Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

## **Professional Skepticism**

- ❖ Requires ongoing questioning of:
  - Whether info. & audit evidence obtained suggest possibility of material misstatement due to fraud.
- ❖ Do not take client integrity and honesty for granted.
- ❖ Documents may be accepted as genuine if no contrary indications:
  - But when in doubt, may:
    - Confirm directly with 3<sup>rd</sup> party.
    - Engage expert to assess authenticity.
    - Investigate - response to inquiries is inconsistent.

### **SA 240**

- ❖ Management integrity:
  - Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's attitude of professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

## **Discussion Among the Engagement Team**

- ❖ Discuss:
  - Susceptibility of financial statements to material misstatements due to fraud – how & where.
  - How fraud might occur.
- ❖ Discuss even if auditor believes management/ those charged with governance are honest.

### **SA 240**

- ❖ SA 315 requires:
  - Discussion among the engagement team members.
  - Determination by the engagement partner of matters which are to be communicated to those team members not involved in the discussion.
- ❖ Matters to be included:
  - How and where entity's financial statements may be susceptible to material misstatement.
  - How management could perpetrate and conceal fraudulent financial reporting.
  - How assets of the entity could be misappropriated.
  - A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
  - A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.
  - A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
  - A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team.
  - An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
  - A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
  - A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
  - A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material misstatement due to fraud and whether certain types of audit procedures are more effective than others.
  - A consideration of any allegations of fraud that have come to the auditor's attention.
  - A consideration of the risk of management override of controls.

- ❖ Benefits of discussion:
  - Experienced team members share insights.
  - Consider appropriate responses to susceptibility.
  - Allocate work responsibility.
  - Decide how results of work would be shared among audit team.
  - How to deal with alleged fraud which come to attention.

**SA 240**

### **Risk Assessment Procedures (RAPs) and Related Activities**

- ❖ Procedures to identify risk of material misstatement due to fraud.
- ❖ Areas covered:
  - Management and others within the entity.
  - Those charged with governance.
  - Unusual/ unexpected relationships.
  - Other information.
  - Evaluation of risk factors.

**SA 240**

- ❖ Fraud RAPs to be applied in conjunction with the RAPs and activities to obtain understanding of the entity and its environment in accordance with SA 315.



## **RAPs - Management and Others in the Entity**

### **Inquiries of management:**

- ❖ Assessment of risk of material misstatement due to fraud in FS:
  - Nature, extent, frequency of assessment.
  - Relevant controls for prevention & detection.
- ❖ Process for identifying & responding to fraud risk:
  - Any specific risk identified.
  - Communication with those charged with governance on above issues.
  - Communication to employees on its views on business practices & ethical behaviour.

### **SA 240**

- ❖ Management assessment:
  - *Depends from entity to entity* – detailed/ yearly/ continuous/ less structured/ less frequent.
  - The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. No assessment of the risk of fraud by management may indicate the lack of importance of internal control.
  - In smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets.
- ❖ Management process:
  - This includes any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist.
  - In multi-location clients, management's processes may include different levels of monitoring of operating locations, or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

**Inquiries of management & others:**

- ❖ Any knowledge about actual, suspected or alleged fraud affecting the entity.

**Inquiries of internal auditors.**

**SA 240**

- ❖ Inquiries of management & others:
  - Cannot provide information about risk of material misstatement due to management fraud.
  - Can get to know otherwise unknown information.
  - Enquire from:
    - Operating (non-financial personnel).
    - Employees with different level of authority.
    - Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
    - In-house legal counsel.
    - Chief ethics officer or equivalent person.
    - The person or persons charged with dealing with allegations of fraud.
  - Management often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, it might be necessary to corroborate responses to inquiries with other information.
- ❖ Inquiries of Internal Auditors :
  - Guided by SA 610, *Using the Work of Internal Auditors*.
  - Specific inquiries include:
    - Procedures performed in current year to detect fraud.
    - Whether management has satisfactorily responded to any findings of above procedures.

## **RAPs – Those Charge with Governance**

- ❖ Understand how those charge with governance exercise oversight of management w.r.t.:
  - Process for Identifying and responding to fraud risk
  - Internal controls for mitigating those risks
- ❖ Enquire those charged with governance:
  - Actual/ suspected/ alleged fraud

**SA 240**

- ❖ Enquire TCWG to corroborate management's responses.
- ❖ TCWG normally responsible for oversight of system for monitoring risks, financial control and compliance with laws.
- ❖ Responsibilities of TCWG and Management vary by entity so understand the extent of responsibilities.
- ❖ Obtain understanding by way of:
  - Attend meetings where TCWG discuss these issues
  - Read minutes of such meetings
  - Make inquiries of TCWG
- ❖ *Smaller entities*- as all TCWG involved in managing the entity, no oversight separation from the mgt.

## **RAPs – Unusual/ Unexpected Relationships**

- ❖ Whether unusual or unexpected relationships identified in performing analytical procedures indicate risks of material misstatement due to fraud.

**SA 240**

## **RAPs – Other Information**

- ❖ Whether other information obtained indicates risk of material misstatement due to fraud.
- ❖ Other information may be obtained from:
  - Discussion with engagement team.
  - Information from client acceptance/ retention process.
  - Experience from other engagements for the client.

**SA 240**

## **RAPs – Evaluation of Fraud Risk Factors**

- ❖ Evaluate if information from RAPs indicate presence of fraud risk factor(s):
  - Not necessarily indicate fraud but usually present where there is a fraud.

### **SA 240**

- ❖ Fraud risk factors cannot easily be ranked in order of importance.
- ❖ Need exercise of professional judgment.
- ❖ Three conditions when frauds exists:
  - Incentive or pressure to commit fraud;
  - Perceived opportunity to commit fraud; and
  - Ability to rationalize the fraudulent action – normally not susceptible to observance by auditor.
- ❖ Size, complexity, and ownership characteristics of the entity significantly influence the consideration of relevant fraud risk factors. For example, in the case of a large entity, there may be factors that generally constrain improper conduct by management, such as:
  - Effective oversight by those charged with governance.
  - An effective internal audit function.
  - The existence and enforcement of a written code of conduct.
- ❖ Fraud risk factors considered at a business segment operating level may provide different insights when compared with those obtained when considered at an entity-wide level.

## **Identification and Assessment of Risk of Material Misstatement**

- ❖ Identify & assess risk of material misstatement due to fraud for:
  - Financial statement level.
  - Assertion level.
  - Classes of transactions.
  - Account balances.
  - Disclosures.
- ❖ Presume fraud risk in revenue recognition:
  - Evaluate types of revenues/ transactions/ assertions leading to this risk.
  - Document if presumption not applicable.

### **SA 240**

- ❖ Risk of Fraud in Revenue Recognition:
  - *Overstatement* - premature revenue recognition, recording fictitious revenue.
  - *Understatement* – improperly shifting revenue to later period.
  - This risk greater in some entities say because of pressure on management (listed companies) or revenues are through cash sales.

- ❖ Treat those assessed risks as significant risks.
- ❖ Obtain further understanding of related internal controls.

### **SA 240**

- ❖ Related internal controls:
  - Management decides fraud risk it want to assume, what controls to apply, cost vs benefits – to prevent/ detect frauds.
  - Auditor should obtain understanding of the above risk appetite & controls so he can identify fraud risk factors that may affect his risk assessment as to misstatements due to frauds.

## **Responses to Assessed Risks of Material Misstatement Due to Fraud**

- ❖ Covers three aspects:
  - Overall responses
  - Audit procedures responsive to assessed risk at assertion level.
  - Audit procedures responsive to risk of management override of controls.

**SA 240**

## **Responses – Overall Responses**

- ❖ Determine overall responses to address assessed risk at FS level:
  - Increase professional skepticism.
- ❖ Essentials:
  - Assign proper audit personnel.
  - Evaluate selection & application of accounting policies.
  - Incorporate unpredictability in audit procedures.

**SA 240**

### **Responses – Overall Responses**

- ❖ Increase professional skepticism:
  - Selection of the nature & extent to documents to be examined to support material transactions.
  - Corroboration of management representations concerning material matters.
- ❖ Assign proper audit personnel:
  - Take into account knowledge, skills and ability *vis a vis* auditor's risk assessment.
  - Can respond to risk by assigning addition personnel with specialised knowledge and skills.
- ❖ Evaluate selection & application of accounting policies:
  - Special attention to those relating to complex transactions and subjective measurements – do these reflect management's efforts to manage earnings.
- ❖ Unpredictability in audit procedures:
  - Unpredictability in nature, timing and selection of audit procedures.
  - Examples:
    - Performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk.
    - Adjusting the timing of audit procedures from that otherwise expected.
    - Using different sampling methods.
    - Performing audit procedures at different locations or at locations on an unannounced basis.



## Responses – At Assertion Level

- ❖ Design & perform further audit procedures responsive to assessed risk at assertion level:
  - Change nature, timing & extent of audit procedures.

SA 240

### I. Responses – At Assertion Level

- ❖ Change in nature, timing and extent of audit procedures:
    - Change **nature** to obtain more reliable/ relevant audit evidence or additional corroborative information.
      - Physical observation/ inspection of certain assets.
      - Use more CAATs w.r.t. electronic transactions.
    - Management under pressure to inflate revenue - external confirmations from customers supplemented by enquiry from non-financial personnel as to change in terms of sales contract/ delivery.
  - ❖ **Timing** of substantive procedures  
May decide to perform near the year end also because of assessed risk of fraud.
  - ❖ **Extent** changed:
    - Increase sample size.
    - Perform analytical procedures at more detailed level.
- II. **If fraud risk in inventory** - examine inventory records to identify location, items needing special attention during or after inventory count.
- III. **If risk in many assertions & accounts** - understanding of entity and its environment would help.

## **Responses – Management Override of Controls**

- ❖ This risk is present in all entities.
- ❖ Unpredictability in how override could occur so it is a significant fraud risk.
- ❖ Assessment of this risk notwithstanding:
  - Test appropriateness of journal entries.
  - Review accounting estimates for biases.
  - Evaluate business rationale for unusual transactions.
  - Any other audit procedure, if required.

**SA 240**

## **Testing Appropriateness of Journal Entries**

- ❖ Important issues:
  - Happens in the form of inappropriate/ unauthorised journal entries.
  - Automated accounting is also not fool proofed against management override.
- ❖ Make inquiries about inappropriate or unusual activity relating to the processing of journal entries.
- ❖ Select journal entries made at the end of a reporting period.
- ❖ Consider the need to test journal entries throughout the period.

**SA 240**

- ❖ Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.

- ❖ Matters to consider:
  - Assessment of presence of fraud risk factors/ other information To identify specific classes of journal entries to be tested.
  - Controls of journal entries To reduce extent of substantive testing provided control effectiveness has been tested.
  - Financial reporting process and nature of evidence that can be obtained.
  - Characteristics of fraudulent journal entries.
  - Nature & complexity of accounts.
  - Processed outside normal course of business.

**SA 240**

- ❖ Characteristics of fraudulent journal entries:
  - Made to unrelated/ unusual/ seldom used accounts.
  - Made by individuals who typically do not make journal entries.
  - Recorded at the end of the period/ post closing entry, having little/ no explanation.
  - Made before/ during the preparation of financial statements that do not have numbers.
  - Contain round numbers/ consistent ending numbers.
- ❖ Nature & complexity of accounts:
  - Contain transactions that are complex or unusual in nature.
  - Contain significant estimates and period-end adjustments.
  - Have been prone to misstatements in the past.
  - Have not been reconciled on a timely basis or contain unreconciled differences.
  - Contain inter-company transactions.
  - Are otherwise associated with an identified risk of material misstatement due to fraud.

In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.
- ❖ *Processed outside the normal course of business* - Non standard journal entries – no adequate internal controls.

## **Review of Accounting Estimates**

- ❖ Do circumstances producing bias represent fraud risk ?
  - Evaluate management judgment w.r.t. estimate.
  - Perform retrospective review of management assumptions w.r.t. estimates of previous years.

**SA 240**

### **Retrospective review of management assumptions:**

- ❖ *Purpose* - to determine whether there is an indication of a possible bias on the part of management.
- ❖ Not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

## **Unusual/ Significant Transactions**

- ❖ Indicators:
  - Overly complex form.
  - No discussion between management & those charged with governance.
  - Management insistence on particular accounting treatment.
  - Involvement of non consolidated related parties.
  - Involvement of previously unidentified related parties.

**SA 240**

## Evaluation of Audit Evidence

- ❖ Evaluate if risk of material misstatement at assertion level remains appropriate.
- ❖ Perform analytical procedures in overall review of financial statements:
  - Review results *vis a vis* overall understanding of entity.
- ❖ Identified misstatement:
  - Is it a fraud?
  - Consider implications on audit procedures.
- ❖ If unable to conclude whether misstatement is there, consider implications for audit.

### SA 240

- ❖ Appropriateness of risk of material misstatement :
  - Evaluation is qualitative, based on auditor's judgment.
  - Provides further insight as to:
    - Risk of material misstatement due to fraud.
    - Need to perform additional/ different procedures.
- ❖ Analytical procedures:
  - Professional judgment needed to understand which relationship indicates fraud.
  - Unusual year end relationships are significant.
- ❖ Identified misstatements:
  - Misstatements, such as, numerous misstatements at a specific location even though the cumulative effect is not material, may be indicative of a risk of material misstatement due to fraud.
  - Implications on audit evidence depend on circumstances:
    - Completeness & truthfulness of management representations.
    - Genuineness of accounting records & documentations.
    - Possibility of collusion.
  - SA 450, *Evaluation of Misstatements Identified During the Period*.
  - SA 700, *Forming an Opinion and Reporting on Financial Statements*.

## **Auditor Unable to Continue the Engagement**

- ❖ Exceptional circumstances.
- ❖ Determine professional & legal responsibilities & reporting to:
  - Appointing authority.
  - Regulator.
- ❖ Consider if withdrawal is appropriate.
- ❖ If withdraws:
  - Discuss reasons with management & those charged with governance.
  - Determine legal/ professional requirement to report to the appointing authority, regulator.

**SA 240**

### **Auditor Unable to Continue the Engagement**

- ❖ Exceptional circumstances:
  - Entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements;
  - Auditor's consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or
  - Auditor has significant concern about the competence or integrity of management or those charged with governance.
- ❖ Withdrawal circumstances:
  - Not possible to define all but involvement of senior management/ those charged with governance>>>reliability of management representations.
  - Withdrawal may not be permitted under some laws.
- ❖ Legal/ professional responsibilities.
- ❖ May need legal advice.

## Management Representations

- ❖ Acknowledges their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud.
- ❖ Have disclosed results of management's fraud risk assessment w.r.t. the FS.
- ❖ Have disclosed their knowledge of fraud or suspected fraud affecting the entity involving:
  - Management;
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the FS.
- ❖ Have disclosed their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's FS.

### SA 240

- ❖ Management Representations:
  - *Disclosures referred above* – to the auditor.
  - Management representations have to be **in writing**.
  - SA 580, "*Written Representations*" is relevant.

## **Communications – Management & Those Charged With Governance**

- ❖ To management:
  - Fraud identified/ information indicating fraud
  - On timely basis.
  - At appropriate level
- ❖ To those charged with governance:
  - Management fraud; OR
  - Frauds by employees having significant role in internal control; OR
  - Frauds by others where they result in material misstatement in financial statements.

### **SA 240**

- ❖ To management:
  - Communicate even if matter might be inconsequential.
  - Use professional judgment to decide which level to communicate:
    - Likelihood of collusion.
    - Nature & magnitude of suspected fraud.
  - Ordinarily one level above the person implicated.
- ❖ To those charged with governance:
  - Also discuss nature, timing and extent of subsequent audit procedures to complete the audit.
  - Communication can be oral/ written. (refer SA 260, *Communication with Those Charged with Governance*)
  - Better if auditor & those charged with governance agree at beginning as to nature & extent of communication by auditor and the types/ levels of other frauds need to be reported to TCWG.
  - Doubts on integrity of management/ TCWG, auditor should seek legal advice.
- ❖ Matters to discuss with those charged with governance:
  - Concerns about the nature, extent and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
  - Failure by management to appropriately address identified material weaknesses in internal control, or to appropriately respond to an identified fraud.
  - Auditor's evaluation of the entity's control environment, including questions regarding the competence and integrity of management.
  - Actions by management that may indicate of fraudulent financial reporting, such as, management's selection and application of accounting policies that may be indicative of management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.
  - Concerns about the adequacy and completeness of the authorisation of transactions that appear to be outside the normal course of business.



## **Communication – Regulators**

- ❖ Actual/ suspected fraud.
- ❖ Determine duty to report to regulator.
- ❖ Legal/regulatory responsibilities normally override client confidentiality requirements.
- ❖ Seek legal advice to determine appropriate course having regard to Public Interest.

**SA 240**

## **Documentation**

- ❖ Understanding of the Entity and its environment as per SA 315.
- ❖ Responses to the Assessed Risks.
- ❖ Communications with mgt. and TCWG.
- ❖ Reasons for non-applicability of presumption of risk of material misstatement relating to revenue recognition.

**SA 240**

- ❖ Documentation of understanding of Entity and its environment shall include:
  - The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and
  - The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.
- ❖ Responses to the Assessed Risks:
  - The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and
  - The results of the audit procedures, including those designed to address the risk of management override of controls.

# SA 250

## Consideration of Laws and Regulations in an Audit of Financial Statements

*Effective for audits of financial statements for periods beginning on or after April 1, 2009*

### Overview of SA 250

- ❖ **Introduction**
  - Scope
  - Effective date
- ❖ **Objectives**
- ❖ **Definition**
- ❖ **Requirements**
  - The Auditor's consideration of compliance with Law and Regulation (L & R)
  - Audit procedures when non-compliance is identified or suspected
  - Reporting of identified or suspected non compliance
  - Documentation
- ❖ **Application and Other Explanatory Material on these Aspects**

SA 250

## **Scope**

- ❖ Deals with auditor's responsibility:
  - To consider L & R when performing audit of FS.
- ❖ Does not apply to:
  - Assurance engagements where testing & reporting on compliance with L&R is the specific objective.

### **SA 250**

- ❖ Effect of Laws and Regulations:
  - The effect of L & R on the FS varies considerably.
    - Provisions of some laws or regulations have a direct effect on the FS in that they determine the reported amounts and disclosures in an entity's FS.
    - Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's FS.
  - Non-compliance with laws and regulations may result in:
    - Fines, litigation, or
    - Other consequences for the entity that may have a material effect on the FS.

## **What is Non-Compliance?**

- ❖ Acts of omission or commission.
- ❖ Either intentional or unintentional.
- ❖ Which are contrary to the prevailing laws or regulations.
- ❖ Does not include personal misconduct (unrelated to business activities of entity) by TCWG, Mgt., employees of the entity.

### **SA 250**

- ❖ Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees.

## **Mgt. Responsibility for Compliance with L & R**

- ❖ Mgt responsible:
  - Under oversight of TCWG.
- ❖ Policies and Procedures:
  - Monitor legal requirements.
  - Ensure effectiveness of operating procedures.
  - Instituting/Operating appropriate systems of Internal controls.
  - Developing/publicising/following/monitoring of Code of conduct.
  - Employee training.
  - Engage legal advisors.
  - Maintain register of significant L & R & record of complaints.

**SA 250**

- ❖ Mgt.'s responsibility includes ensuring compliance with those L&R also which determine the form & content of FS.
- ❖ In large entities, supplemental procedures are:
  - Internal audit function.
  - Audit committee.
  - Compliance function.

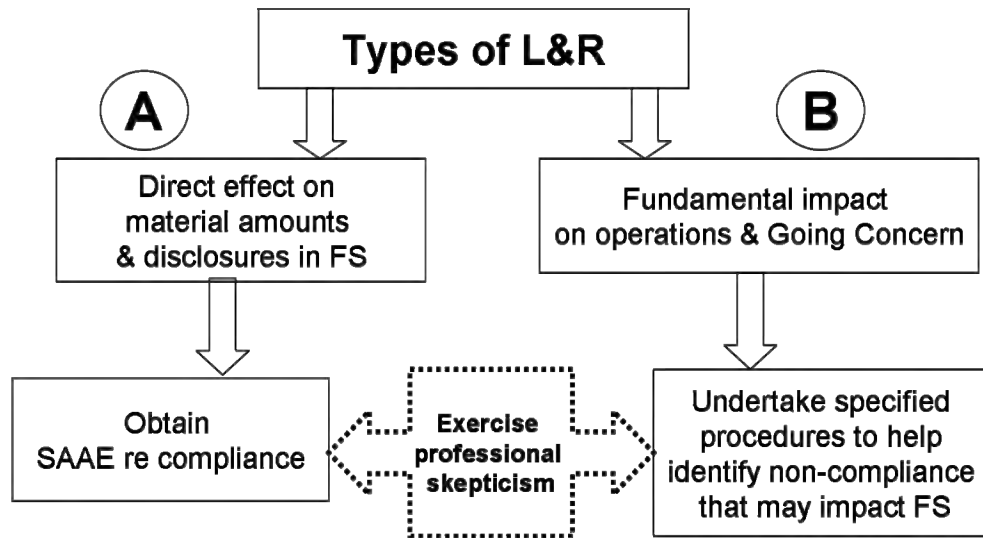
## **Auditor's Responsibility**

- ❖ Auditor responsible for obtaining reasonable assurance that FS taken as a whole are free from Material Misstatement, whether by fraud or error.
- ❖ SA assists auditor in identifying material misstatements in FS due to non-compliance.
- ❖ Auditor is not, responsible for preventing non compliance and cannot be expected to detect non-compliance with all L & R.
- ❖ Factors increasing the risk of not detecting the non- compliance:
  - Inherent limitations of audit.
  - Some L&R relate to operations, no impact on FS and are not captured by entity's information system.
  - Deliberate concealment of non compliance, e.g., collusion, forgery.
  - Non-compliance - Ultimate determination is a matter of court of law.

**SA 250**

- ❖ Note that the emphasis is on the word **"preventing"**. The word "detecting" has not been used.
- ❖ Legal determination of non compliance is beyond professional competence. **Nevertheless**, the auditor's training, experience and understanding of the entity and its industry or sector may provide a basis to recognise that some acts, coming to the auditor's attention, may constitute non-compliance with laws and regulations.
- ❖ Detection of non-compliance, regardless of materiality, may affect other aspects of the audit including, for example, the auditor's consideration of the integrity of management or employees.

## Responsibility w.r.t. different types of L&R



SA 250

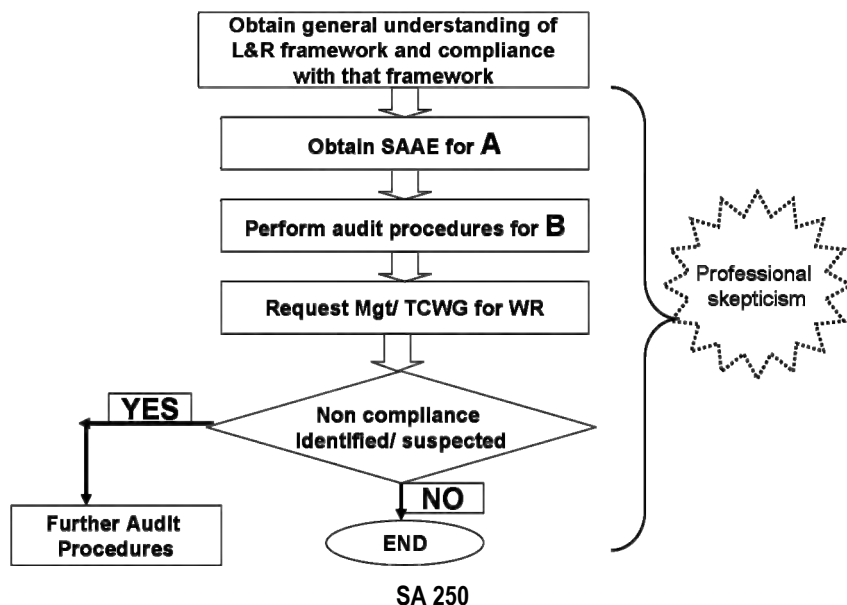
- ❖ Remain alert to possibility that other audit procedures applied for forming an opinion on FS may bring to light identified/ suspected non - compliance.

## Auditor's Objectives

- ❖ **For A** – obtain SAAE.
- ❖ **For B** – perform specified audit procedures:
  - May not be captured by financial reporting system.
- ❖ Respond appropriately to actual/ suspected non-compliance identified during audit .

SA 250

## Auditor's Consideration of L&R



### Understanding

- ❖ Apply SA 315, obtain/ update **general** understanding of:
  - L&R framework.
  - Industry or sector.
  - How entity is complying with L&R Framework.

### Procedures

- ❖ To obtain a general understanding of the legal and regulatory framework, and how the entity complies with that framework, the auditor may, for example:
  - Use the auditor's existing understanding of the entity's industry, regulatory and other external factors;
  - Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements;
  - Inquire of management:
    - other laws or regulations that may be expected to have a fundamental effect on the operations of the entity; and its financial statements;
    - concerning the entity's policies and procedures regarding compliance with laws and regulations; and
    - policies or procedures adopted for identifying, evaluating and accounting for litigation claims.

### SAAE for A

- May include, e.g.,
  - The form and content of financial statements;
  - Industry-specific financial reporting issues;
  - Accounting for transactions under government contracts; or
  - The accrual or recognition of expenses for income tax or retirement benefits.
- Non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements covered by **A**.

### Procedures for B

- Inquiry of mgt./TCWG whether entity is in compliance with L & R.
- Inspect correspondence with relevant licensing/ regulatory authority.

### Professional Skepticism

- ❖ Remain alert to the possibility that other audit procedures may bring instances of non compliance or suspected non compliance with L& R to auditor's attention:
  - Reading minutes.
  - Inquiry of mgt., & in house legal counsel/ external legal counsel re litigations, claims & assessments.
  - Perform substantive tests of details of classes of transactions, account balances or disclosures.

### Written representations

- ❖ WR provide necessary but not SAAE thus do not affect the nature, timing & extent of other AE to be obtained by auditor.

### **Indications of Non-Compliance with Laws and Regulations- I**

- ❖ Investigations by regulatory organisations and government departments or payment of fines or penalties.
- ❖ Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- ❖ Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- ❖ Purchasing at prices significantly above or below market price.
- ❖ Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
- ❖ Unusual payments towards legal and retainership fees.

**SA 250**

### **Indications of Non-Compliance with Laws and Regulations- II**

- ❖ Unusual transactions with companies registered in tax havens.
- ❖ Payments for goods or services made other than to the country from which the goods or services originated.
- ❖ Payments without proper exchange control documentation.
- ❖ Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- ❖ Unauthorised transactions or improperly recorded transactions.
- ❖ Adverse media comment.

**SA 250**

## **Non compliance Suspected/ Identified**

- ❖ Obtain:
  - Understanding of nature of act & circumstances; and
  - Information to evaluate possible effect on FS.
- ❖ Suspected non compliance:
  - Discuss matter with mgt./ TCWG.
  - Obtain legal advice if:
    - Mgt./ TCWG not providing sufficient information, and
    - Auditor adjudges possible effect to be material to FS.
- ❖ Insufficient information on suspected non-compliance, evaluate the effect of lack of SAAE on auditor's opinion.
- ❖ Evaluate implication also in respect of auditor's risk assessment and reliability of WR:
  - Take appropriate action.

### **SA 250**

- ❖ **Evaluating effect on FS – relevant matters:**
  - Potential financial consequences of possible non-compliance on FS.
  - Need to disclose potential financial consequences.
  - Negative effect of potential consequences on true & fair view or otherwise, they make FS misleading.
- ❖ **Discussion with TCWG:**
  - May provide additional evidence.
  - TCWG may have same understanding of non-compliance as the auditor have.
- ❖ **Legal Advice:**
  - Consult entity's in-house/ external legal counsel re:
    - application of L&R.
    - possibility of frauds.
    - possible effects on FS.
  - If auditor is not satisfied, he may consult his own legal counsel re:
    - Contravention of L&R.
    - Possible legal consequences.
    - Possibility of fraud.
    - Further action, if any, needed.

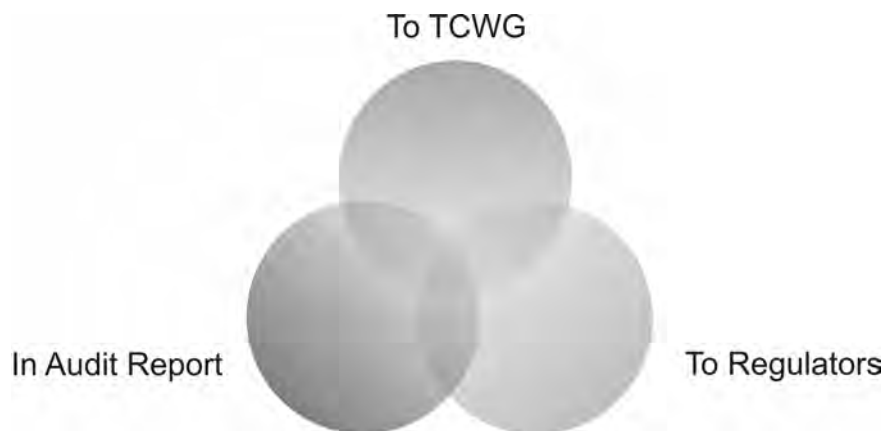


## Withdrawal from Engagement

- ❖ If no remedial action by Mgt./TCWG, consider if withdrawal necessary:
  - Materiality of non-compliance to FS is secondary.
  - Seek legal opinion if decided on withdrawing.
  - If withdrawal not permitted by law, consider alternative actions:
    - Include EMP in the auditor's report.

SA 250

## Reporting of Identified/ Suspected Non-compliance



SA 250

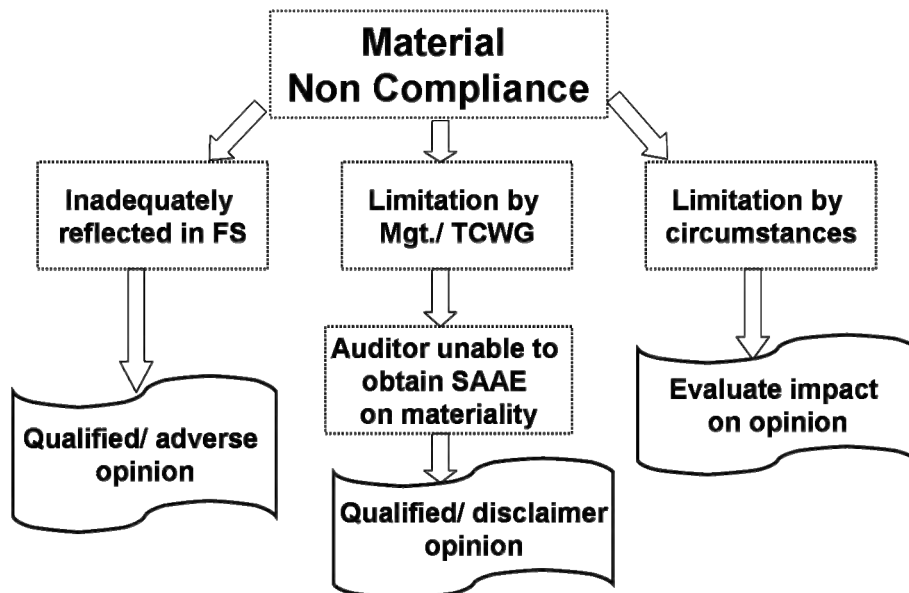
- ❖ These reportings are not mutually exclusive.

## Reporting to TCWG

- ❖ Communicate matters that come to auditor's attention during audit.
- ❖ No need to communicate if:
  - TCWG = Mgt.
  - Matters clearly inconsequential.
- ❖ Communicate ASAP non-compliance believed to be intentional & material.
- ❖ Involvement of Mgt./ TCWG, communicate to next higher level:
  - If no higher level, seek legal advice.

SA 250

## Reporting in Audit Report



SA 250

## **Reporting to Regulators**

- ❖ Determine:
  - Responsibility to report identified/ suspected non compliance to parties outside the entity.
- ❖ Client confidentiality may be an issue But:
  - Legal responsibilities may vary under law.
  - Law may override confidentiality requirements.
  - Consider the need to seek legal advice.

**SA 250**

## **Documentation**

- ❖ Identified/ suspected non-compliance.
- ❖ Results of discussions with mgt./TCWG/ parties outside the entity.
- ❖ Examples:
  - Copies of records or documents.
  - Minutes of discussions held with mgt./TCWG/parties outside the entity.

**SA 250**

# SA 260

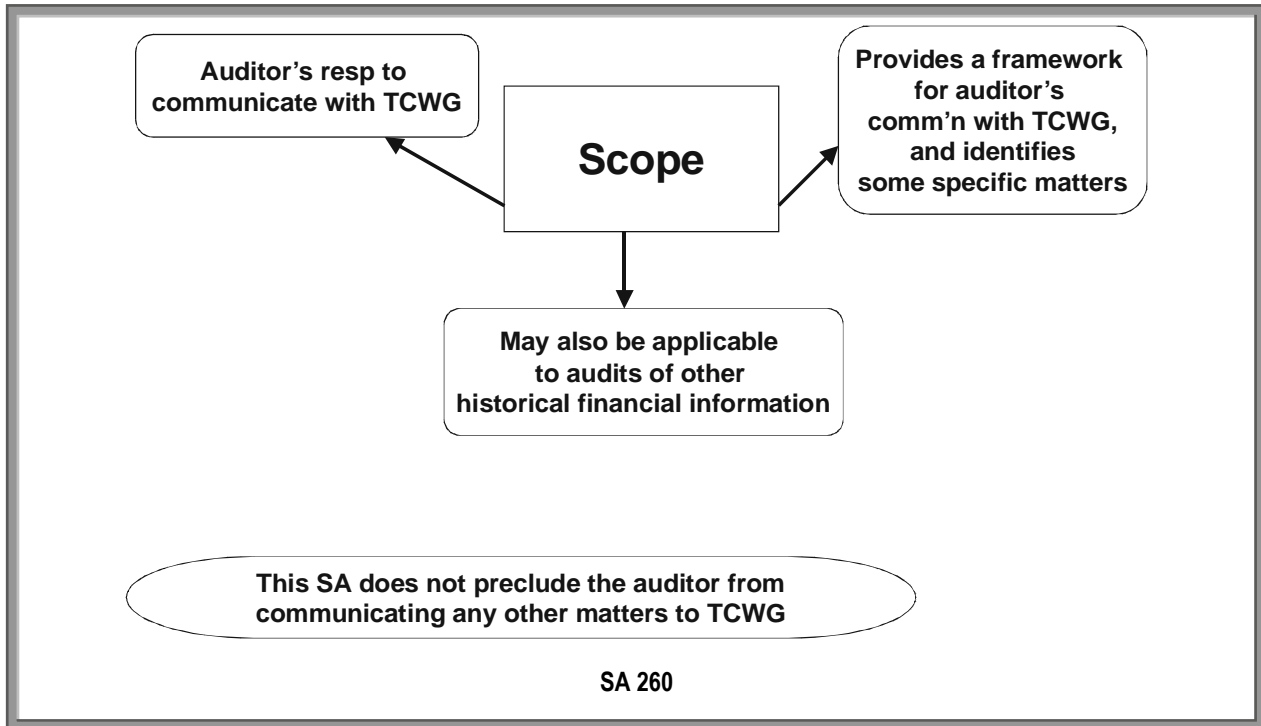
## Communication with Those Charged with Governance

*Effective for audits of financial statements for periods beginning on or after April 1, 2009*

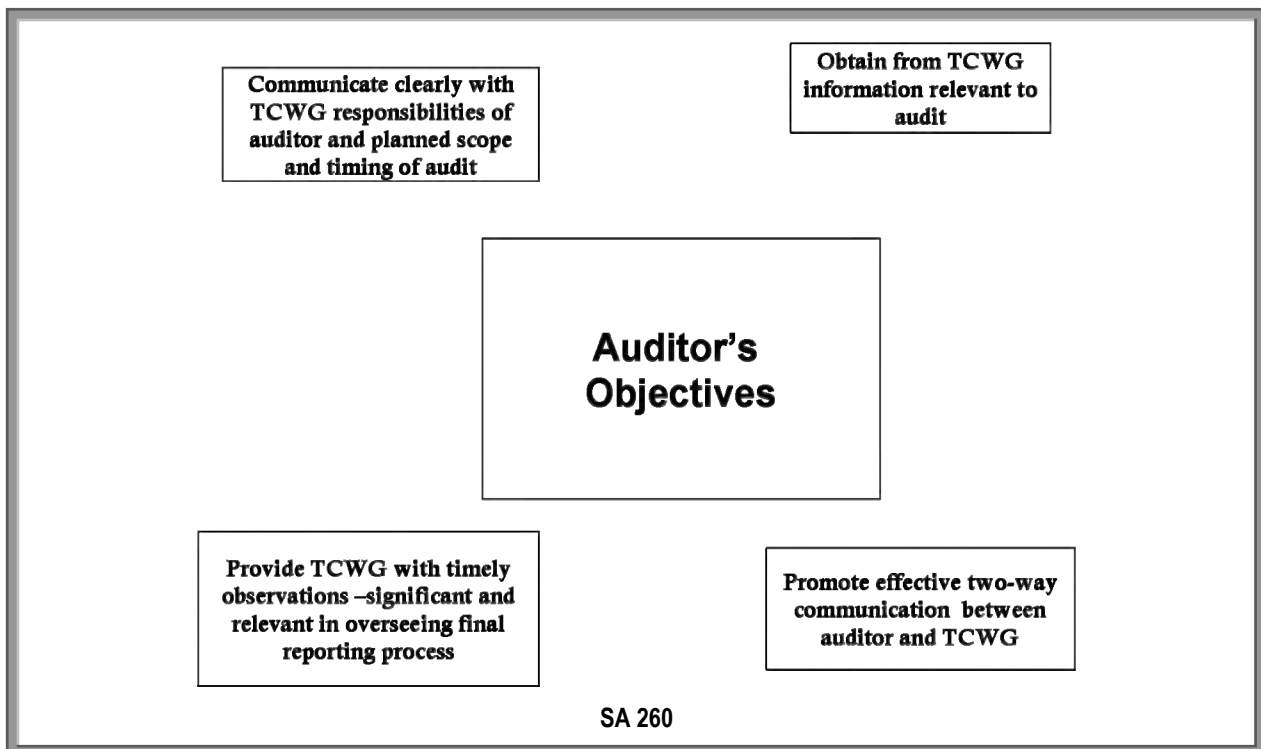
### Overview of SA 260

- ❖ **Introduction**
  - Scope
  - Effective Date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements:**
  - Those Charged with Governance
  - Matters to be Communicated
  - The Communication Process
  - Documentation.
- ❖ **Application and Other Explanatory Material on these Aspects**

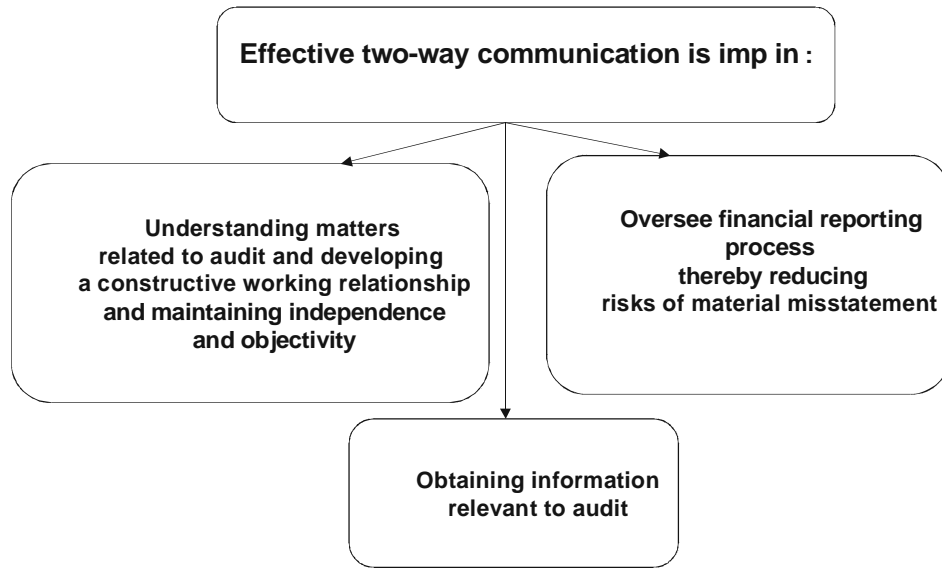
SA 260



- ❖ Although this SA applies irrespective of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity, and for listed entities. This SA does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.



## **Role of Communication**



**SA 260**

- ❖ Auditor and management both are responsible for communicating matters of governance interest to TCWG. Communication by one does not relieve the other of this responsibility.
- ❖ Clear communication is an integral part of every audit.
- ❖ Obtain legal advice if:
  - Laws or regulations restricts the auditor's communication of certain matters with those charged with governance.
  - Complexity of potential conflicts between the auditor's obligations of confidentiality and obligations to communicate.

## **Definitions-I**

### **Those charged with governance:**

- ❖ Person(s) or organization(s).
- ❖ With responsibility for overseeing strategic direction of the entity.
- ❖ And obligations related to accountability of the entity.
- ❖ May include management personnel.

### **SA 260**

- ❖ Governance structures may vary, reflecting different size and ownership characteristics:
  - In most entities, TCWG hold positions that are an integral part of the entity's legal structure, for example, company directors.
  - In some government undertakings, a body that is not part of the entity, is charged with governance.
  - In some cases, some or all of TCWG are involved in managing the entity, in others, TCWG and mgt comprise different persons.
  - In some cases, TCWG are responsible for approving the entity's FS (in other cases, mgt. has this responsibility).
  - In most entities, governance is the collective responsibility of a governing body, sub-group charged with specific task to assist this governing body may be appointed.
  - In some smaller entities, however, one person may be charged with governance.
- ❖ Such diversity means that it is not possible for this SA to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Auditor should discuss and agree with the engagement party the relevant persons with whom to communicate.

## **Definitions-II**

### **Management:**

- ❖ Person(s) with executive responsibility for conduct of the entity's operations.
- ❖ For some entities, mgt includes some or all of TCWG.

### **SA 260**

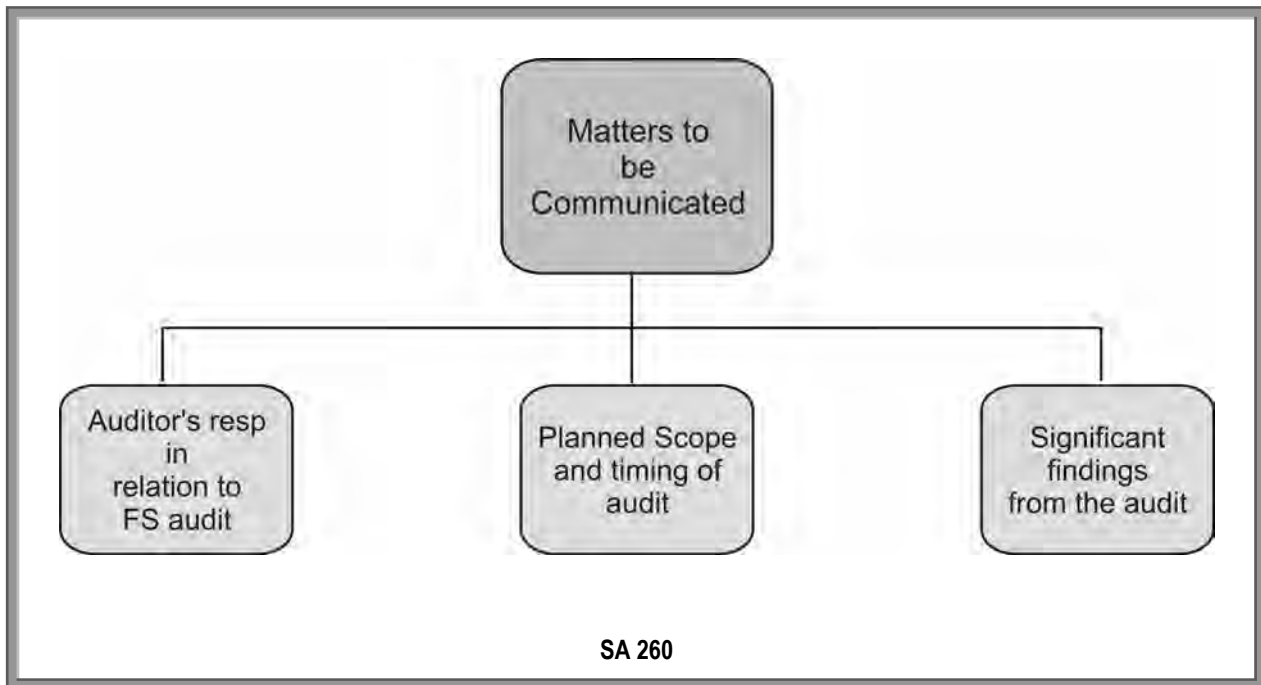
## **Those charged with Governance**

- ❖ Determine the appropriate person(s) within the entity's governance structure with whom to communicate.
- ❖ Communicate with Sub-group - Determine the need for communicating with Governing Body.
- ❖ Communication with all TCWG involved in managing the Entity.
- ❖ Single Owner Manager - No need to communicate once again.

### **SA 260**

- ❖ **Communication with a Subgroup of Those Charged with Governance:**
  - When auditor communicates with a subgroup of TCWG, e.g. an audit committee, or an individual, auditor shall determine whether there is also a need to communicate with the governing body.
  - Auditor may need to discuss and agree with engaging party the relevant person(s) with whom to communicate.
- ❖ **When considering communicating with a subgroup of TCWG, auditor may take into account such matters as:**
  - Respective responsibilities of subgroup and governing body.
  - Nature of matter to be communicated.
  - Relevant legal or regulatory requirements.
  - Whether subgroup has authority to take action and can provide further information and explanations.
  - Communication form, i.e., in full or in summary form, influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. the auditor may retain the right to communicate directly with the governing body in the terms of engagement.
- ❖ **When All of TCWG are Involved in Managing the Entity:**
  - In some cases, all of those charged with governance are involved in managing the entity, and the application of communication requirements is modified to recognise this position. In such cases, communication with person(s) with management responsibilities may not adequately inform all of those with whom the auditor would otherwise communicate in their governance capacity. For example, in a company where all directors are involved in managing the entity, some of those directors (e.g., one responsible for marketing) may be unaware of significant matters discussed with another director (e.g., one responsible for the preparation of the financial statements).
  - Matters need not be communicated again with those same person(s) in their governance role.





#### The Auditor's Responsibilities in Relation to the FS Audit

- ❖ Auditor shall communicate with TCWG that:
  - auditor is responsible for forming and expressing an opinion on the FS.
  - audit of the FS does not relieve mgt or TCWG of their responsibility.
- ❖ Auditor's responsibility are included in Engagement Letter. Providing TCWG with a copy of that EL may be an appropriate way to communicate regarding such matters.

#### Planned Scope and Timing of Audit

- ❖ Communication regarding planned scope and timing of audit may:
  - (a) Assist TCWG:
    - To understand better the consequences of the auditor's work,
    - To discuss issues of risk and concept of materiality with auditor, and
    - To identify any areas in which they may request auditor to undertake additional procedures.
  - (b) Assist the auditor to understand better the entity and its environment.
- ❖ **Matters communicated may include:**
  - How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.
  - Auditor's approach to internal control.
  - Application of concept of materiality.
- ❖ **Other Planning matters that may be appropriate to discuss are:**
  - Extent of use of an internal audit function by the auditor.
  - How external and internal auditors can best work together in a constructive and complementary manner.
  - The views of TCWG on various matters such as to whom communicate, allocation of responsibilities, entity's objectives and strategies, and the related business risks that may result in material misstatements, matters which requires additional attention, Significant communications with regulators, etc.
  - Control Environment .
  - The responses of TCWG to previous communications with the auditor.

## **Communication of Significant Finding from the Audit**

- ❖ Auditor's view on significant qualitative aspects of entity's accounting practices.
- ❖ Significant difficulties encountered during audit.
- ❖ Unless all TCWG are involved in managing the entity:
  - Significant matters arising from audit.
  - WR requested.
- ❖ Other matters required to be discussed as per auditor's professional judgment.
- ❖ May request TCWG for further information to complete audit evidence.

### **SA 260**

- ❖ Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures. Open and constructive communication about significant qualitative aspects of the entity's accounting practices may include comment on the acceptability of significant accounting practices.
- ❖ **Examples of Significant difficulties encountered during the audit:**
  - Significant delays in management providing required information.
  - An unnecessarily brief time within which to complete the audit.
  - Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
  - The unavailability of expected information.
  - Restrictions imposed on the auditor by management.
  - Management's unwillingness to make or extend its assessment of entity's ability to continue as a Going Concern.
  - Scope limitation that leads to a modification of auditor's opinion.
- ❖ **Significant Matters Discussed, or Subject to Correspondence with Management:**
  - Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.
  - Concerns about management's consultations with other accountants on accounting or auditing matters.
  - Discussions or correspondence in connection with the initial or recurring appointment of the auditor regarding accounting practices, the application of auditing standards, or fees for audit or other services.
- ❖ **Other Significant Matters:**
  - Material misstatements of fact.
  - Material inconsistencies in information accompanying the audited financial statements that have been corrected.

## **Auditor Independence**

- ❖ In case of listed entities, auditor shall communicate with TCWG:
  - A statement that Engagement Team has complied with ethical requirements regarding independence.
  - All relationships and other matters between firm, network firms, and entity that bear on independence.
  - Related safeguards to eliminate identified threats to independence.
- ❖ The other communication may include an inadvertent violation of relevant ethical requirements as they relate to auditor independence, and any remedial action taken or proposed.

### **SA 260**

- ❖ The auditor is subject to independence and other ethical requirements as enunciated in the **Code of Ethics** issued by the ICAI.
- ❖ The relationships and other matters, and safeguards to be communicated, vary with the circumstances of the engagement, but generally address:
  - Threats to independence, which may be categorised as: self-interest threats, self-review threats, advocacy threats, familiarity threats, and intimidation threats; and
  - Safeguards created by the profession, legislation or regulation, safeguards within the entity, and safeguards within the firm's own systems and procedures.

## **The Communication Process**

- ❖ Auditor shall communicate with TCWG:
  - The form, timing and expected general content of communications.
- ❖ Smaller Entities:
  - Communication in less structured manner.

### **SA 260**

- ❖ Matters that may also contribute to effective two-way communication includes discussion of:
  - Purpose of communications
  - Form of communications
  - Person(s) in the audit team and amongst TCWG who will communicate regarding particular matters.
  - Auditor's expectation that communication will be two-way.
  - Process for taking action and reporting back on matters communicated by auditor and TCWG.
- ❖ Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and TCWG is not adequate for the purpose of the audit.
- ❖ The communication process will vary with:
  - Size and governance structure of the entity.
  - How TCWG operate.
  - Significance of matters to be communicated.
- ❖ Communication with Management:
  - Before communicating matters with TCWG, the auditor may discuss them with management, unless that is inappropriate.
- ❖ **Communication with Third Parties**  
Auditor may be required by L&R to:
  - Report misstatements to authorities where mgt and TCWG fail to take corrective action
  - Submit copies of certain reports to relevant regulatory or funding bodies
  - Make reports prepared for TCWG publicly available

## **Forms of Communication**

- ❖ Oral communication not adequate.
- ❖ Communicate in writing with TCWG:
  - Significant findings from the audit and auditor independence.
- ❖ Written communication need not include all matters that arose during the course of audit.

### **SA 260**

- ❖ In addition to the significance of a particular matter, the form of communication (e.g., whether to communicate orally or in writing, the extent of detail or summarisation in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:
  - Whether the matter has been satisfactorily resolved.
  - Whether management has previously communicated the matter.
  - The size, operating structure, control environment, and legal structure of the entity.
  - In the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.
  - Legal requirements. In some jurisdictions, a written communication with those charged with governance is required in a prescribed form by local law.
  - The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
  - The amount of ongoing contact and dialogue the auditor has with those charged with governance.
  - Whether there have been significant changes in the membership of a governing body.

## **Timing of Communication**

Auditor shall communicate with TCWG on a timely basis.

### **SA 260**

- ❖ The appropriate timing for communications will vary with the significance and nature of the matter, and the action expected to be taken by TCWG. For example:
  - Communications regarding planning matters may be made early in the audit engagement
  - A significant difficulty encountered during the audit as soon as practicable
  - Material weaknesses in the design, implementation or operating effectiveness of internal control as soon as practicable
  - Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards.
  - When auditing both general purpose and special purpose financial statements, it may be appropriate to coordinate the timing of communications.
- ❖ **Other factors that may be relevant to the timing of communications include:**
  - Size, operating structure, control environment, and legal structure of the entity being audited.
  - Any legal obligation to communicate certain matters within a specified timeframe.
  - The expectations of TCWG, including arrangements made for periodic meetings or communications with auditor.
  - The time at which the auditor identifies certain matters, for example, the auditor may not identify a particular matter (e.g., noncompliance with a law) in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.

### **Communication with Those Charged with Governance**

- ❖ Evaluate two way communication for adequacy of Communication process, based on observation:
  - Appropriateness and timeliness of actions taken by TCWG in response to matters raised by auditor.
  - Apparent openness of TCWG in communication with auditor.
  - Willingness and capacity of TCWG to meet auditor without mgt.

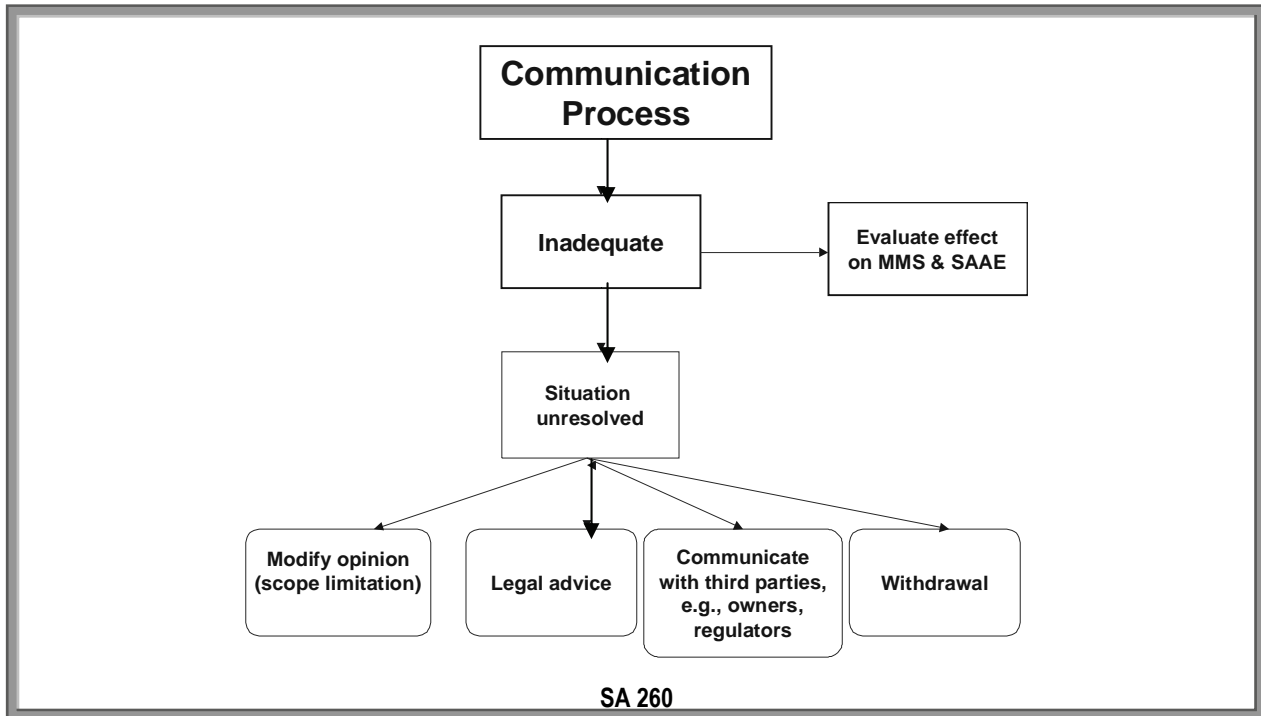
SA 260

### **Adequacy of the Communication Process**

- ❖ Ability of TCWG to fully comprehend matters raised by auditor.
- ❖ Difficulty in establishing Mutual understanding with TCWG.
- ❖ When TCWG are managing entity, apparent awareness of how matters discussed with auditor affect their governance and mgt. Responsibility.
- ❖ Whether two-way communication between auditor and TCWG meets applicable L&R requirements.

SA 260

- ❖ Mutual understanding of the form, timing and expected general content of communications.



## Documentation

- ❖ Matters communicated orally:
  - Document matters; and
  - Also when and to whom matter were communicated.
- ❖ Matters Communicated in writing:
  - Retain a copy of the communication.

**SA 260**

- ❖ Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.



# SA 265

## Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

*Effective for Audits of financial statements for periods beginning on or after April 1, 2010*

### Overview of SA 265

- ❖ **Introduction**
  - Scope
  - Effective Date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements**
- ❖ **Application & Other Explanatory Material:**
  - Determination of whether Deficiencies in Internal Control have been identified
  - Significant Deficiencies in Internal Control
  - Communication of Deficiencies in Internal Control

SA 265

## **Scope**

- ❖ **Deals with auditor's responsibility to:**
  - Communicate appropriately with TCWG/ Mgt.
  - Deficiencies in IC Identified by auditor in audit of FS.
- ❖ **Casts no additional responsibility wrt:**
  - Obtaining an understanding of IC.
  - Designing & performing ToC more than that required by SA 315 & SA 330.
- ❖ **Does not override SA 260.**
- ❖ Specifies which deficiencies need to be communicated to TCWG/Mgt.

### **SA 265**

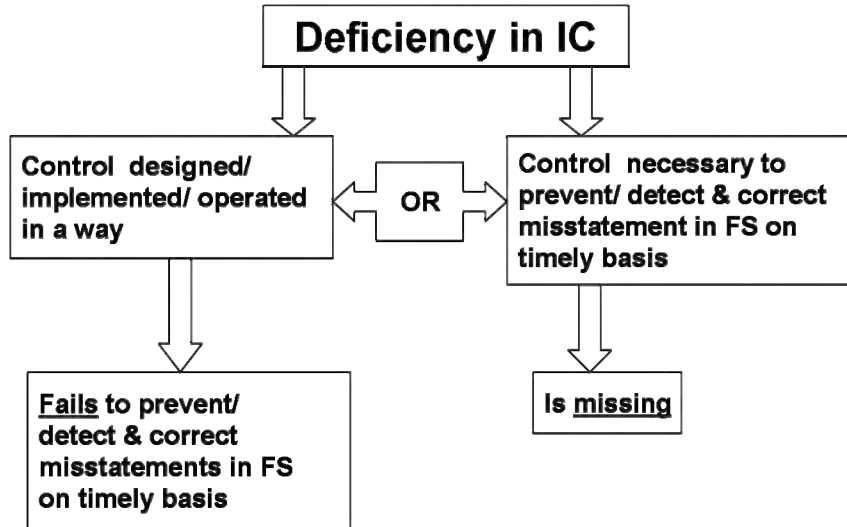
- ❖ SA 260 establishes further requirements and provides guidance on auditor's responsibility to communicate with TCWG in relation to audit.
- ❖ The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit.
- ❖ Nothing in this SA precludes the auditor from communicating to TCWG/ Mgt other internal control matters identified during audit.

## **Auditor's Objective**

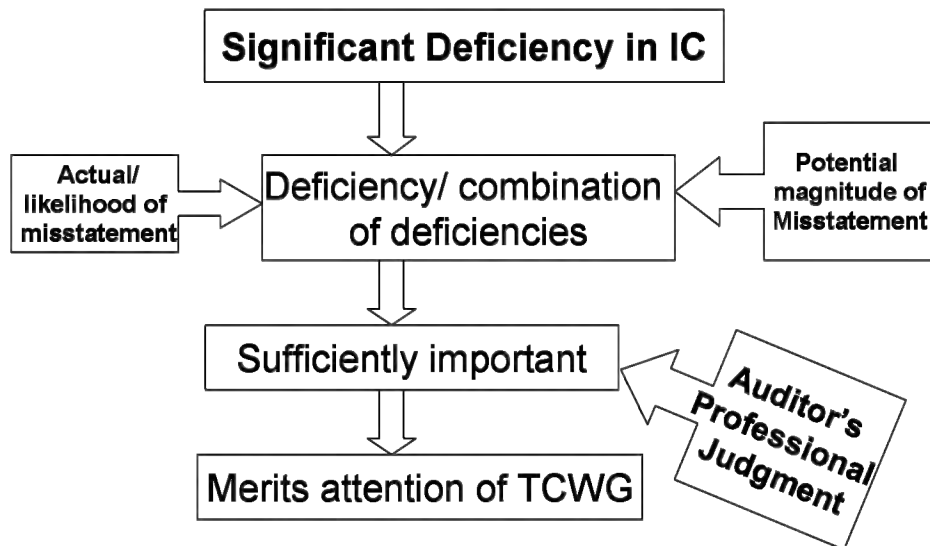
- ❖ Communicate appropriately to TCWG & Mgt:
  - Deficiencies in IC identified during audit, and
  - That in the auditor's professional judgment
    - Are sufficiently important to merit their attentions.

### **SA 265**

## Definitions



SA 265



SA 265

## **Requirements**

- ❖ Determine whether deficiency(s) in IC identified.
- ❖ If deficiencies in IC identified, determine:
  - Whether individually/in combination they constitute significant deficiencies.
- ❖ Communicate in writing **significant deficiencies** in IC identified to TCWG on a timely basis.
- ❖ Communicate to mgt at appropriate level on a timely basis:
  - In writing, significant deficiencies in IC.
  - Other deficiencies in IC.

### **SA 265**

#### **Communication with Management**

- ❖ Auditor shall also communicate to management at an appropriate level of responsibility on a timely basis:
  - In writing, significant deficiencies in IC that the auditor has communicated or intends to communicate to TCWG, unless it would be inappropriate to communicate directly to management in the circumstances; and
  - Other deficiencies in IC identified during audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention.

## **Matters to be Included in Communication**

- ❖ Description of deficiencies & explanation of potential impact.
- ❖ Sufficient information to enable TCWG & Mgt to understand the context of communication.
  - Purpose of audit was to express opinion on FS.
  - Audit includes consideration of IC but not directed to express an opinion on effectiveness of IC.
  - Deficiencies reported restricted to those identified during audit & sufficiently important to merit reporting to TCWG.

### **SA 265**

- ❖ Potential effects of the significant deficiencies:
  - Need not quantify those effects.
  - Significant deficiencies may be grouped together for reporting purposes.
  - May include suggestions for remedial action on the deficiencies, management's actual or proposed responses.
  - Statement as to whether or not the auditor has undertaken any steps to verify whether management's responses have been implemented.
- ❖ The auditor may consider it appropriate to include the following information as additional context for the communication:
  - An indication that if the auditor had performed more extensive procedures on internal control, the auditor might have identified more deficiencies to be reported, or concluded that some of the reported deficiencies need not, in fact, have been reported.
  - An indication that such communication has been provided for the purposes of those charged with governance, and that it may not be suitable for other purposes.
- ❖ Law or regulation may require the auditor or management to furnish a copy of the auditor's written communication on significant deficiencies to appropriate regulatory authorities. Where this is the case, the auditor's written communication may identify such regulatory authorities.

## **Determination of Whether Deficiencies in ICs Have Been Identified**

- ❖ Discuss with appropriate level of Mgt:
  - Is familiar with IC.
  - Has authority to take remedial action.

Do not discuss if Mgt competence is in question.
- ❖ Discussion can throw up more info to consider:
  - Mgt understanding of actual/ suspected cause.
  - Exceptions arising from noted deficiencies.
  - Preliminary Mgt response to deficiencies.

**SA 265**

- ❖ Considerations Specific to Smaller Entities:
  - Underlying control activities similar to those in larger entities, the formality in operation varies. Certain types of control activities are not necessary because of controls applied by management.
  - Fewer employees limits the extent of segregation of duties. Owner- manager may be able to exercise more effective oversight. This higher level of management oversight needs to be balanced against the greater potential for management override of controls.

## **Significant Deficiencies in ICs**

- ❖ Significant deficiency may exist even if misstatements not identified during audit.
- ❖ Matters to consider:
  - Likelihood of deficiency leading to material misstatement in FS in future.
  - Susceptibility to loss/ fraud.
  - Subjectivity & complexity in determining estimated amounts.
  - FS amounts exposed to the deficiencies.
  - Volume of activity in Account balance/ class of Transactions exposed to deficiency.
  - Importance of controls to financial reporting process.
  - Cause & frequency of exception detected.
  - Interaction of deficiency with other deficiencies in IC.

**SA 265**

- ❖ The importance of the controls to the financial reporting process; for example:
  - General monitoring controls (such as oversight of management).
  - Controls over the prevention and detection of fraud.
  - Controls over the selection and application of significant accounting policies.
  - Controls over significant transactions with related parties.
  - Controls over significant transactions outside the entity's normal course of business.
  - Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).

- ❖ Indicators of Significant Deficiencies:
  - Evidence of Ineffective aspects of Control Environment.
  - Entity's Risk Assessment Process - Absent/ Ineffective.
  - Ineffective response to identified significant risks.
  - Correction of prior period misstatements arising due to fraud/ error.
  - Mgt inability to oversee FS preparation.
  - Misstatements detected by the auditor's procedures were not prevented, or detected and corrected, by the entity's IC.
- ❖ Where L&R require reporting on specific types of IC deficiencies:
  - Auditor to use the terms & their definitions as given in L&R.
  - Where no definition given, use professional judgment.
- ❖ SA 265 applies notwithstanding absence of such requirement in L&R.

**SA 265**

- ❖ Evidence of ineffective aspects of the control environment, such as:
  - Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
  - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
  - Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.

## Communicating with TCWG

- ❖ May communicate orally in first place to Mgt:
  - Must follow up with written communication.
- ❖ Level of detail:
  - Nature of entity.
  - Size & complexity of entity.
  - Nature of significant deficiencies identified by auditor.
  - Composition of TCWG.
  - L&R requirement wrt communication of specific type of deficiency in IC.
- ❖ Deficiency continuing from previous audit – communicate in current audit also.
- ❖ Assessment of cost vs benefit of remedy to be done by TCWG/ Mgt – Auditor to communicate.

### SA 265

- ❖ Communicating significant deficiencies in writing to TCWG reflects the importance of the matters, and assists TCWG in fulfilling their oversight responsibilities.
- ❖ Timing to issue the written communication, the auditor may consider:
  - Whether receipt of such communication would be an important factor in enabling TCWG to discharge their oversight responsibilities.
  - *listed entities* - TCWG may need to receive the auditor's written communication before the date of approval of the FS in order to discharge specific responsibilities in relation to internal control for regulatory or other purposes.
  - *For other entities*- the auditor may issue the written communication at a later date.
  - As the auditor's written communication of significant deficiencies forms part of the final audit file, the written communication is subject to the overriding requirement for the auditor to complete the assembly of the final audit file on a timely basis.
- ❖ Certain identified significant deficiencies in internal control may call into question the integrity or competence of management.
  - For example, there may be evidence of fraud or intentional non-compliance with laws and regulations by management, or management may exhibit an inability to oversee the preparation of adequate financial statements that may raise doubt about management's competence.
  - It may not be appropriate to communicate such deficiencies directly to management.
  - See SA 250 & SA 240 for further guidance.



## **Communicating Other Deficiencies**

- ❖ Sufficiently important other deficiencies – matter of professional judgment.
- ❖ Communication may be oral.
- ❖ Previous period communications – Mgt decided not to remedy:
  - No need to repeat in current period.
  - No need to repeat deficiencies reported to Mgt by internal auditors/ regulators.
  - *Re-communicate if:*
    - Change in Mgt.
    - New info comes to attention that alters prior understanding of deficiencies.
- ❖ Other deficiency may become Significant Deficiency later – need to communicate to TCWG

**SA 265**

# **SA 299**

## **Responsibility of Joint Auditors**

*Effective for all audits relating to accounting periods beginning on or after April 1, 1996*

- ❖ Issued in November 1996.

## **Introduction**

- ❖ Deals with auditor's professional responsibilities as joint auditors.
- ❖ Does not cover situations covered under SA 600.

### **SA 299**

- ❖ Appointment of joint auditors is a common phenomenon in India, especially, in case of audit of public sector banks, other public sector undertakings.
- ❖ No other country in the world except Germany and France has an auditing standard corresponding to our SA 299.
- ❖ Does not cover relationship between principal auditor and the branch auditor as envisaged under section 224 of the Companies Act, 1956.

## Division of Work

- ❖ By mutual discussion:
  - Usually in terms of audit of identifiable units/ specified areas.
  - Where such division not possible – in terms of assets/ liabilities/ income/ expenditure, etc.
  - Critical areas covered by all auditors.
- ❖ Document the division & communicate to client.

### SA 299

ABC Company appointed P and Q as joint auditors. Comment on the division of work that can be worked out between the joint auditors in the following cases relating to ABC Company. (each case is unique).

**Ques: ABC company has two divisions, namely Automobile division and Auto Finance division.**

**Ans.:** The division of work can be in terms of audit of identifiable units. In this case the Automobile division and the Auto Finance divisions are two identifiable units and thus each of the joint auditors may decide to pick up one division.

**Ques: ABC company has one factory in Delhi and another in Chandigarh.**

**Ans.:** The division of work can be in terms of specified areas. Thus each one of the joint auditors can audit one location each; namely Delhi & Chandigarh.

**Ques: ABC company does not have any identifiable divisions. Is it advisable that the joint auditors in this case divide the work:**

- with reference to items of assets and liabilities.
- with reference to items of income and expenditure.
- with reference to periods of time.

**Ans.:** At times it is not possible to divide the business in terms of identifiable units or geographical areas. In such situations, the division of work may be:

- with reference to items of assets and liabilities.
- with reference to items of income and expenditure.
- with reference to periods of time.

**Ques: There were some critical areas of the audit that P and Q both decided to cover. There were few other areas that owing to the nature of the work was covered by both P and Q. Comment on the above decision.**

**Ans.:** Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors.

**Ques: P and Q did not document the areas that they are covering individually. They also did not communicate to the entity (ABC company) details regarding division of the work between P and Q. Is it the correct thing to do?**

**Ans.:** The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

## **Coordination**

- ❖ Share significant information with other joint auditors:
  - Deserve their attention.
  - Require disclosure.
  - Require mutual discussion.
  - Application of judgment by others auditors.
- ❖ Before finalisation of audit.

**SA 299**

**Ques.:** During the course of the audit P came across some information that were relevant for Q in terms of disclosure and that required application of judgement by Q. P promptly, over the phone, informed Q about his finding. Is P correct in taking such a step? (Para 4) What are the responsibilities of Q in case he was informed after the submission of the audit report (para 6)?

**Ans.:** Where, in the course of his work, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgement by, other joint auditors, he should communicate the same to all other joint auditors **in writing**. This should be done by the submission of a report or note prior to the finalisation of the audit (para 4).

If any matters of the nature referred to in paragraph above are brought to the attention of the entity or other joint auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible for those matters (para 6).

Thus, in the above case P should have communicated his findings in writing to Q and it should have been communicated to Q before the audit report has been submitted.

## Relationship among Joint Auditors

- ❖ Each Joint Auditor responsible only for work allocated, whether or not separate report therefor is made.
- ❖ Each Joint Auditor jointly and severally responsible for:
  - Undivided work.
  - Nature, timing, extent of audit procedures.
  - Compliance with disclosure requirements.
  - Audit report compliance with statute requirements.
  - Matter brought to notice of all by any one of them, and on which there is an agreement.

### SA 299

**Ques.: In the above case P prepared a separate report on his portion of the work but Q did not prepare any report. Is it possible for Q to deny his responsibility under the plea that he did not prepare any separate report (para 5)?**

**Ans.:** In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. Thus Q cannot deny his responsibility under the plea that he did not prepare any separate report.

**Ques.: P and Q decided on the area of work to be covered. P prepared an audit programme to determine the nature, timing and extent of audit procedures to be applied in relation to the area allocated to him. Q did not prepare any separate audit programme but broadly followed P's audit steps to cover his own areas. After the audit some irregularities were revealed in Q's area of work. Can Q take a plea that he broadly followed P's audit steps? Is Q required to determine his own audit steps (Para 7)?**

**Ans.:** It is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him. The issues such as appropriateness of using test checks or sampling should be decided by each joint auditor in relation to his own area of work. This responsibility is not shared by the other joint auditors. Thus it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him. Similarly, the nature, timing and extent of the enquiries to be made in the course of audit as well as the other audit procedures to be applied are solely the responsibility of each joint auditor.

Thus in the above case Q was expected to formulate his own audit steps specific to the areas covered by him.

### **Joint Allocation**

- ❖ Specific and separate responsibility to review the audit report/returns of the divisions/branches allocated and ensure proper incorporation into accounts of the entity.
- ❖ Exercise judgement regarding necessity of visiting allocated branch/division.
- ❖ Share responsibility of obtaining and evaluating information and explanations from management, unless specific pattern of distribution of responsibility agreed upon.

**SA 299**

**Ques.:** ABC company has two branches X and Y. The branch auditors send the branch audit reports/returns to the head office. Are P and Q responsible for reviewing such reports/returns? In case they are, then how can they divide the work (para 8)?

**Ans.:** In the case of audit of a large entity with several branches, including those required to be audited by branch auditors, the branch audit report/returns may be required to be scrutinised by different joint auditors in accordance with the allocation of work. In such cases, **it is the specific and separate responsibility** of each joint auditor to **review the audit reports/ returns of the divisions/branches allocated to him** and to ensure that they are properly incorporated into the accounts of the entity.

Thus in the above case P and Q should decide about the division of work relating to review of branch audit reports/returns.

### **Own Areas - Execution**

- ❖ Each responsible to determine:
  - Nature, timing & extent of audit procedures.
  - Appropriateness of test checking / sampling.
  - Study and evaluate prevailing system of internal control in relation to work allocated.
  - Nature, timing and extent of enquiries to be made.
  - Other audit procedures.

**SA 299**

## Assumption

- ❖ Entitled to assume that other joint auditor:
  - Is competent and has worked according to Generally Accepted Audit Procedures.
  - Not necessary to review work performed by him.
  - Rely for bringing to notice any departure from generally accepted accounting principles or material error noticed during course of audit.
- ❖ If branch/division audited by one of them then others entitled to rely upon observations communicated.

### SA 299

**Ques.:** In the above case P was assigned the work of branch X and Q was assigned branch Y. Neither P nor Q visited the respective branches. Later on some irregularity was noticed in branch X. What is the responsibility of P in this regard? Will the fact that Q did not visit branch Y have any bearing on P? (para 8) Is Q required to review the work of P in this case or under any other circumstances (para 10 and 11)?

**Ans.:** It is the **separate and specific responsibility** of each joint auditor to exercise his **judgement** with regard to the **necessity of visiting such divisions/branches in respect of which the work is allocated to him** (para 8). Thus in the above case P might be held responsible for not visiting branch X. The fact that Q did not visit branch Y will not have any bearing on P. As regards review of work by any joint auditor or other joint auditors SA 299 specifies that each joint auditor is entitled to **assume** that the **other joint auditors** have **carried out** their part of the audit work **in accordance** with the generally accepted audit procedures. It is **not necessary** for a joint auditor **to review the work** performed by other joint auditors.

Thus Q is not required to review P's work under any circumstances.

## **Reporting**

- ❖ Normally, joint auditors are able to arrive at an agreed report.
- ❖ If disagreement, then:
  - each one of them should express his opinion through a separate report.
  - a joint auditor is not bound by majority view regarding matters to be covered in the report and should express his opinion in a separate report.

### **SA 299**

**Ques.:** P, Q and R were appointed joint auditors. The three of them could not arrive at an agreed report. P and Q agreed to the report but R had a different opinion. What are the options open to R in this particular case?

**Ans.:** Normally, the joint auditors are able to arrive at an **agreed report**. However, where the joint auditors are in **disagreement with regard to any matters** to be covered by the report, **each one of them should express his own opinion through a separate report**. A joint auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Thus R can issue a separate report in this particular case.

## **300 – 499: Risk Assessment and Responses to Assessed Risks**

- ❖ SA 300, "Planning an Audit of Financial Statements" (April 1, 2008).
- ❖ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", (April 1, 2008).
- ❖ SA 320, "Materiality in Planning & Performing an Audit" (April 1, 2010).
- ❖ SA 330, "The Auditor's Responses to Assessed Risks" (April 1, 2008).
- ❖ SA 402, "Audit Considerations relating to an Entity Using a Service Organisation" (April 1, 2010).
- ❖ SA 450, "Evaluation of Misstatements Identified During the Audit" (April 1, 2010).



# SA 300

## Planning an Audit of Financial Statements

*Effective for audits of financial statements for periods beginning on  
or after April 1, 2008*

## Overview of SA 300

- ❖ **Introduction**
  - Scope
  - Effective Date
- ❖ **Objective**
- ❖ **Requirements**
  - Involvement of Key Engagement Team Member
  - Preliminary Engagement Activities
  - Planning Activities
  - Documentation
  - Additional Considerations in Initial Audit Engagements.
- ❖ **Application and Other Explanatory Material on these Aspects**
- ❖ **Appendix**

SA 300

## **Scope**

- ❖ Auditor's responsibility to plan audit of financial statements.
- ❖ Framed in the context of recurring audits.
- ❖ Additional considerations for initial audit engagements.

### **SA 300**

- ❖ Planning involves:
  - Establish overall audit strategy.
  - Developing audit plan.
- ❖ Adequate planning helps the auditor:
  - To devote appropriate attention to important areas.
  - Identify and resolve potential problems on timely basis.
  - Properly organise and manage the audit.
  - Assists Selection of engagement team members with requisite capabilities and competence.
  - Co-ordination of the work done by auditors of components and experts.
  - Facilitating direction and supervision of engagement team.
- ❖ The nature and extent of planning activities vary according to:
  - Size and complexity of the entity.
  - Key engagement team members' previous experience.
  - Changes in circumstances.
- ❖ Planning is a continuous and iterative process.
- ❖ Timings of certain planning activities needs to be completed prior to the performance of further audit procedures.
- ❖ Auditor may discuss elements of planning with management, but planning remains responsibility of the auditor.

## **Objective**

- ❖ Plan an audit so that engagement is performed in an effective manner.

### **SA 300**

## **Involvement of Key Engagement Team Members**

- ❖ To be involved in planning:
  - Participate in discussion with audit team.
  - Benefit of their experience & insight.
  - Increases effectiveness & efficiency of planning.

**SA 300**

- ❖ Involvement of Key Engagement Team Members:
  - SA 315 also contains a requirement for discussion with the audit team as to the susceptibility of the financial statements of the entity to material misstatements.
  - SA 240 also contains a requirement for discussion among audit team as to susceptibility of the financial statements to fraud.

## **Preliminary Engagement Activities**

- ❖ Perform procedures required under SA 220, "Quality Control for an Audit of Financial Statements":
  - Client continuation, etc.
- ❖ Evaluate compliance with ethical requirements including independence.
- ❖ Establish understanding of terms of engagement as per SA 210, "Agreeing the Terms of Audit Engagement".

**SA 300**

### **Preliminary engagement activities**

- ❖ Assists in identifying & evaluating events/circumstances that may adversely affect the auditors ability to plan & perform the engagement.
- ❖ Enables the auditor to plan an audit engagement for which, for example:
  - The auditor maintains the necessary independence and ability to perform the engagement.
  - There are no issues with management integrity that may affect the auditor's willingness to continue the engagement.
  - There is no misunderstanding with the client as to the terms of the engagement.
- ❖ Client continuance and ethical requirements:
  - Occurs throughout the Audit.
  - Current audit - At the beginning.
  - Continuing audit – Shortly after (In connection with) the completion of previous audit.

## **Planning Activities**

- ❖ Establish overall strategy to set the scope, timing & direction of audit plan.
- ❖ To establish overall audit strategy:
  - Identify characteristics of engagement.
  - Ascertain reporting objectives.
  - Identify factors significant to direct audit team's efforts.
  - Consider results of preliminary engagement activities.
  - Ascertain nature, timing & extent of resources required.

**SA 300**

### **Planning activities**

#### **Scope:**

- ❖ Assists the auditor in determining:
  - How/ When/ Amount of resources deployed for specific audit areas and their management.
- ❖ Establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

#### **Considerations Specific to Smaller Entities**

- ❖ Co-ordination of, and communication between, team members are easier. Establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise.

- ❖ Contents of Audit Plan:
  - Nature, timing & extent of RAPs.
  - Nature, timing & extent of planned further audit procedures at assertion level.
  - Other procedures required to comply with SAs.
- ❖ Update & change the overall audit strategy & audit plan as necessary.
- ❖ Plan nature, timing & extent of direction, supervision & review of engagement team members.

**SA 300****Contents of audit plan**

- Planning of the auditor's risk assessment procedures occurs early in the audit process.
- Planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures.
- Auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

**Update audit plan**

- ❖ Need:
  - Unexpected events,
  - Changes in conditions,
  - Audit evidence obtained from the results of audit procedures, and
  - Information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures.

**Direction, supervision & review**

- ❖ Factors affecting direction, supervision & review:
  - The size and complexity of the entity.
  - The area of the audit.
  - The assessed risks of material misstatement.
  - The capabilities and competence of the individual team members performing the audit work.
 (See SA 220, 'Quality Control for an Audit of Financial Statements' for more guidance.)
- ❖ Considerations for SMEs:
  - Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual also performs the entire audit.
  - When particularly complex or unusual issues are involved, and the audit is performed by a sole practitioner, it may be desirable to consult with other suitably-experienced auditors or the auditor's professional body.

## **Documentation**

- ❖ Overall audit strategy:
  - Necessary for proper planning & communicating significant matters to audit team.
- ❖ Audit plan:
  - Record of proper planning & review of audit procedures for approval before use.
- ❖ Significant changes to overall audit strategy/ audit plan and reasons for changes:
  - Reflects appropriate response to these changes.

**SA 300**

### **Documentation**

#### *Considerations Specific to Smaller Entities*

- ❖ A suitable, brief memorandum may serve as the documented strategy.
- ❖ For the audit plan, standard audit programs or checklists drawn up on the assumption of few relevant control activities, as is likely to be the case in a smaller entity, may be used provided that they are tailored to the circumstances of the engagement, including the auditor's risk assessments.

## **Additional Considerations in Initial Audit Engagements**

- ❖ Before starting initial audit engagement:
  - Perform procedures required under SA 220 – client acceptance, etc.
  - Communicating with predecessor auditor.
- ❖ Additional matters to consider in Audit Strategy and Audit Plan:
  - Any major issues discussed with management.
  - Audit procedures necessary regarding opening balances.
  - Other procedures required by firm's QC system.

**SA 300**

### **Special considerations for initial audit engagements in establishing overall audit strategy and audit plan:**

- ❖ Major issues discussed with management:
  - Application of accounting principles or of auditing and reporting standards.
  - The communication of these matters to TCWG.
  - How these matters affect the overall audit strategy and audit plan.
- ❖ Audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances (see SA 510, *Initial Audit Engagements-Opening Balances*).
- ❖ Other procedures required by the firm's system of QC for initial audit engagements.

# SA 315

## **Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment**

*Effective for audits of financial statements for periods beginning on or after April 1, 2008.*

### **Overview of SA 315**

- ❖ **Introduction**
  - Scope
  - Effective Date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements:**
  - Risk Assessment Procedures and Related Activities
  - The Required Understanding of the Entity and Its Environment, including Internal Control
  - Identifying and Assessing the Risks of Material Misstatement
  - Material Weakness in Internal Control
  - Documentation
- ❖ **Application and other Explanatory Material on these Aspects**
- ❖ **Appendices**

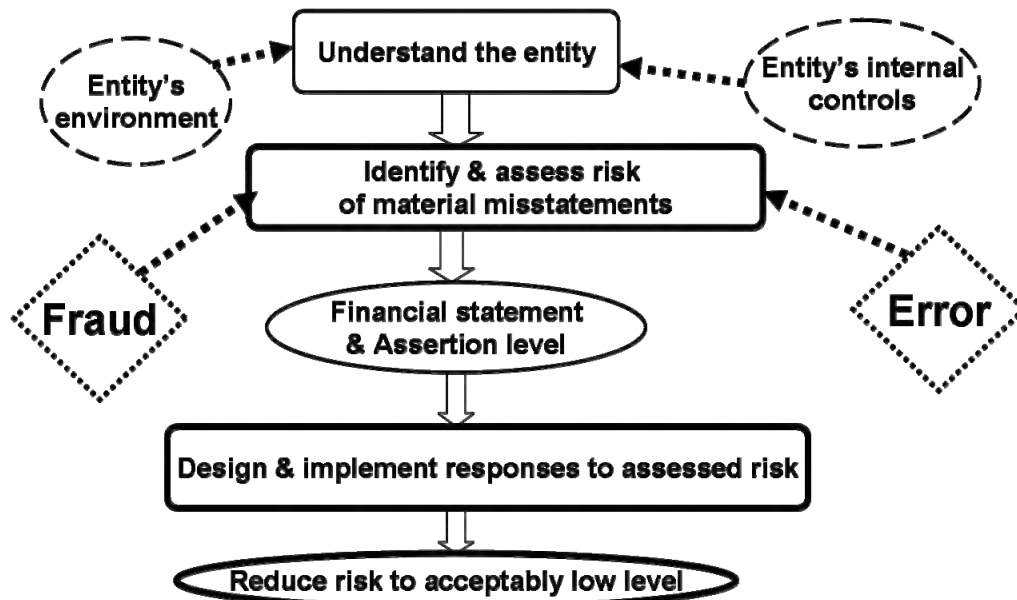
SA 315

## Scope

- ❖ Auditor's responsibility to identify & assess risks of material misstatements in financial statements.
- ❖ Through understanding:
  - The entity.
  - Its environment.
  - Its internal controls.

SA 315

## Objective – of the Auditor



SA 315



## Important Definitions

### ❖ **Assertions:**

- Representations by management.
- Embodied in financial statements.
- Used to assess potential misstatements.

### ❖ **Business Risk:**

- Results from:
  - Significant conditions/events/ actions/inactions/ circumstances.
  - Inappropriate goal setting.
- Adversely affects achievement of objectives/ strategies.

SA 315

### ❖ **Internal control (IC):**

- Process to ensure:
  - Reliability of financial reporting.
  - Effectiveness & efficiency of operations.
  - Safeguarding of assets.
  - Compliance with applicable laws & regulations.
- Designed, implemented & maintained by TCWG.
- Provides only reasonable assurance.
- *Control* – Any aspects of one or more of the component of IC.

SA 315

❖ **Risk Assessment Procedures (RAPs):**

- Procedures to understand entity & its environment (ICs also).
- To identify & assess risk of material misstatement – fraud/ error – at financial statement & assertion level.

❖ **Significant Risk:**

- Risk of material misstatement requiring special audit consideration.

**SA 315**

**Risk Assessment Procedures – Need**

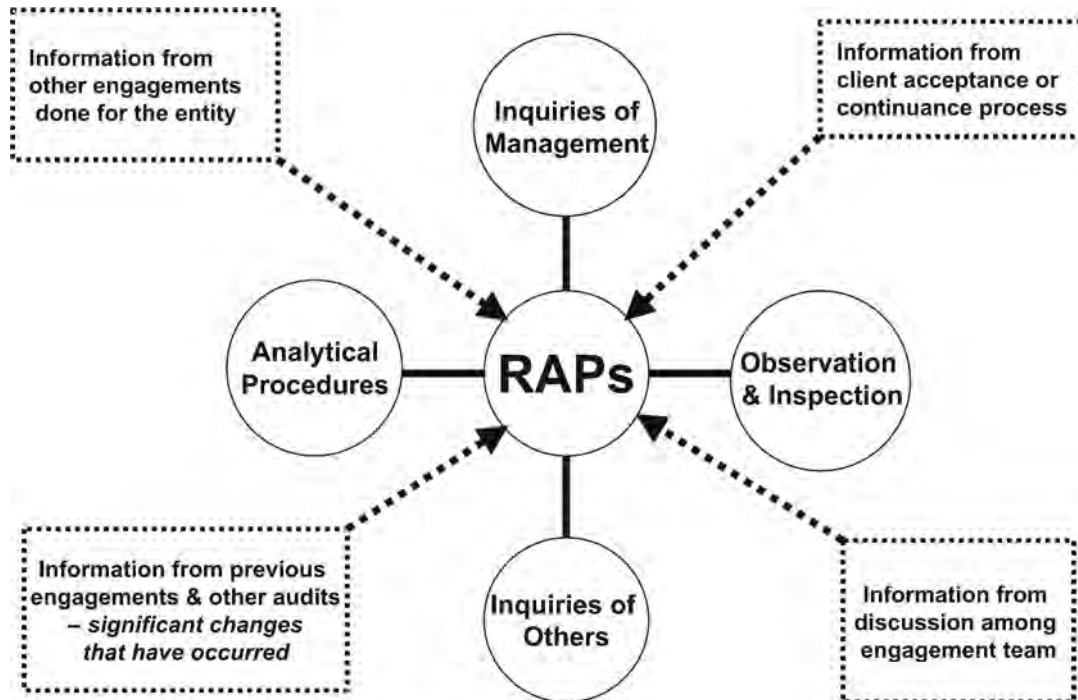
**Establish frame of reference for:**

- ❖ Assessing risk of material misstatements in FS.
- ❖ Establishing and assessing continued relevance of established materiality levels.
- ❖ Evaluating appropriateness of accounting policies-selection & application, disclosures.
- ❖ Identifying areas needing special audit consideration.
- ❖ Developing expectations wrt Analytical Procedures.
- ❖ Responding to assessed risk of material misstatements.
- ❖ Evaluating sufficiency & appropriateness of audit evidence.

**SA 315**

- ❖ Examples of procedures to identify risks of material misstatement:
  - Reviewing information obtained from external sources.
  - Making inquiries of entity external legal counsel or experts.

## RAPs – Types



SA 315

### **RAPs – Inquiry of Management**

<b>Source</b>	<b>Information obtained</b>
Those Charged with governance	Understand environment in which financial statements are prepared
Internal auditors	Internal audit procedures wrt design and effectiveness of internal controls, management's responses thereto
Employees	Appropriateness of selection, application of certain accounting policies
Marketing personnel	Changes in marketing strategies, sales trends, contracts etc.
In-house legal counsel	Litigation, compliance with laws, Knowledge of frauds, etc.

**SA 315**

**Inquiry:**

- Employees – those involved in initiating, processing or recording complex or unusual transactions.

### **RAPs – Analytical Procedures**

- ❖ May identify aspects of entity of which auditor was unaware.
- ❖ May assist in assessing the RMM to provide basis for designing & implementing responses to assessed risks.
- ❖ Identify unusual transactions/ relationships, etc. (possibility of fraud).
- ❖ APs on data aggregated at high level gives only broad initial indication of material misstatement.

**SA 315**

### **RAPs – Observation & Inspection**

- ❖ May support inquiries of management and others.
- ❖ Provide information about entity/ its environment.
- ❖ Examples:
  - Entity's operations.
  - Documents.
  - Management/TCWG reports.
  - Premises & plant facilities.

SA 315

### **RAPs – Some important aspects-I**

- ❖ Can use substantive procedures & tests of controls alongwith RAPs, if necessary.
- ❖ Use professional judgment to decide sufficiency of understanding – should be able to meet objectives of SA.
- ❖ Consider risk of fraud as well as error.
- ❖ RAPs not required for all aspects of entity & its environment.

SA 315

## **RAPs – Some important aspects-II**

- ❖ Use of information from past experience e.g.:
  - Past misstatements – whether corrected on timely basis.
  - Nature of entity, its environment.
  - Significant changes in entity, its operations.
- ❖ Evaluate relevance of information from prior period to current audit.
- ❖ Make inquiries/perform walk-throughs to identify changes.

**SA 315**

## **RAPs – Some important aspects-III**

- ❖ Discussion among engagement partner & other team members:
  - Susceptibility of FS to fraud/error.
  - Determine matters to be communicated to other team members:
    - Experienced members can share insights based on knowledge of entity.
    - Exchange information on business risks facing entity for aspects allocated to them.
    - Understand how their audit procedures affect other team members' work.
    - Provides basis for communication and share new information obtained throughout the audit.

**SA 315**

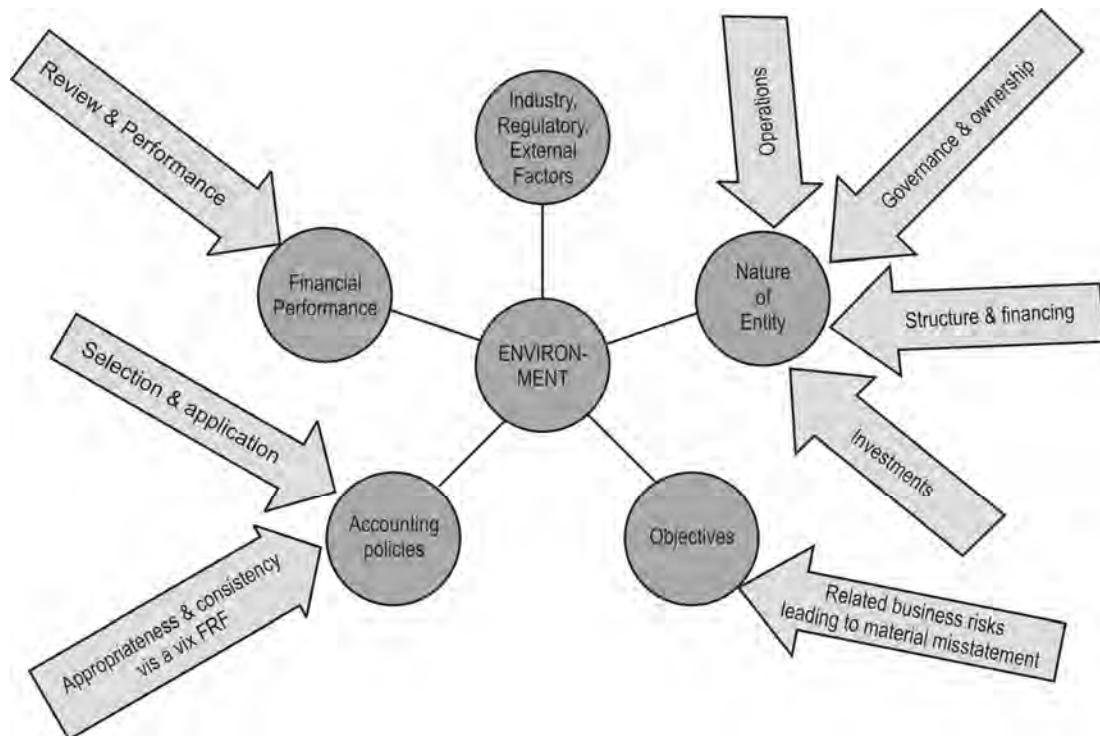
- ❖ **Note:** It is not necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. Not necessary:
  - To include all Engagement Team Members in a Single discussion.
  - Informed about all the decisions reached.

## Smaller Entity Considerations

- ❖ Small audits may be carried out by engagement partner alone (eg., sole practitioner).
- ❖ He is responsible for considering the susceptibility of FS to fraud/ error.

SA 315

## Entity & Its Environment



SA 315

- ❖ Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.

## **Entity & Its Environment – Industry, Regulatory & Other Factors**

### ❖ **Industry Factors:**

- Market competition
- Product technology
- Cyclical/ seasonal activity
- Energy cost & supply

Type of industry may give rise to specific risk factors.

### ❖ **Regulatory Factors:**

- Accounting principles & industry specific practices.
- Regulatory framework, Government policies.
- Legislation affecting operations.
- Taxation.
- Environmental requirements.

### ❖ **Other External Factors:**

- General economic conditions.
- Interest rates & availability of finance.
- Inflation/ currency revaluation.

**SA 315**

- ❖ SA 250 includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry.
- ❖ In case of certain entities, there may be government policy requirements and resolutions of the legislature that affect the entity's operations.
- ❖ The Industry in which the entity operates give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation.

## **Entity & Its Environment – Nature of the Entity-I**

### ❖ **Helps in understanding:**

- Structure of the entity – complex/ simple
- Ownership and related parties

### ❖ **Business operations:**

- Nature of revenue sources
- Conduct of operations
- Stages of production
- Joint ventures/ outsourcing etc.
- Geographic location
- Key customers & suppliers
- R & D activities
- Related party transactions

**SA 315**



### **Entity & Its Environment – Nature of the Entity-II**

- ❖ Investment activities:
  - Planned/ recent Merger and Acquisitions
  - Investments & dispositions of securities/ loans
  - Capital investment activities
  - Investment in non-consolidated entities
- ❖ Financing:
  - Major subsidiaries & associates
  - Debt structure & related terms
  - Beneficial owners
  - Use of derivative financial instruments

SA 315

### **Entity & Its Environment – Nature of the Entity- III**

- ❖ Financial Reporting:
  - Accounting principles & industry.
  - Revenue recognition policy.
  - Accounting for fair values.
  - Foreign currency transactions.
  - Accounting for unusual/ complex transactions.

SA 315

### **Entity & Its Environment – Selection & application of accounting policies**

- ❖ Method of accounting for significant/ unusual transactions.
- ❖ Effect of accounting policies in controversial/ emerging areas.
- ❖ Changes in accounting policies.
- ❖ Financial reporting standards/ law & regulations new to the entity.

**SA 315**

### **Entity & Its Environment – Objectives, strategies & related business risks- I**

- ❖ Strategy - approach by which management intends to achieve objectives.
- ❖ Understanding of business risk increases chance of detection of risk of material misstatement.
- ❖ Business risk may or may not have immediate impact.
- ❖ Management responsibility to identify & address business risk.
- ❖ Auditor not responsible for identifying all business risks but only those that may give rise to risk of material misstatement.

**SA 315**

- ❖ Business risk may arise from the following factors:
  - The development of new products or services that may fail.
  - A market which, even if successfully developed, is inadequate to support a product or service.
  - Flaws in a product or service that may result in liabilities and reputational risk.

## **Entity & Its Environment – Objectives, strategies & related business risks-II**

- ❖ Matters to consider:
  - Industry developments.
  - New products & services.
  - Expansion of business.
  - New accounting requirements.
  - Regulatory requirements.
  - Current & prospective financing requirement.
  - Use of IT.
  - Effects of implementing a strategy.

**SA 315**

## **Entity & Its Environment – Measurement & review of financial performance**

- ❖ Aimed at assessing achievement of objectives by management.
- ❖ Performance measures may motivate management to misstate financial statements.
- ❖ Not same as monitoring of internal controls.
- ❖ Internally generated information:
  - Key performance indicators.
  - Periodic financial performance analyses:
    - Budgets/ forecasts/ variance analysis.
    - Employee performance measures.
    - Comparison with competitors.
- ❖ Also done by external parties – analysts.

**SA 315**

- ❖ The measurement and review of financial performance is not same as monitoring of control through their purposes:
  - Whether business performance is meeting the objectives set by management (or third parties).
  - Monitoring of controls is specifically concerned with the effective operation of internal control.
- ❖ Internal Measures:
  - May highlight unexpected results or trends.
  - To determine their cases and take corrective action.

### **Small Entity Considerations**

- ❖ Do not have formal processes to measure & review financial performance.
- ❖ Inquire management for any informal process.
- ❖ If no performance measurement/ review exists, leads to increased risk of undetected & uncorrected misstatements.

**SA 315**

### **Internal Controls - I**

- ❖ **Obtain an Understanding:**
  - Not all controls are relevant to Financial Reporting.
  - Use Professional judgement.
- ❖ **Purpose:**
  - Reliable financial reporting.
  - Efficiency/ effectiveness of operations.
  - Compliance with laws & regulations.
  - Safeguarding of assets.

Design, implementation & maintenance varies with size & complexity of entity.
- ❖ **Smaller Entity Consideration:**
  - Internal controls – less structures & simple.

**SA 315**

- ❖ An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risk of material misstatement and in designing the nature/ timing/ extent of further audit procedure.
- ❖ The following application material on internal control is presented in four section, as follows:
  - The reliability of the entity's financial reporting.
  - The effectiveness and efficiency of its operations.
  - Its compliance with applicable laws and regulations.
  - Safeguarding of assets.

## Internal Controls- II

- ❖ Limitations:
  - Faulty human judgment.
  - Collusion among employees and/ or management.
  - Management override of controls.
  - Costs vs benefits.
  - Judgments as to nature & extent of risk assumed *vis a vis* controls.

### **Small Entity Considerations**

- ❖ Fewer employees therefore less segregation of duties but closer owner oversight.
- ❖ More chances of owner override of controls.

**SA 315**

## Internal Controls – Manual vs Automated

Benefits of automated controls	Risks of automated controls
Consistency in application	Inaccuracy in design
Enhanced timelines, availability & accuracy of information	Unauthorised access
Additional analysis possible	Unauthorised changes to master files
Better monitoring	Unauthorised changes to systems or programs
Reduced risk of circumvention of controls	Failure to make necessary changes to programs / systems.
Better segregation of duties	Inappropriate manual intervention
	Inability to access data

**SA 315**

- ❖ The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:
  - Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.
  - Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, record, process or report transactions, or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT.

An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT.

- ❖ Suitability of manual controls:
  - Large/unusual/ non recurring transactions.
  - Where errors are difficult to design/ predict.
  - Changing circumstances not covered by automated controls.
  - Monitoring effectiveness of controls.
- ❖ Manual controls less reliable because can be easily bypassed, ignored, overridden & more prone to errors—consistency cannot be assumed.
- ❖ Not suitable for:
  - High volume/ recurring transactions.
  - Control activities where automation is possible.

**SA 315**

- ❖ The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system.

### **Understanding Controls Relevant to Audit-I**

- ❖ Factors to consider:
  - Materiality.
  - Significance of related risk.
  - Size of entity.
  - Nature of entity's business.
  - Diversity & complexity of entity's operations.
  - Circumstances & applicable internal controls.
  - How a specific control prevent/ detects & corrects misstatements.
  - Nature and complexity of the systems.
  - Legal/ regulatory requirements.

**SA 315**

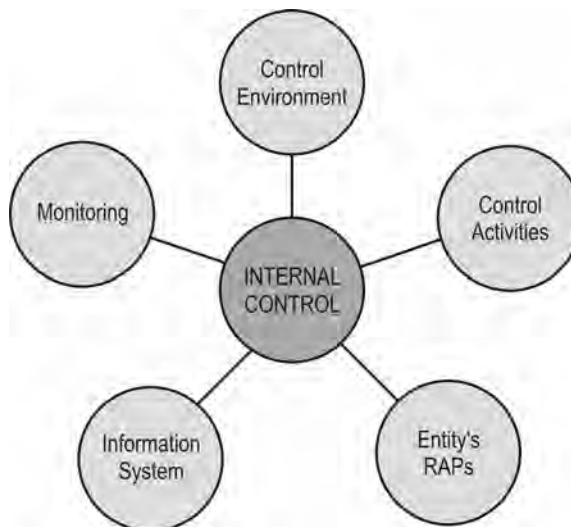
## Understanding Controls Relevant to Audit- II

- ❖ **Nature & extent of understanding controls relevant to audit:**
  - Evaluate the design of these controls.
  - Determine their implementation.
- ❖ **Procedures:**
  - Inquiry of entity personnel.
  - Observing application of specific controls.
  - Inspecting documents & reports.
  - Tracing transactions through information system relevant to financial reporting.
- ❖ **Understanding ICs alone not sufficient to test operating effectiveness unless there is some automation to ensure consistency.**

**SA 315**

- ❖ Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures.
- ❖ Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives.

### Internal Control – Components



**SA 315**

## Control Environment – Elements



SA 315

- ❖ **Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:**
- (a) *Communication and enforcement of integrity and ethical values* – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
  - (b) *Commitment to competence* – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
  - (c) *Participation by those charged with governance* – Attributes of those charged with governance such as:
    - Their independence from management.
    - Their experience and stature.
    - The extent of their involvement and the information they receive, and the scrutiny of activities.
    - The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
  - (d) *Management's philosophy and operating style* – Characteristics such as management's:
    - Approach to taking and managing business risks.
    - Attitudes and actions toward financial reporting.
    - Attitudes toward information processing and accounting functions and personnel.
  - (e) *Organisational structure* – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
  - (f) *Assignment of authority and responsibility* - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.
  - (g) *Human resource policies and practices* – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.



## **Control Environment – Important Audit considerations**

- ❖ Evaluate:
  - Existence of ethical values & culture.
  - Collective strength of control environment *vis a vis* control environment deficiencies.
  - Effect of control environment on risk assessment.
- ❖ RAPs:
  - Inquiry + Observation + Inspection.

### **SA 315**

- ❖ The control environment includes the governance and management functions and the attitudes, awareness, and actions of TCWG concerning the entity's internal control and its importance in the entity.

## **Internal Control – Control Environment**

- ❖ Effects on Assessment of Risk of Material Misstatements:
  - Pervasive effect – control consciousness driven by those charged with governance.
  - Satisfactory control environment reduces but not absolutely deters fraud.
  - Does not in itself prevent/ detect & correct material misstatement but affect auditor's assessment of effectiveness of other controls.

### **SA 315**

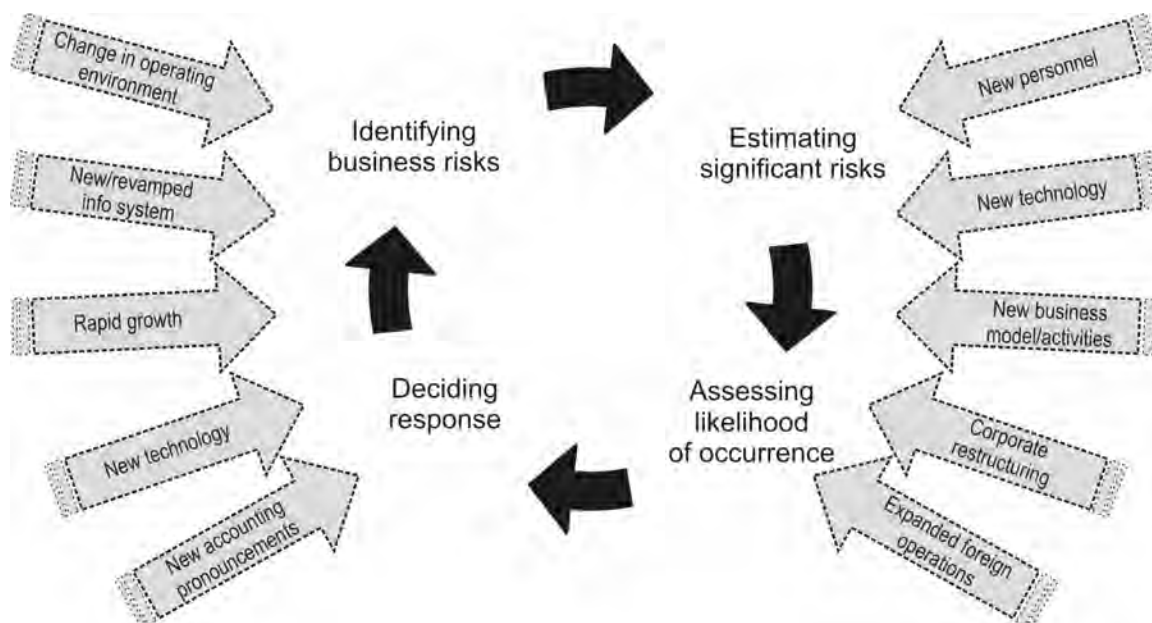
- ❖ The effectiveness of design of control environment of those charged with governance is influenced by matters such as:
  - Their independence from management and their ability to evaluate the actions of management.
  - Whether they understand the entity's business transactions.
  - The extent of their evaluation about FS are prepared in accordance with FRF.
- ❖ Philosophy and operating style of senior management is influenced by their activeness and independence.

## Smaller Entity Considerations

- ❖ TCWG may not be independent/ outside members.
- ❖ Governance role undertaken by owner.
- ❖ No documentary evidence on existence of control environment.
- ❖ Attitudes, awareness and actions of owner are of particular importance.

SA 315

## Entity's RAPs – Elements & Risk Factors



SA 315

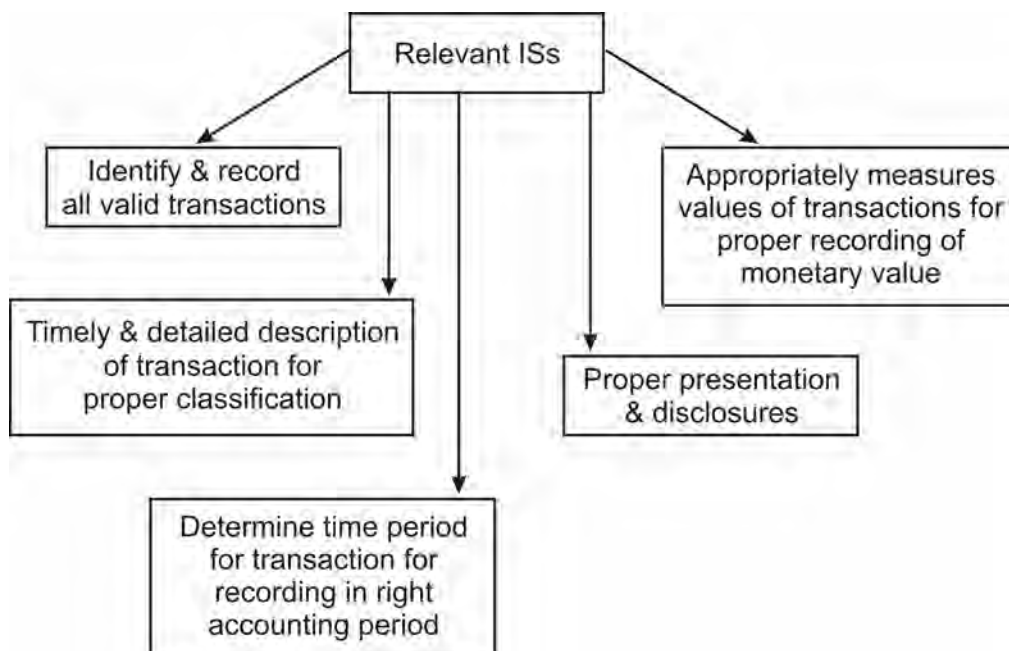
## Entity's RAPs – Important aspects

- ❖ Entity RAP's failure to identify material misstatement:
  - Why failure?
  - Appropriateness of process to circumstances.
  - Material weakness in entity's RAP.
- ❖ Absence of Entity's RAPs:
  - Discuss with management
    - How risks identified & addressed.
  - Evaluate appropriateness or otherwise of a documented entity's RAPs.
    - Is it a material weakness?

SA 315

- ❖ Use Professional judgment in determining appropriateness of RAPs.
- ❖ Considerations specific to smaller entities:
  - Unlikely to be establish RAP.
  - Identification through personal involvement.
  - Inquiry for identified Risk and how addressed.

## Information System



SA 315

### **Information System – important aspects**

- ❖ Manual/Automated Info System relevant to financial reporting objectives:
  - Initiates, records, processes & reports entity transactions.
  - Maintains accountability of related assets, liabilities & equity.
  - Resolves incorrect processing of transactions.
  - Processes & accounts for system/ control overrides.
  - Transfers information to General Ledger.
  - Captures other relevant information.
  - Ensures accumulation, recording, processing & summarisation & appropriate reporting of information relevant to FRF.

**SA 315**

- ❖ Journal Entries:
  - IS includes use of standard journal entries, for recurring transactions.
  - Also include use of non-standard journal entries for non-recurring transactions.
- ❖ Relating business process:
  - An entities business process are the activities designed to:
    - Develop, purchase, produce, sell and distribute an entity's products and services.
    - Ensure compliance with laws and regulations.
    - Record information, including accounting and financial reporting information.

### **Information System – important Audit considerations**

- ❖ Understand – *the Process*:
  - Significant classes of transactions
  - Procedure for initiation, recording, processing, correcting, transferring information to general ledger & FS.
  - Related accounting records & supporting information.
  - How other information is captured.
  - Process for preparing FS – accounting estimates & disclosures.
  - Controls surrounding journal entries.

**SA 315**

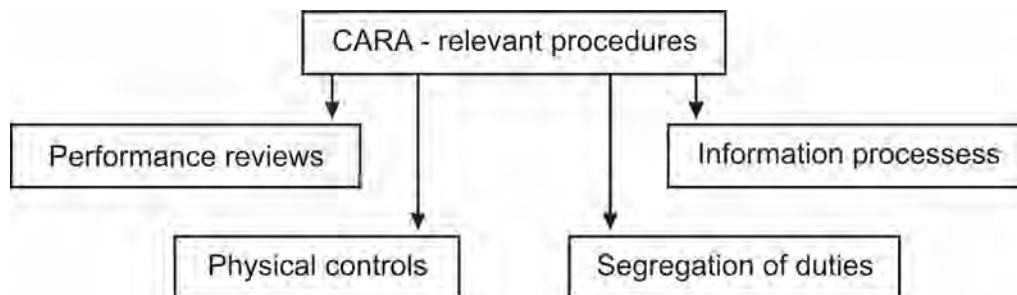
- ❖ Understand – the Communication:
  - How financial reporting roles & responsibilities are communicated.
  - Communication between TCWG.
  - External communications

**Smaller Entity Considerations:**

- ❖ **Info systems less sophisticated but role equally significant** – understanding them is therefore important.
- ❖ **Active management** → less description of accounting procedures/ sophisticated accounting records/ written policies.
- ❖ More of inquiry than review of documentation.
- ❖ Less structured communication.

SA 315

**Control Activities relevant to Audit (CARA) – relevant procedures**



SA 315

### **Control Activities relevant to Audit (CARA) – important Audit aspects**

- ❖ CARA relevant to auditor:
  - Relate to significant classes of transactions/ account balances.
  - Disclosures in FS.
  - Relate to assertions relevant to risk assessment.
  - May give rise to material misstatement.
  - Need to test effectiveness of controls.
  - Substantive procedures alone not sufficient.
  - Considered relevant by auditor.
  - Where risk of material misstatement is higher.

**SA 315**

- ❖ The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

- ❖ Smaller Entity Considerations:
  - Underlying concepts same as in larger entities, but less formal.
  - Some controls may not be relevant due to direct owner oversight.
  - Relate mainly to transaction cycles.
- ❖ Understand CARA:
  - Necessary for assessing risk of material misstatement at assertion level & designing audit procedures responsive to risk.
  - Response to IT risks.

**SA 315**

## IT Risks & Controls

General IT Controls	Application Controls
Policies & procedures relating to many applications	Manual / automated controls operating at business process level
Apply to mainframe, miniframe, end user	Apply to processing of individual transactions
Maintain integrity of information & security of data	Ensure authorisation, completeness, accuracy & processing of transaction.
<b>Coverage:</b> <ul style="list-style-type: none"> <li>• Data centre &amp; network operations</li> <li>• System s/w acquisition, change &amp; maintenance</li> <li>• Program change</li> <li>• Access security</li> <li>• Application system acquisition, development &amp; maintenance</li> </ul>	<b>Coverage:</b> <ul style="list-style-type: none"> <li>• Initiation</li> <li>• Recording</li> <li>• Processing</li> <li>• Reporting of transaction &amp; other financial data</li> </ul>

SA 315

## Monitoring Controls –important aspects

- ❖ Process to assess effectiveness of IC performance over time.
- ❖ Involves assessing effectiveness of controls on a timely basis & taking necessary remedial actions.
- ❖ Done by separate evaluations + ongoing activities
  - Communication from external parties (eg. regulators).

SA 315

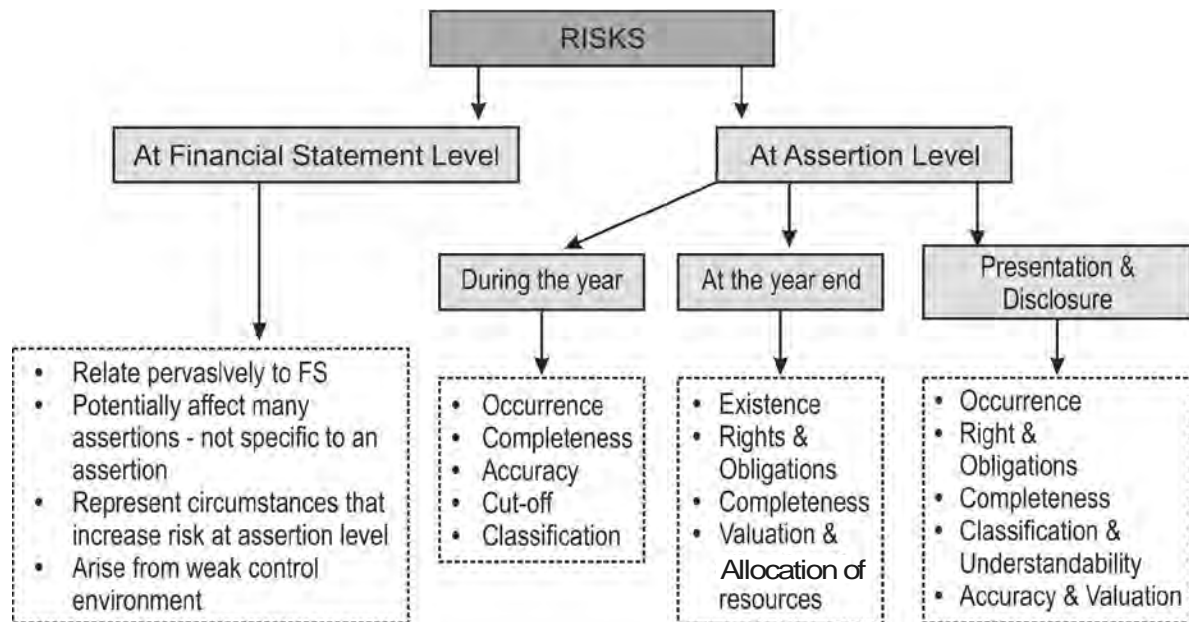
## Monitoring Controls –important Audit aspects

- ❖ Understand:
  - Major monitoring activities.
  - Entity's Remedial Actions to deficiencies in controls.
  - Internal audit function, if existing in entity.
  - Sources of information used in monitoring activities.
  - Basis upon which management assesses reliability of information.
- ❖ **Smaller Entity Considerations:**
  - Monitoring often accomplished by owners' close involvement in operations.

SA 315

- ❖ Auditor should obtain the understanding of:
  - The sources of the information related to the entity's monitoring activities.
  - The basis upon which management considers the information to be sufficiently reliable for the purpose.

## Identifying & Assessing Risks of Material Misstatement



SA 315

- ❖ The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:
  - Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.
  - Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements.



## **Identifying & Assessing Risks of Material Misstatement – Audit aspects**

- ❖ Auditor's procedures:
  - Identify risks – understanding the entity & its environment.
  - Assess identified risks.
  - Evaluate their effect on financial statements.
  - Relate identified risks to possible misstatement at assertion level:
    - Consider relevant controls & relate them to assertions.
  - Consider likelihood of misstatement(s) & magnitude.

**SA 315**

- ❖ Assessment of risk at assertion level at risk in determining the nature/timing/extent of further audit procedures:
  - In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.
  - In case of certain entities, also consider relevant laws/regulations.

## **Special Aspects of Risks**

- ❖ Risks requiring special audit consideration–Significant Risks depend upon auditor's judgment.
  - Effects of relevant controls is excluded.
  - Factors to consider:
    - Fraud risk.
    - Relate to recent significant economic/ accounting/ other developments.
    - Complexity of transactions.
    - Transactions with related parties.
    - Subjectivity in measurement of financial information.
    - Outside normal course of business.

**SA 315**

## Identifying Significant Risks

Significant Non Routine Transactions	Judgmental matters
<ul style="list-style-type: none"> <li>• Unusual due to size / nature.</li> <li>• Occur infrequently.</li> </ul>	<ul style="list-style-type: none"> <li>• Include development of accounting estimate for significant measurement uncertainty.</li> </ul>
<p><b>Risk areas:</b></p> <ul style="list-style-type: none"> <li>• Management intervention to specify accounting treatment.</li> <li>• Manual intervention for data collection &amp; processing.</li> <li>• Complex calculations / accounting principles.</li> <li>• Nature of non routine transactions → difficulty in implementing effective controls over risks.</li> </ul>	<p><b>Risk areas:</b></p> <ul style="list-style-type: none"> <li>• Required judgment may be subjective / complex or require assumptions re-effects of future events.</li> <li>• Accounting principles for accounting aspects subject to differing interpretations.</li> </ul>

SA 315

## Controls related to Significant Risks

- ❖ When auditor determines that a significant risk exists, obtain understanding of:
  - Entity's Controls.
  - Control activities to those risks.
- ❖ Understand:
  - Whether entity has designed & implemented controls for significant risks.
  - How management responds to these risks:
    - Control activities – reviews by senior management/ experts.
    - Documentation of the process for estimation.
    - Approval by those charge with governance.
    - Assessment of one-off events.
  - Inappropriate response of management to significant risk → material weakness in IC.

SA 315

- ❖ Risks for which substantive procedure alone do not suffice:
  - Depend on auditor's judgment.
  - May relate to inaccurate/ incomplete automated recording of routine & significant classes of transactions.
  - Substantive procedures not possible in fully automated accounting system:
    - Audit evidence available in electronic form only.
    - Sufficiency & appropriateness of audit evidence depends upon its accuracy & completeness.
    - Potential for misstatement is greater if appropriate controls do not operate effectively.

SA 315

### Revision of Risk Assessment



SA 315

## **Documentation**

- ❖ Discussion with engagement team and significant decisions reached.
- ❖ Key elements of understanding of entity, its environment & ICs.
- ❖ Identified & assessed risks of material misstatements at financial statement & assertion level.
- ❖ Risks that require special audit consideration.
- ❖ Risks for which substantive procedures alone do not suffice.
- ❖ Form & extent of documentation depends upon:
  - Nature, size & complexity of entity & ICs.
  - Availability of information from entity.
  - Audit methodology.
  - Technology used in audit.

**SA 315**

# **SA 320**

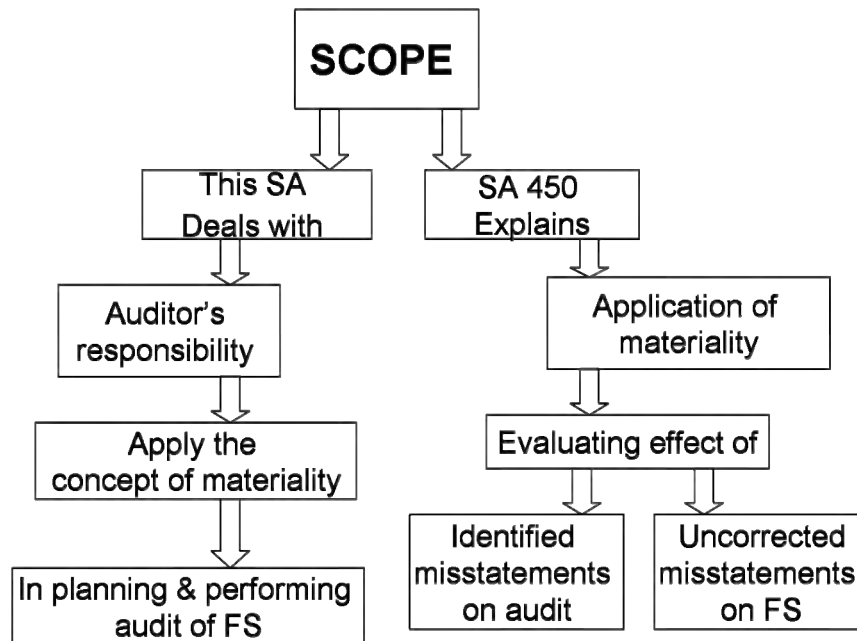
## **Materiality in Planning and Performing an Audit**

*Effective for Audits of financial statements for periods beginning on or after April 1, 2010*

## Overview of SA 320

- ❖ **Introduction**
  - Scope
  - Materiality in the Context of an Audit
  - Effective Date
- ❖ **Objective**
- ❖ **Definition**
- ❖ **Requirements:**
  - Determining Materiality and Performance Materiality when Planning the Audit
  - Revision as the Audit Progresses
  - Documentation
- ❖ **Application and Other Explanatory Material on these aspects**

SA 320



SA 320

## **Materiality in the Context of an Audit**

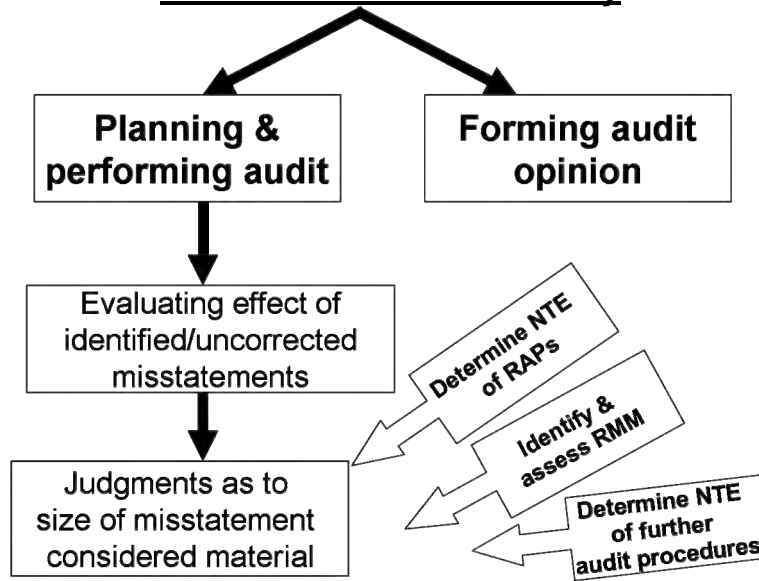
- ❖ FRFs normally discuss “materiality” in context of preparation & presentation of FS:
  - Misstatements are material if in aggregate/ individually may influence economic decision of users.
  - Judgments on materiality made in the light of surrounding circumstances.
    - Affected by size/nature of misstatements or both.
  - **Judgments on matters material for FS users are based on common financial info needs as a group:**
    - Not specific needs.

**SA 320**

- ❖ Determination of materiality is matter of professional judgment:
  - Affected by auditor’s perception of info needs of FS users.
- ❖ Auditor may assume that users:
  - Have:
    - Reasonable knowledge of business & economic activities & accounting.
    - Willingness to study FS with reasonable diligence.
  - Understand that FS are prepared, presented & audited to levels of materiality.
  - Recognise inherent limitations in accounting estimates, judgments & consideration of future events.
  - Make reasonable economic decisions based on info in FS.

**SA 320**

## Consideration of Materiality



SA 320

### **Materiality and Audit Risk:**

- ❖ Materiality and audit risk are considered throughout audit, in particular, when;
  - Identifying and assessing the risks of material misstatement;
  - Determining the nature, timing and extent of further audit procedures; and
  - Evaluating the effect of uncorrected misstatements, if any, on the FS and in forming the opinion in the auditor's report.

## Auditor's Objective

- ❖ Apply the concept of materiality.
- ❖ Appropriately in planning and performing the audit.

SA 320

## Definition

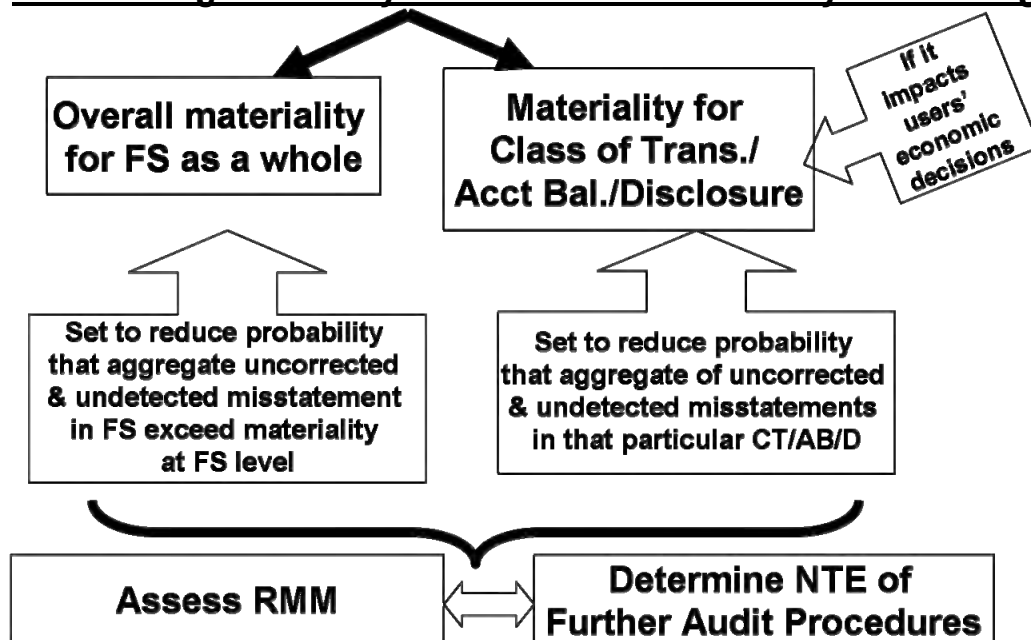
### ❖ **Performance materiality:**

- Amount(s) set by auditor at less than materiality for FS as a whole.
- To reduce to an appropriate low level.
- Probability that aggregate of uncorrected & undetected misstatements exceeds materiality for FS as a whole.

SA 320

- ❖ If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

## Determining Materiality & Performance Materiality in Planning



SA 320

- ❖ Materiality determination is done while establishing the overall audit strategy.
- ❖ Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the FS to be materially misstated, and leaves no margin for possible undetected misstatements.
- ❖ Determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by:
  - Auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and
  - Nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.



## **Using Benchmarks to Determine Materiality at FS level**

- ❖ Involves use of professional judgment.
- ❖ Starting point - a percentage often applied to a chosen benchmark.
- ❖ For less/ more than 12 month FS period, materiality relates to whole of that period.
- ❖ Chosen benchmarks ordinarily include:
  - Prior period financial results & State of Affairs (SoA).
  - Period to date results & SoA.
  - Budgets & forecasts (adjusted for significant changes).
  - Changes in the industry/economic environment of entity.

### **SA 320**

- ❖ Factors affecting identification of an appropriate benchmark include:
  - Elements of FS.
  - Items of focus for users of FS.
  - Nature of the entity.
  - Industry & economic environment.
  - Ownership & finance structure.
  - Relative volatility of benchmark.
- ❖ Chosen Benchmark:
  - For example, when, as a starting point, the materiality at FS level is determined for a particular entity based on a percentage of Profit before Tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality at FS level is more appropriately determined using a normalised Profit before Tax from continuing operations figure based on past results.

## **Materiality for Classes of Transactions/ Account Balances/ Disclosures**

- ❖ Factors that may indicate need to set such materiality level:
  - L&R or FRF affect users' expectations regarding measurement/ disclosure of certain items.
  - Key disclosures wrt industry in which entity operates.
  - Focus on particular aspects of entity's business that is separately disclosed in FS.

### **SA 320**

- ❖ In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, auditor may find it useful to obtain an understanding of views and expectations of TCWG and management.

## **Revision as Audit Progresses**

- ❖ Revise materiality if auditor becomes aware of information during audit :
  - That would have caused him to have determined a different amount initially.
- ❖ If materiality level requires lowering, determine:
  - Need to revise performance materiality.
  - Appropriateness of Nature, Timing and Extent (NTE) of further audit procedures.

**SA 320**

- ❖ Materiality may need to be revised as a result of:
  - A change in circumstances that occurred during the audit for example, a decision to dispose of a major part of the entity's business.
  - New information.
  - A change in auditor's understanding of entity and its operations as a result of performing further audit procedures.
  - For example, if during audit it appears as though actual financial results are likely to be substantially different from anticipated period end financial results that were used initially to determine materiality for Fs as a whole, auditor revises that materiality.

## **Documentation**

- ❖ Include following amounts & the factors considered in their determination:
  - Materiality for FS as a whole.
  - Materiality level for CT/AB/D.
  - Performance materiality.
  - Any revision to any of above.

**SA 320**

# SA 330

## The Auditor's Responses to Assessed Risks

*Effective for audits of financial statements for periods beginning on or after April 1, 2008*

## Overview of SA 330

- ❖ **Introduction**
  - Scope
  - Effective Date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements:**
  - Overall responses
  - Audit Procedures Responsive to the Assessed Risk of material Misstatement at the Assertion level
  - Adequacy of Presentation & disclosures
  - Evaluating the sufficiency & appropriateness of audit evidence
  - Documentation
- ❖ **Application & Other Explanatory Material on these Aspects**

SA 330

## **Scope**

- ❖ Auditor's responsibility to:
  - Design & implement responses to risk of material misstatements identified & assessed in accordance with SA 315.

**SA 330**

## **Objective**

- ❖ Obtain sufficient appropriate evidence about the assessed risk of material misstatement:
  - Through designing & implementing appropriate responses to risks.

**SA 330**

## **Definitions**

### **❖ Substantive Procedures:**

- Audit Procedures designed to detect material misstatements at assertion level:
  - Tests of details – classes of transactions/ account balances/ disclosures.
  - Substantive analytical procedures.

### **❖ Tests of Controls:**

- Audit Procedure for evaluating operating effectiveness of controls in preventing/ detecting & correcting material misstatement at assertion level.

**SA 330**

## **Overall Responses - I**

- ❖ Designed & implemented to address risk of material misstatement at Financial Statement level.
- ❖ Include:
  - Emphasising on professional skepticism.
  - Assigning more experienced/ skilled staff or experts.
  - More supervision.
  - Incorporate unpredictability in audit procedures.
  - General changes to nature, timing & extent of audit procedures.

**SA 330**

## **Overall Responses - II**

- ❖ Overall responses affected by auditor's understanding of control environment:
  - Weakness in IC:
    - Conduct more audit procedures at period end.
    - Obtain more extensive audit evidence from substantive procedures.
    - Increase the number of locations to be audited.
- ❖ Above significantly affects auditor's general approach.

**SA 330**

- ❖ Benefits of effective control environment :
  - More confidence in internal control.
  - Reliability of internally generated audit evidence.

## **Audit Procedures Responsive to Risks at Assertion Level- I**

- ❖ Design & perform further audit procedures to address identified risk of material misstatement at assertion level.
- ❖ Nature, timing & extent of audit procedures should be based on this identified risk:
  - Only tests of controls would suffice ?
  - Only substantive procedures would suffice ?
  - Combined approach is needed?

**SA 330**

## **Audit Procedures Responsive to Risks at Assertion Level- II**

- ❖ Audit Procedures:
  - *Nature* means purpose & type.
  - *Timing* means when it is performed or period/ date to which audit evidence applies.
  - *Extent* means quantity to be performed.
- ❖ Match between nature, timing & extent of audit procedures & assessed risk at assertion level links auditor's further procedures & risk assessment.

SA 330

## **Further Audit Procedures- I**

- ❖ Designing further audit procedures:
  - Consider reason for assessment given to risk at assertion level.
    - Likelihood of misstatement due to particular characteristic of that class of transactions/ account balance/ disclosure (INHERENT RISK).
    - Whether risk assessment takes into account relevant controls (CONTROL RISK) & consequently the operating effectiveness of controls.
  - Obtain more persuasive audit evidence the higher the auditor's assessment of risk, may increase:
    - Quantity of the evidence, and
    - Obtain more reliable evidence.

SA 330

## **Further Audit Procedures- II**

- ❖ Reasons for risk assessment given impact the nature of audit procedures.
- ❖ High risk of material misstatement:
  - Perform substantive procedures near/ at period end.
  - Incorporate unpredictability.
- ❖ Audit procedures at interim date:
  - Assist in identifying significant matters at early stage.
- ❖ Timing of audit procedure affected by:
  - Control environment.
  - When relevant information is available.
  - Nature of risk.
  - Period/ date to which evidence relates.

**SA 330**

- ❖ The auditor's assessed risks may affect both the types of audit procedures to be performed and their combination.
- ❖ Examples of certain audit procedures which can be performed only at or after the period end:
  - Agreeing the FS to the accounting records.
  - Examining adjustments made during the course of preparing the FS.
  - Procedures for checking of improper sales contracts/transactions, not yet finalised by the entity.

## **Further Audit Procedures- III**

- ❖ Extent of audit procedures affected by:
  - Materiality.
  - Assessed risk.
  - Degree of assurance required by auditor.
- ❖ In a combination of procedures, extent of each procedure to be decided separately.
- ❖ Increasing extent of audit procedures effective only when it addresses the relevant risk:
  - Emphasis on third party evidence/ corroboration from independent sources.
- ❖ CAATs enable more extensive testing of electronic transactions.
- ❖ Nature, timing & extent may also be affected by specific audit mandate.

**SA 330**



### **Smaller Entity Considerations**

- ❖ Not many control activities exist.
- ❖ Extent of documentation of controls is limited.
- ❖ Use substantive procedures.
- ❖ In some cases – absence of control activities or a component of IC, obtaining appropriate audit evidence difficult.

SA 330

### **Tests of Controls- I**

- ❖ Design and perform tests of controls (ToC) at assertion level when:
  - Auditor expects controls are operating effectively.
    - Auditor intends to rely on operating effectiveness of controls to determine nature, timing & extent of substantive procedures.
  - Substantive procedures alone cannot provide SAAE.

SA 330

## **Tests of Controls- II**

- ❖ ToC different from understanding & evaluating design & implementation of controls:
  - But same type of audit procedures used, so ToC can be done while obtaining understanding of IC.
- ❖ ToC may be done simultaneously with Test of Details (ToD) – DUAL PURPOSE TEST.
- ❖ Difficulty in designing effective substantive procedures to perform ToC:
  - Entity uses IT in operations & no documentation of transactions is generated/ maintained except through IT system.

**SA 330**

- ❖ The auditor's risk assessment procedures may include:
  - Inquiring about management's use of budgets.
  - Observing management's comparison of monthly budgeted and actual expenses.
  - Inspecting reports pertaining to the investigation of variances.

## **Tests of Controls- III**

- ❖ In designing & performing ToC, obtain more persuasive audit evidence to be able to place greater reliance on effectiveness of controls:
  - Especially where substantive procedures alone do not suffice.

**SA 330**

## Tests of Controls – Nature & Extent- I

### ❖ In designing & performing ToC:

- Perform other procedures in combination with inquiry (when inquiry alone is not sufficient) for evidence re control effectiveness:
  - How controls were applied at relevant times during audit period.
  - Consistency in application.
  - By whom/ what means they were applied.
- Whether controls to be tested depend upon **INDIRECT CONTROLS – controls over accuracy of information:**
  - Necessity to obtain audit evidence regarding Indirect Controls.

**SA 330**

- ❖ For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorised credit limits, the user review and related follow up is the control that is directly of relevance to the auditor.

## Tests of Controls – Nature & Extent- II

### ❖ Extent of ToC – factors to consider:

- Frequency of performance of control by entity during the period.
- Length of time during the audit period of reliance on control effectiveness.
- Expected rate of deviation from control.
- Relevance & reliability of audit evidence at assertion level.
- Extent to which audit evidence is obtained from tests of other controls related to the assertion.

**SA 330**

### **Tests of Controls – Nature & Extent- III**

- ❖ IT systems inherently consistent → increased testing of automated control may not be necessary.
- ❖ But check that:
  - Changes to programs are not made without subjecting to program change control.
  - Authorised version of program is used.
  - Other relevant general controls are effective.

SA 330

### **Tests of Controls – Timing**

- ❖ **Reliance at a point of time** – test controls at point of time.
  - Controls over physical inventory counting.
- ❖ **Reliance over a period of time** – test should be able to provide evidence that controls were effective over the period of time.

SA 330

## **Using Audit Evidence Obtained During Interim Period**

- ❖ Reliance on audit evidence re operating effectiveness of controls at interim period:
  - Obtain evidence re significant changes to those controls subsequent to interim period.
  - Determine additional audit evidence to be obtained for the remaining period – *factors to consider*:
    - Significance of the assessed risks of material misstatement at assertion level.
    - Specific controls that were tested during interim period & subsequent significant changes to them.
    - Degree of audit evidence re operating effectiveness.
    - Length of remaining period.
    - Intention to reduce further substantive procedures.
    - Control environment.
  - May test entity's monitoring of control for remaining period.

**SA 330**

## **Using Audit Evidence Obtained in Previous Audits- I**

- ❖ **Factors to consider before re-testing operating effectiveness:**
  - Effectiveness of other elements of IC, including control environment, entity's monitoring of controls, entity's RAPs.
  - Risks from characteristics of controls – manual/ automated.
  - Effectiveness of general IT controls.
  - Effectiveness of control & its application by entity.
  - Whether lack of change in a control poses risk.
  - Risks of material misstatement & extent of reliance on the control.

**SA 330**

## **Using Audit Evidence Obtained in Previous Audits- II**

### **Before using evidence from previous audit:**

- ❖ Establish continuous relevance of that evidence.
- ❖ Understand whether there is any change in relevant controls affecting the relevance of audit evidence by performing: Inquiry + Observation + Inspection.
- ❖ If change in control – test controls in current audit.
- ❖ If no change:
  - Test controls atleast once in every third audit.
  - Test some controls each audit – provides corroborating evidence about continuing effectiveness.
- ❖ Use professional judgment.

**SA 330**

## **Using Audit Evidence Obtained in Previous Audits- III**

- ❖ Greater reliance on controls/ higher risk of material misstatement → shorter time span between re-testing:
  - Weak control environment.
  - Weak monitoring of controls.
  - Significant manual element in relevant controls.
  - Personnel changes that significantly affect application of control.
  - Changing circumstances indicating need for change in controls.
  - Weak general IT controls.

**SA 330**

## Controls Over Significant Risks

Controls over a **significant risk** should be tested in the current period.

SA 330

## Evaluating Operating Effectiveness of Controls- I

- ❖ Evaluate whether material misstatements detected by substantive procedures indicate controls are not working effectively:
  - Non detection of misstatements is not an evidence that relevant controls are effective.
- ❖ Deviation from controls – inevitable but make specific inquiries to understand the matter & potential consequences & determine if:
  - ToC performed provide appropriate basis for reliance on controls.
  - Additional ToC are necessary.
  - Potential risk of misstatement to be addressed using substantive procedures.
  - Compare detected rate of deviation *vis-a-vis* expected rate of deviation.

SA 330

- ❖ Factors for the deviations from prescribed manner:
  - Change in key personnel.
  - Significant seasonal fluctuations in volume of transactions.
  - Human error.

### **Substantive Procedures-I**

- ❖ Irrespective of assessed risk of material misstatement, design & perform substantive procedures for each material class of transactions, account balance & disclosures:
  - Assessment of risk is judgmental so auditor may not identify all risks.
  - Inherent limitations of IC.
- ❖ Consider whether external confirmation procedures are to be performed as substantive procedures.
- ❖ Substantive APs used more in case of large volumes of data that tend to be predictable over time.

**SA 330**

- ❖ Depending on circumstances, auditor may determine that:
  - Only substantive analytical procedures will suffice.
  - Only test of details will suffice.
  - Combination of both will suffice.
- ❖ Substantive analytical procedures – applicable to large volume of transactions.

### **Substantive Procedures- II**

- ❖ Extent of substantive procedures increased if results of ToC are not satisfactory.
- ❖ Nature of risk & assertion is relevant to design ToD.
- ❖ Designing ToD → Sample size.

**SA 330**



### **Substantive Procedures- III**

- ❖ Related to financial statement closing process
  - Agreeing/ reconciling financial statements with underlying accounting records.
  - Examining material journal entries & other adjustments.
- ❖ Nature & extent of examination of journal entries and other adjustments depends upon nature & complexity of financial reporting process & related risks of material misstatements.

SA 330

### **Substantive Procedures- IV**

#### **Responsive to Significant Risks**

- ❖ Substantive procedures should be specifically responsive to that significant risk.
- ❖ Substantive procedures include ToD.

#### **Timing of Substantive Procedures**

- ❖ Audit evidence from substantive procedures of previous audit provides no evidence for current period.
- ❖ At interim date – cover the balance period by:
  - Substantive procedures combined with ToC, or
  - Only substantive procedures (depending on auditor's judgment).

SA 320

## **Substantive Procedures- V**

❖ **Performing substantive procedures at interim date – *factors to consider:***

- Control environment & other relevant controls.
- Availability at a later date of necessary information.
- Purpose of substantive procedures.
- Assessed risk of material misstatement.
- Nature of class of transaction/ account balance & related risk.
- Ability to perform substantive procedures and/or ToC for remaining period.

**SA 330**

❖ Compare and reconcile balance of the period end with the comparable information at the interim date to:

- Identify amounts that appear unusual.
- Investigate any such amounts.
- Perform substantive analytical procedures or tests of details to test the intervening period.

## **Substantive Procedures-VI**

❖ **Performing substantive procedures between interim date & period end- *factors to consider:***

- Whether the period end balances are reasonably predictable with respect to amount, relative significance & composition.
- Whether entity's procedures for analysing & adjusting classes of transactions/ account balances are reasonably predictable.
- Whether information system relevant to financial reporting will provide information sufficient to permit investigation of:
  - Unusual/significant transactions.
  - Other causes of significant fluctuations/absence of expected fluctuations.
  - Changes in composition of classes of transactions/ account balances.

**SA 330**

### **Substantive Procedures- VII**

- ❖ If unexpected misstatements are detected, evaluate need to modify related assessment of risk & planned nature, timing & extent of substantive procedures covering remaining period:
  - Modification of audit procedures may include extending/ re-performance of interim date procedures.

**SA 330**

### **Adequacy of Presentation & Disclosure**

- ❖ Evaluate whether overall presentation of financial statements including related disclosures is in accordance with applicable FRF.

**SA 330**

- ❖ Ensure that the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information, and the form, arrangement, and content of the financial statements and their appended notes.

## **Sufficiency & Appropriateness of Audit Evidence - I**

- ❖ Before conclusion of audit, evaluate whether assessment of risk of material misstatement at assertion level remain appropriate.
- ❖ Auditor cannot assume that an instance of fraud/ error is an isolated occurrence.
- ❖ **Sufficiency & appropriateness** – consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict assertions in FS.

SA 330

## **Sufficiency & Appropriateness of Audit Evidence - II**

- ❖ **Sufficiency & appropriateness – factors to consider:**
  - Significance of potential misstatement in assertion & its potential for materially affecting financial statements.
  - Effectiveness of management responses & controls to address the risk.
  - Experience gained during previous audits.
  - Results of audit procedures performed.
  - Sources & reliability of available information.
  - Persuasiveness of audit evidence.
  - Understanding entity, its environment & ICs.
- ❖ **Unable to obtain sufficient appropriate audit evidence:**
  - Qualified/ disclaimer opinion.

SA 330

## **Documentation**

### ❖ **Document:**

- Overall responses to address assessed risks of material misstatement at FS level & nature, timing & extent of further audit procedures.
- Linkage of those procedures to assessed risks at assertion level.
- Results of audit procedures & conclusions (where not clear).
- Conclusions re operating effectiveness of controls tested in previous audit.
- Demonstration that FS agree with underlying accounting records.

### ❖ **Form and Extent of Documentation is matter of professional judgment.**

SA 330

## **SA 402**

### **Audit Considerations Relating to an Entity Using a Service Organisation**

*Effective for Audits of financial statements for periods beginning on or after April 1, 2010*

## **Overview of SA 402**

- ❖ **Introduction**
  - Scope
  - Effective date
- ❖ **Objectives**
- ❖ **Definitions**
- ❖ **Requirements**
  - Obtaining an Understanding of the Services provided by a Service Organisation, including Internal Control
  - Responding to the Assessed Risks of Material Misstatement
  - Type 1 and Type 2 Reports that Exclude the Services of a Sub-service Organisation
  - Fraud, Non-Compliance with Laws and Regulations and Uncorrected Misstatements in Relation to Activities at the Service Organisation
  - Reporting by the User Auditor
- ❖ **Application & Other Explanatory Material on these aspects.**

**SA 402**

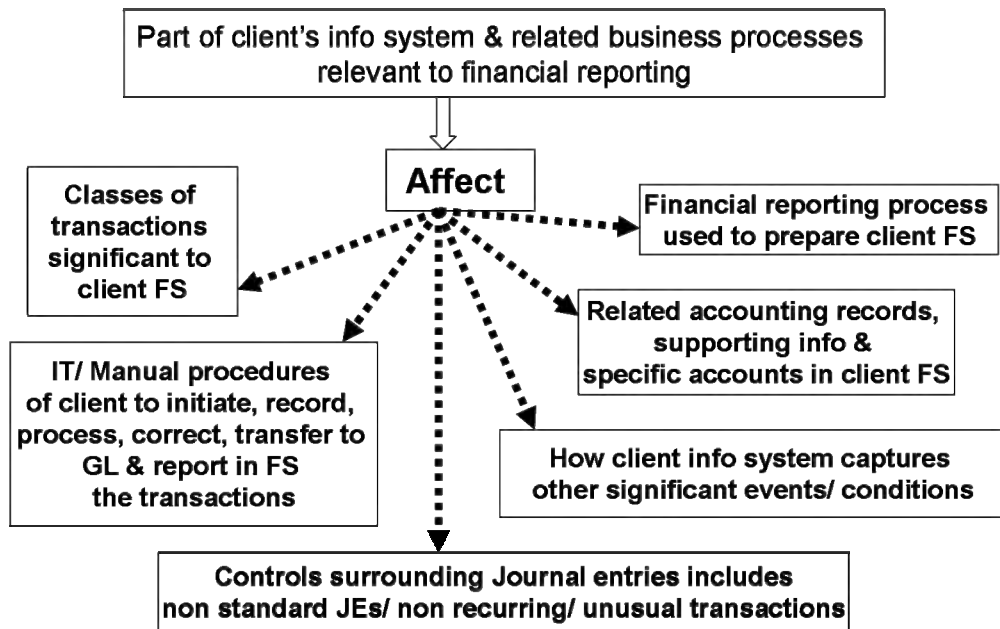
## **Scope**

- ❖ Responsibility to obtain SAAE:
  - When client uses services of Service Organisation (SO).
- ❖ How to apply SA 315 & SA 330 in such situations.
- ❖ Not all services outsourced to SO are relevant.

**SA 402**

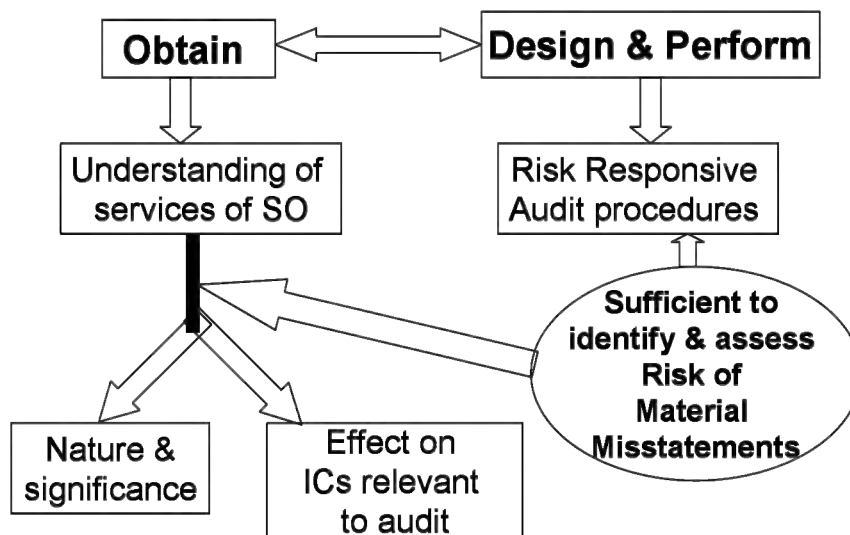
- ❖ **Non- applicability of SA 402:**
  - Financial Institutions' services limited to processing transactions specifically authorised by entity.
  - Processing of securities transactions by brokers.
  - Transactions arising from proprietary financial interests in other entities.

### Relevant Activities



SA 402

### Auditor's Objectives



SA 402

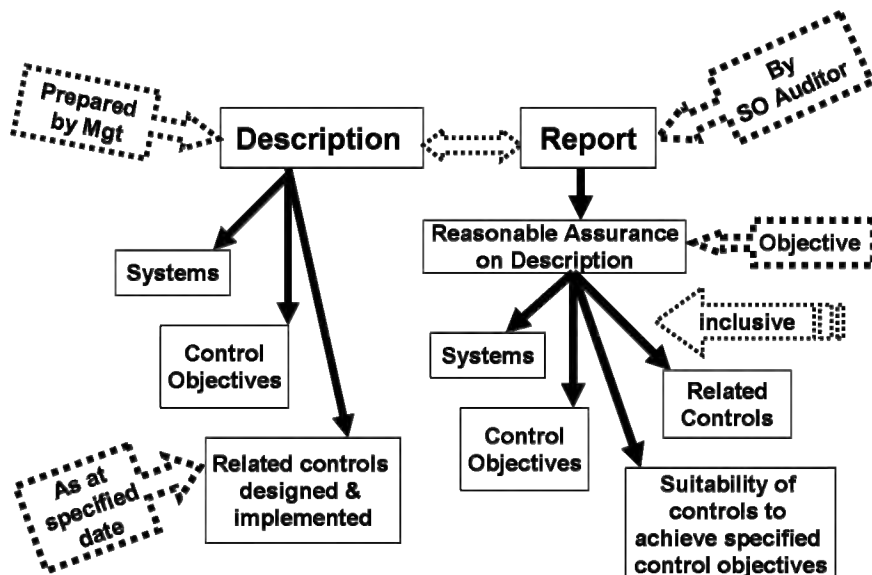
## Definitions

### **Complementary User Entity Controls**

- ❖ Controls assumed by SO.
- ❖ In design of its service.
- ❖ To be implemented by the user entity (UE) (i.e. client).
- ❖ If necessary to achieve control objectives, identified in SO's description of its system.

SA 402

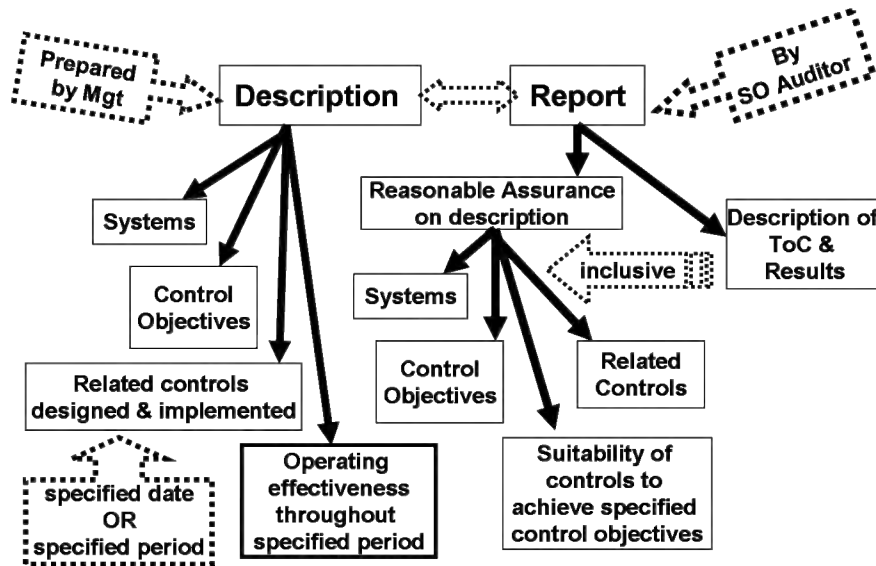
## Type 1 Report – Description & Design of Controls at SO



SA 402



## Type 2 Report – Description, Design & Operating Effectiveness of Controls at SO



SA 402

### Service Auditor

- ❖ Auditor who.
- ❖ At the request of SO.
- ❖ Provides an assurance report.
- ❖ On controls of SO.

### Service Organisation

- ❖ 3<sup>rd</sup> party organisation (or its segment).
- ❖ Provides services to UE.
- ❖ That are part of UE's info system relevant to financial reporting.

### SO's System

- ❖ Policies & procedures.
- ❖ Designed, implemented & maintained by SO.
- ❖ To provide services covered by SO auditor's report to UE.

SA 402

### Subservice Organisation

- ❖ SO used by another SO.
- ❖ To perform some of the services provided to UE.
- ❖ That are part of UE's info systems relevant to financial reporting.

### User Auditor

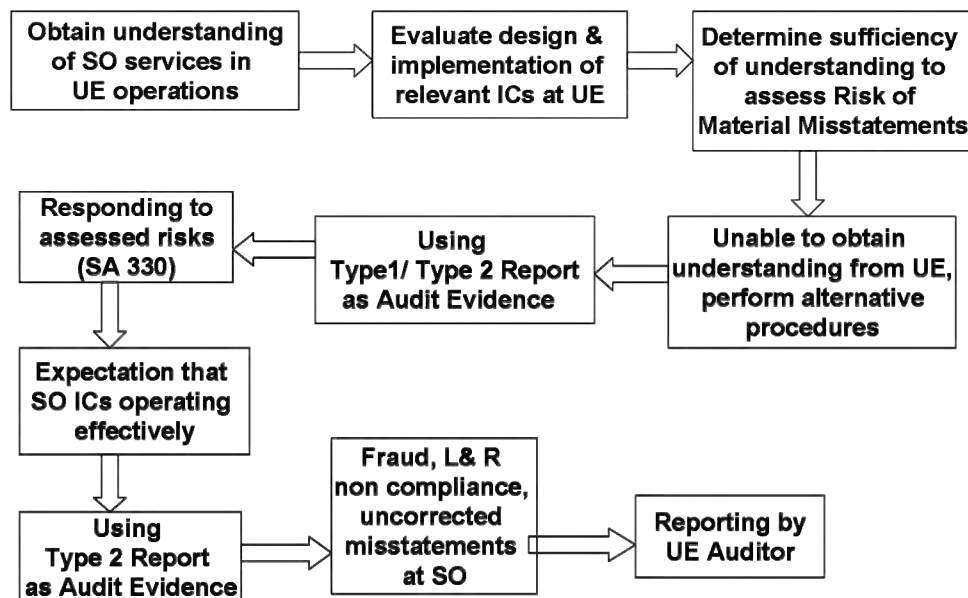
- ❖ Auditor who audits & reports on the FS of UE.

### User Entity

- ❖ Entity that uses SO & whose FS are being audited.

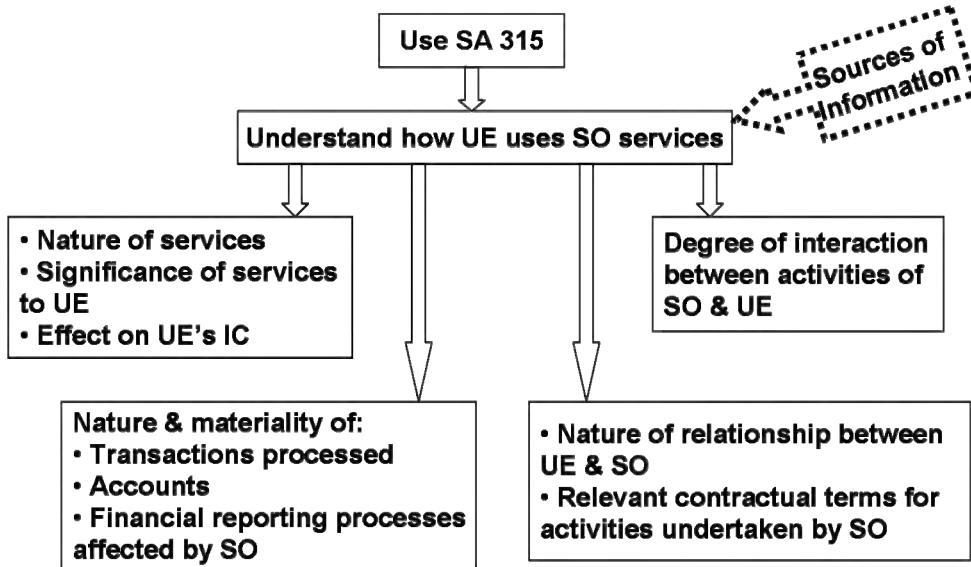
SA 402

### Basic Flow of UE Auditor's Procedures



SA 402

## Understanding Services Provided by SO



SA 402

- ❖ Sources of Information on SO services:
  - User manuals.
  - System overviews.
  - Technical manuals.
  - The contract or service level agreement between the UE and SO.
  - Reports by SO, internal auditors or regulatory authorities on controls at SO.
  - Reports by the service auditor, including management letters, if available.
  - UE auditor's experience with SO, particularly if the services and controls at SO over those services are highly standardised.

## Evaluating Design & Implementation of Relevant Controls at UE

- ❖ UE auditor may test if UE controls operating effectively not withstanding controls at SO.
- ❖ Examples of controls:
  - Comparing data submitted to SO with reports received from SO after data processing.
  - Re-computing sample for clerical accuracy & reviewing total amount for reasonableness.
- ❖ For risks wherefor it is not possible to obtain SAAE only from substantive procedures, UE auditor to obtain understanding of such controls & evaluate them.

SA 402

## **Determining Sufficiency of Understanding**

- ❖ Determine if:
  - Sufficient understanding of:
    - Nature & significance of SO services.
    - Their effect on UE controls relevant to audit.
  - Has been obtained.
  - To provide basis for:
    - Identification & assessment of Risks of Material Misstatements.

**SA 402**

## **Unable to Obtain Sufficient Understanding from UE**

### **One or more of:**

- ❖ Obtain Type 1/ Type 2 Report.
- ❖ Contact SO through UE to obtain specific info.
- ❖ Visit SO & perform procedures to obtain necessary info.
- ❖ Use another auditor to perform necessary procedures.

**SA 402**

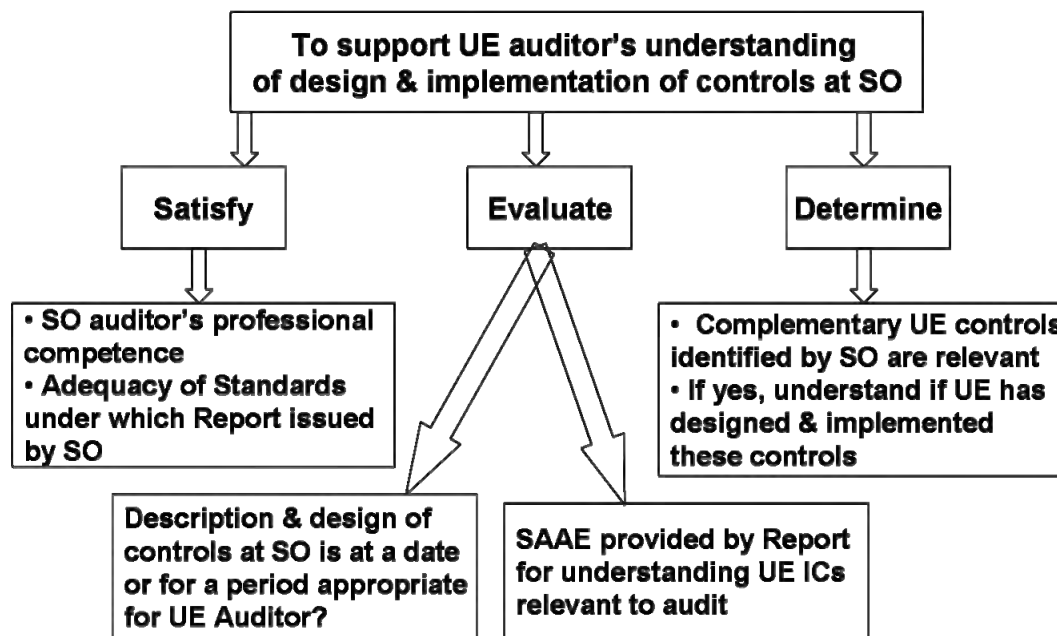
- ❖ Choice of procedure, individually or in combination, influenced by such matters as:
  - Size of both UE & SO;
  - Complexity of the transactions at UE and the complexity of services provided by SO;
  - Location of SO;
  - Expected effectiveness of procedure(s) to provide SAAE; and
  - Nature of the relationship between the UE & SO.

## Using Type 1/Type 2 Report as Audit Evidence

- ❖ To support UE auditor's understanding of design & implementation of controls at SO.
- ❖ UE auditor to satisfy as to:
  - SO auditor's professional competence & independence from SO; AND
  - Adequacy of Standards under which report issued by SO auditor.

SA 402

## Using Type 1/Type 2 Report as Audit Evidence



SA 402

- ❖ A Type 1 or Type 2 report, along with info about the UE assists the user auditor in obtaining an understanding of:
  - Aspects of controls at SO that may affect processing of UE transactions, including use of SSO;
  - Flow of significant transactions through SO to determine the points in the transaction flow where material misstatements in the Use's FS could occur;
  - Control objectives at SO relevant to the Use's FS assertions; and
  - Whether controls at SO are suitably designed and implemented to prevent or detect processing errors that could result in material misstatements in the UE FS.
- ❖ A Type 1 or Type 2 report of a date or for a period outside of the reporting period of a UE assists UE auditor in obtaining a preliminary understanding of the controls implemented at SO if the report is supplemented by additional current information from other sources. If the SO's description of controls is as of a date or for a period that precedes the beginning of the period under audit, the UE auditor may perform procedures to update the information in a Type 1 or Type 2 report, such as:
  - Discussing the changes at the service organisation with user entity personnel who would be in a position to know of such changes;
  - Reviewing current documentation and correspondence issued by the service organisation; or
  - Discussing the changes with service organisation personnel.

### **Responding to Assessed Risk of Material Misstatement**

- ❖ Determine if SAAE re FS assertions available from records at UE.

#### **IF NOT**

- ❖ Perform further audit procedures to obtain SAAE;

#### **OR**

- ❖ Use another auditor to perform those procedures,

**At SO.**

**SA 402**

### **Type 1/2 Report that Exclude SSO**

- ❖ When using such Type 1 or Type 2 reports, UE auditor to apply requirements of this SA to services provided by SSO.

**SA 402**

## **Fraud/Non-compliance at SO**

- ❖ Inquire of UE mgt if SO has reported:
  - Fraud.
  - Non-compliance with L&R.
  - Uncorrected Misstatements.
 affecting FS of UE.
- ❖ Evaluate impact on:
  - Nature, timing & extent of further audit procedures.
  - Conclusions.
  - Audit report.

**SA 402**

## **Reporting by User Auditor**

- ❖ Modified opinion if:
  - Unable to obtain SAAE.
  - Re services of SO.
  - Relevant to audit.
  - Of UE FS.
- ❖ Do not refer to report of SO auditor unless required by L&R.

**SA 402**

- ❖ Inability to obtain SAAE means a scope limitation. This may be the case when:
  - UE auditor unable to obtain a sufficient understanding of SO services and does not have a basis for the identification and assessment of the risks of material misstatement;
  - UE auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively and UE auditor is unable to obtain SAAE about the operating effectiveness of these controls; or
  - SAAE available only from records held at SO, and UE auditor is unable to obtain direct access to these records.
- ❖ Whether the user auditor expresses a qualified opinion or disclaims an opinion depends on the user auditor's conclusion as to whether the possible effects on the financial statements are material or pervasive.

# **SA 450**

## **Evaluation of Misstatements Identified During the Audit**

*Effective for Audits of financial statements for periods beginning on or after April 1, 2010*

## **Overview of SA 450**

- ❖ **Introduction**
  - Scope
  - Effective Date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements**
  - Accumulation of Identified Misstatements
  - Consideration of Identified Misstatements as the Audit Progresses
  - Communication & Correction of Misstatements
  - Evaluating the Effect of Uncorrected Misstatements
  - Written Representation
  - Documentation
- ❖ **Application and Other Explanatory Material on these aspects.**

**SA 450**



### **Scope**

- ❖ Auditor's responsibility to evaluate effect of:
  - Identified misstatements on audit; and
  - Uncorrected misstatement (if any) on FS.
- ❖ Auditor's opinion as per SA 700 influenced by evaluation of impact of uncorrected misstatements on FS as per SA 320.

**SA 450**

### **Auditor's Objective**

- ❖ Evaluate:
  - Effect of identified misstatements on audit; AND
  - Effect of uncorrected misstatements (if any) on FS.

**SA 450**

## Definitions

### ❖ **Misstatement:**

- Difference between:
  - Amount/classification/presentation/disclosures of reported FS item vis-à-vis
  - Requirements of FRF.
- Includes adjustments as are necessary, in auditor's judgment, to provide True & Fair view.
- Can arise from fraud/ error.

### ❖ **Uncorrected Misstatements:**

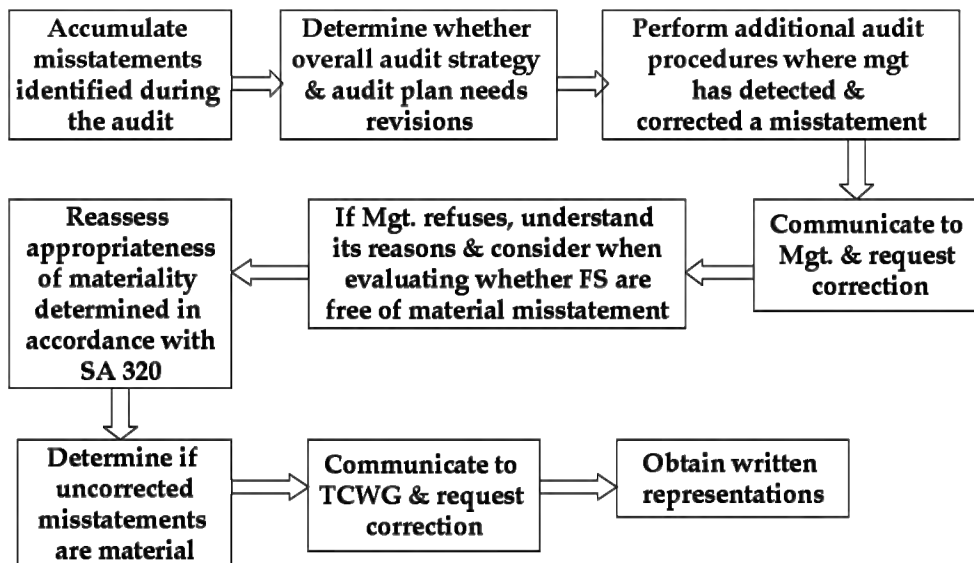
- Misstatements accumulated by auditor during the audit; and
- That have not been corrected.

SA 450

### ❖ Misstatements may result from:

- An inaccuracy in gathering or processing data from which FS are prepared.
- An omission of an amount or disclosure.
- An incorrect accounting estimate arising from overlooking, or clear misinterpretation of facts.
- Judgments of management concerning accounting estimates that auditor considers unreasonable or selection and application of accounting policies that auditor considers inappropriate.
- Examples of misstatements arising from fraud are provided in SA 240.

## Basic Flow of the Audit Process



SA 450

## Accumulation of Identified Misstatements

- ❖ Accumulate misstatements identified during the audit:
  - Except those clearly trivial.
- ❖ Types of misstatements:
  - Factual.
  - Judgmental.
  - Projected.

### SA 450

- ❖ Concept of Clearly Trivial:
  - Clearly trivial does not mean **not material**. These are matters that are:
    - Wholly smaller than that determined in accordance with SA 320; **AND**
    - Are clearly inconsequential, individually or in aggregate and by any criteria.
  - If there is an uncertainty whether one or more items are clearly trivial, the matter is not considered clearly trivial.
- ❖ To assist auditor in evaluating the effect of misstatements accumulated during audit and in communicating misstatements to management and TCWG, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.
  - **Factual misstatements** Misstatements about which there is no doubt.
  - **Judgmental misstatements** - Differences arising from:
    - judgments of mgt concerning accounting estimates that auditor considers unreasonable, or
    - selection or application of accounting policies that auditor considers inappropriate.
  - **Projected misstatements** Auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn.

## **Consideration of Identified Misstatements as the Audit Progresses**

- ❖ Determine need to revise overall audit strategy & audit plan if:
  - Nature of identified misstatements & circumstances of occurrence indicate existence of other (possibly material) misstatements; OR
  - Aggregate of misstatements accumulated during audit approaches materiality determined as per SA 320 .
- ❖ Perform additional procedures, if at auditor's request:
  - Mgt has examined a CoT/AB/D and
  - Corrected misstatements that were detectedto determine if misstatement remain.

### **SA 450**

- ❖ A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.
- ❖ If the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320 , there may be a greater than an acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed the materiality. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk.
- ❖ Auditor may request management to examine a class of transactions, account balance or disclosure to understand the cause of a misstatement identified by auditor, perform procedures to determine the amount of actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to FS. Such a request may be made, for example, based on auditor's projection of misstatements identified in an audit sample to the entire population from which it was drawn.

## Communication & Correction of Misstatements

- ❖ Communicate:
  - On timely basis.
  - All misstatements accumulated during the audit.
  - To appropriate level of Mgt.

**Unless prohibited by law/ regulation.**
- ❖ Request Mgt to correct misstatements.
- ❖ If Mgt refuses correction:
  - Understand its reasons; AND
  - Take that into account when evaluating whether FS as a whole are free from material misstatements.

### SA 450

- ❖ **Timely communication** is important because it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees, and take action as necessary. **Appropriate Level of Mgt** is one that has responsibility and authority to evaluate misstatements and to take the necessary action.
- ❖ **Prohibition by L & R:**
  - L&R may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act.
  - In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.
- ❖ Correction of all misstatements, including those communicated by auditor, enables management to:
  - Maintain accurate accounting books and records; and
  - Reduces risks of material misstatement of future FS because of cumulative effect of immaterial uncorrected misstatements related to prior periods.

## Evaluating the Effect of Uncorrected Misstatements

- ❖ Reassess appropriateness of materiality determined as per SA 320 in context of entity's actual financial results.
- ❖ Determine if uncorrected misstatements are material, individually or in aggregate. Factors to consider:
  - Size & nature of misstatements.
  - Particular circumstances of occurrence of misstatement.
  - Effect of uncorrected misstatements related to prior periods.

### SA 450

- ❖ This assessment is to be done prior to evaluating effect of uncorrected misstatements. The auditor's determination of materiality in accordance with SA 320 is often based on estimates of entity's financial results, because actual financial results may not yet be known. Therefore, prior to auditor's evaluation of effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with SA 320 based on the actual financial results.

- ❖ Consider each misstatement to evaluate its effect.
- ❖ A material misstatement is unlikely to be offset by other misstatements.
- ❖ May offset immaterial misstatements within the same AB/CoT:
  - But consider risk of existence of further undetected misstatements.
- ❖ Determining whether a classification misstatement is material involves evaluation of qualitative considerations.
- ❖ The circumstances related to some misstatements may cause the auditor to evaluate them as material, even if they are lower than the materiality for the financial statements as a whole.

**SA 450**

- ❖ Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.
- ❖ If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the FS as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses.
- ❖ Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as :
  - Effect of the classification misstatement on debt or other contractual covenants, and
  - Effect on individual line items or sub-totals on the effect on key ratios.
- ❖ SA 240 explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of misstatement is not material in relation to the FS.

- ❖ Evaluation whether a misstatement is material also affected by L&R and additional responsibilities for the auditor to report other matters, including, for example, fraud.
- ❖ Issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, may affect the assessment whether an item is material by virtue of its nature.
- ❖ The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements.

**SA 450**

## **Communication with TCWG**

- ❖ Communicate:
  - Uncorrected misstatements (Identify material uncorrected misstatements individually), and
  - Impact (individually/aggregated) on audit opinion,**Unless prohibited by L&R.**
- ❖ Request correction of uncorrected misstatements.
- ❖ Also communicate effect of Uncorrected misstatements of prior periods.

**SA 450**

- ❖ Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate:
  - Number and overall monetary effect of uncorrected misstatements rather than details of each individual uncorrected misstatement.
  - The auditor may discuss with TCWG the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, and possible implications in relation to future financial statements.

## **Written Representations**

- ❖ From Mgt or TCWG (where appropriate):
  - Whether they believe effects of uncorrected misstatements are immaterial, individually/in aggregate, to FS as a whole:
    - Summary of such items to be included/ attached to WR.

**SA 450**

- ❖ Where, Mgt./ TCWG do not believe that certain uncorrected misstatements are misstatements, they may want to add to their written representation words such as: "We do not agree that items.....and..... constitute misstatements because [description of reasons]". Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

## **Documentation**

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

### **SA 450**

- ❖ Auditor's documentation of uncorrected misstatements may take into account:
  - The consideration of the aggregate effect of uncorrected misstatements.
  - The evaluation of whether the materiality level or levels for a particular classes of transactions account balances or disclosures, if any, has been exceeded.
  - The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (e.g., debt covenants).

## **500-599 Audit Evidence**

- ❖ SA 500, "Audit Evidence" (April 1, 2009)
- ❖ SA 501, "Audit Evidence – Specific Considerations for Selected Items" (April 1, 2010)
- ❖ SA 505, "External Confirmations" (April 1, 2010)
- ❖ SA 510, "Initial Audit Engagements-Opening Balances" (April 1, 2010)
- ❖ SA 520, "Analytical Procedures" (April 1, 2010)
- ❖ SA 530, "Audit Sampling" (April 1, 2009)
- ❖ SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures" (April 1, 2009)
- ❖ SA 550, "Related Parties" (April 1, 2010)
- ❖ SA 560, "Subsequent Events" (April 1, 2009)
- ❖ SA 570, "Going Concern" (April 1, 2009)
- ❖ SA 580, "Written Representations" (April 1, 2009)



# SA 500

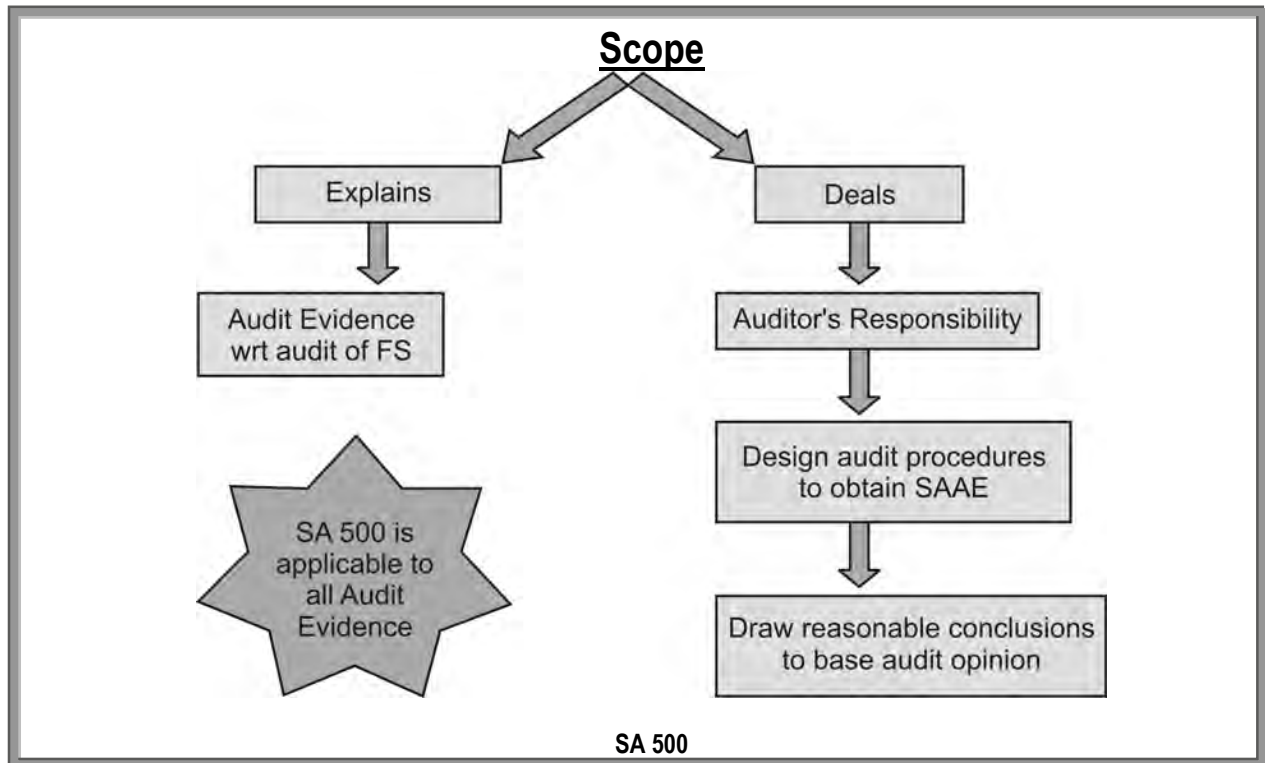
## Audit Evidence

*Effective for audits of financial statements for periods beginning on or after April 1, 2009*

## Overview of SA 500

- ❖ **Introduction**
  - Scope
  - Effective date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements:**
  - Sufficient Appropriate Audit Evidence (SAAE)
  - Information to be used as audit evidence
  - Selecting items for testing to obtain audit evidence
  - Inconsistency/doubts over reliability of audit evidence
- ❖ **Application and Other explanatory Material on these Aspects**

SA 500



- ❖ Other SAs deal with:
  - Specific aspects of audit (SA 315).
  - Audit evidence to be obtained in relation to particular topic (SA 570).
  - Specific procedures to obtain audit evidence (SA 520).
  - Evaluation whether SAAE has been obtained (SA 330).

## **Objective of the Auditor**

- ❖ Design & perform audit procedures:
  - In such a way that,
  - Enable him to obtain SAAE.
  - To be able to draw reasonable conclusions.
  - On which to base the auditor's opinion.

**SA 500**

## Definitions

- ❖ **Accounting Records:**
  - Records of initial accounting entries and supporting documents.
- ❖ **Audit Evidence:**
  - Information used by auditor in arriving at conclusions on which audit opinion is based.
- ❖ **Appropriateness of audit evidence:**
  - Measure of **quality** of audit evidence:
    - Relevance; and
    - Reliability
 in supporting conclusions on which audit opinion is based.

### SA 500

- ❖ SA 500 contains five definitions – accounting records, audit evidence, appropriateness of audit evidence, sufficiency of audit evidence and management's expert.
- ❖ Examples of accounting records:
  - Cheques and records of electronic funds transfer.
  - Invoices.
  - Contracts.
  - General & subsidiary ledgers.
  - Journal entries and any adjustments thereto.
  - Worksheets to support reconciliations, cost allocations, etc.
- ❖ Audit evidence includes:
  - Information contained in underlying accounting records.
  - Other information.

- ❖ **Sufficiency of audit evidence:**
  - Measure of quantity of audit evidence.
- ❖ **Management's Expert:**
  - An individual/ organisation.
  - Possessing expertise in a field.
  - Other than accounting/ auditing.
  - Whose work is used by the entity.
  - In preparing financial statements.

### SA 500

- ❖ Sufficiency is affected by:
  - Auditor's assessment of Risk of Material Misstatements.
  - Quality of such audit evidence.

## **SAAE**

- ❖ Design and perform audit procedures.
- ❖ Appropriate in circumstances.
- ❖ For obtaining SAAE.
- ❖ Auditor to use professional judgment to decide if SAAE has been obtained:
  - Affected by:
    - Nature of audit procedures.
    - Timeliness of financial reporting.
    - Balance between cost and benefits.

### **SA 500**

#### **SAAE**

- ❖ Sufficiency & appropriateness are interrelated but obtaining more audit evidence does not compensate its poor quality.
- ❖ SAAE is related to the concept of reasonable assurance (SA 200). Reasonable assurance is obtained when the auditor has obtained SAAE to reduce audit risk to an acceptable low level. Audit risk means the risk that the auditor expresses an inappropriate opinion when the financial statements when the financial statements are materially misstated.
- ❖ Reliability affected by:
  - Source.
  - Nature.
  - Circumstances under which obtained.

- ❖ Other important facts about audit evidence:
  - Is cumulative in nature.
  - Primarily obtained from audit procedures during an audit.
  - Information from other sources:
    - Previous audits (re-evaluate before using).
    - QC policies of audit firm (client acceptance & continuance).
    - Accounting records of client.
    - Other sources – internal/ external to entity.
  - Audit evidence comprises both information **that corroborates** and **that contradicts** management assertions.
  - Absence of information is also sometimes used as audit evidence.

### **SA 500**

## Obtaining Audit Evidence – I



**SA 500**

### **Sources of Audit Evidence:**

- ❖ Audit evidence obtained by performing audit procedures to test the accounting records enables the auditor to determine that the accounting records are internally consistent and agree to FS.
- ❖ More assurance is ordinarily obtained from consistent audit evidence obtained from different sources/ nature than from items of audit evidence considered individually.
- ❖ More assurance from corroborating information obtained from a source independent of the entity than from audit evidence that is generated internally.
- ❖ Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts' reports, and comparable data about competitors (benchmarking data).

## **Obtaining Audit Evidence - II**

- ❖ Obtained by performing:
  - Risk assessment procedures; and
  - Further audit procedures:
    - Tests of controls.
    - Substantive procedures:
      - Tests of details; and
      - Substantive analytical procedures.
- ❖ Nature and timing of audit procedures affected by:
  - Availability of audit evidence in electronic form only.
  - Availability of audit evidence at certain points/ periods in time.

**SA 500**

- ❖ Procedures described in previous slide can be used as risk assessment procedures, Tests of controls or substantive procedures, depending upon the context in which applied.
- ❖ Certain electronic information may not be retrievable after a specified period of time. Accordingly, the auditor may find it necessary to request the entity to retain some information for the auditor's review or to perform audit procedures at a time when the information is available.

## **Audit Evidence – Inspection**

- ❖ Involves examining records or documents:
  - Internal/ external.
  - In paper form/ electronic/ other media.
- ❖ Or physical examination of an asset.
- ❖ Reliability depends upon source:
  - Internal documents – reliability depends upon effectiveness of controls over their production.

**SA 500**

- ❖ Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value.
- ❖ Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets.

### **Audit Evidence – Observation**

- ❖ Consists of looking at a process or procedure being performed by others.
  - Audit evidence provided is limited to:
    - Point in time at which observation takes place.
    - The fact that auditor is observing may affect the manner in which process/ procedure is performed.

**SA 500**

- ❖ For more guidance, please refer SA 501, “Audit Evidence–Specific Considerations for Selected Items”.

### **Audit Evidence – External Confirmation**

- ❖ Audit evidence obtained as direct written response to the auditor from the 3<sup>rd</sup> party, in paper form, electronic/ other medium.
- ❖ Normally used to confirm account balances but may also be used to confirm agreements/ transactions.

**SA 500**

- ❖ Refer SA 505, “External Confirmations” for further guidance.

## **Audit Evidence – Re-calculation & Re-performance**

- ❖ **Re-calculation:**
  - Checking mathematical accuracy of documents/ records.
  - May be done manually/ electronically.
- ❖ **Re-performance:**
  - Involves auditor's independent execution of procedures/ controls that were originally performed as entity's internal controls.

**SA 500**

## **Audit Evidence – Analytical Procedures**

- ❖ Consists of evaluations of financial information.
- ❖ Made by study of plausible relationships.
- ❖ Among both financial and non-financial data.
- ❖ Also encompass investigation of identified fluctuations/ relationships that are inconsistent with other relevant information/ show significant deviations from predictions.

**SA 500**

- ❖ Refer SA 520, "Analytical Procedures" for further guidance.



## **Audit Evidence – Inquiry**

- ❖ Consists of seeking information of knowledgeable persons.
- ❖ Both financial & non-financial.
- ❖ Within/ outside the entity:
  - May be written/ oral.
  - Evaluation of responses to inquiries is an integral part of inquiry process.
- ❖ Obtain WR from mgt. and TCWG to confirm responses to the inquiry.

### **SA 500**

- ❖ Responses to inquiries may provide the auditor with:
  - Information not previously possessed, or
  - With corroborative audit evidence.
  - Information that differs significantly from other information that the auditor has obtained.
  - In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.
- ❖ In the case of inquiries about management intent, the information available to support management's intent may be limited. The following may provide information to corroborate the evidence obtained through inquiry:
  - Understanding management's past history of carrying out its stated intentions,
  - Management's stated reasons for choosing a particular course of action, and
  - Management's ability to pursue a specific course of action.

## **Information to be Used as Audit Evidence**

- ❖ When designing & performing audit procedures, consider **relevance & reliability** of information to be used as audit evidence.

### **SA 500**

- ❖ ToC – designing ToC includes identifying:
  - Conditions that indicate performance of control.
  - Deviations that indicate departures from adequate performance.
- ❖ Designing substantive procedures include:
  - Identifying conditions relevant to purpose of the test that constitute a misstatement in the relevant assertion.

- ❖ Relevance:
  - Deals with logical connection with, or bearing upon,
    - the purpose of the audit procedure; and
    - where appropriate, the assertion under consideration.
  - Affected by direction of testing.
- ❖ Reliability:
  - Affected by:
    - Source;
    - Nature;
    - Circumstances under which obtained; and
    - Controls over preparation & maintenance.
  - Generalisation regarding reliability are subject to important exceptions.

**SA 500**

More Reliability	Lesser Reliability
Source is external to & independent of client.	
	Sources external to entity and is not knowledgeable or mgt. expert lacks objectivity.
Internal source only if related controls are effective.	
Evidence obtained directly by auditor.	Evidence obtained indirectly or by inference.
Documentary evidence – paper / electronic / other medium.	Oral evidence.
Original.	Photocopy / fax / filmed documents.

**SA 500**

## **Audit Evidence Prepared by Management's Expert**

- ❖ Having regard to the significance of such work to audit:
  - Evaluate competence, capabilities & objectivity of expert.
  - Obtain an understanding of his work.
  - Evaluate appropriateness of his work as audit evidence.

### **SA 500**

- ❖ Entity, when needed, may employ expert in preparing FS. Failure to do so may lead to risk of material misstatement.
- ❖ When information to be used as audit evidence has been prepared using the work of a management's expert, the requirements given in this slide applies. For example, an individual or organisation may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organisation applies that expertise in making an estimate which the entity uses in preparing its financial statements, the individual or organisation is a management's expert and the requirements given in this slide applies.  
If, on the other hand, that individual or organisation merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is subject to requirements of the previous slide, but is not the use of a management's expert by the entity.
- ❖ Auditor's procedures wrt use of management's experts work are affected by:
  - Nature and complexity of the matter.
  - Risks of material misstatement.
  - Availability of alternative sources of audit evidence.
  - Nature, scope and objectives of his work.
  - Whether the management's expert is employed by the entity, or is a party engaged by it to provide services.
  - Extent of entity's control or influence over the work.
  - Applicability of technical performance/other standards.
  - Auditor's knowledge & experience of the management's expert's field of expertise.
  - Auditor's previous experience of the work of that expert.

## **Competence, Capability & Objectivity (CCO) of Management's Expert**

- ❖ **Competence:**
  - Relates to nature & level of expertise.
- ❖ **Capability:**
  - Ability to exercise that competence.
- ❖ **Objectivity:**
  - Relates to possible effects that bias, conflict of interest or influence of others may have on the professional/business objectivity of mgt's expert.

**SA 500**

- ❖ Sources of Information on CCO:
  - Personal experience with previous work.
  - Discussions with that expert.
  - Discussions with others who are familiar with that expert's work.
  - Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
  - Published papers or books written by that expert.
  - An auditor's expert.

### SA 500

- ❖ Other matters that may be relevant include:
  - The relevance of the management's expert's competence:
    - To the matter for which that expert's work will be used, including any areas of specialty within that expert's field.
    - To relevant accounting requirements that are consistent with the applicable financial reporting framework.
  - Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the management's expert as the audit progresses.
- ❖ A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats and intimidation threats. Safeguards may reduce such threats, and may be created either by external structures (for example, the management's expert's profession, legislation or regulation), or by the management's expert's work environment (for example, quality control policies and procedures).
- ❖ Although safeguards cannot eliminate all threats to a management's expert's objectivity, threats such as intimidation threats may be of less significance to an expert engaged by the entity than to an expert employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be present, an expert employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.
- ❖ When evaluating the objectivity of an expert engaged by the entity, it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity, and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include :
  - Financial interests.
  - Business and personal relationships.
  - Provision of other services.

## **Understanding the Expert's Work**

- ❖ Includes understanding relevant field of expertise:
  - Auditor himself may have the expertise to evaluate.
  - Auditor may use services of auditor's expert.
- ❖ Understanding may include:
  - Areas of specialty within field of expertise.
  - Applicable professional or other standards, and regulatory or legal requirements.
  - Assumptions and methods are used, their general acceptability within that expert's field and appropriateness for financial reporting purposes.
  - Nature of internal and external data or information the auditor's expert uses.

**SA 500**

- ❖ Evaluating the agreement between management & expert to assess appropriateness of:
  - Nature, scope and objectives of the work.
  - Respective roles & responsibilities of management/ expert.
  - Nature, timing and extent of communication between management & expert:
    - Includes form of report.
- ❖ Evaluating Appropriateness of Expert's Work:
  - The relevance and reasonableness of that expert's findings or conclusions;
  - Consistency with other audit evidence;
  - Whether they have been appropriately reflected in the FS;
  - Relevance and reasonableness of assumptions and methods; and
  - Relevance, completeness, and accuracy of the source data.

**SA 500**

### **Evaluate Reliability of Information Produced by Entity**

- ❖ Obtain audit evidence about the accuracy and completeness of the information:
  - Concurrently with actual audit procedures where obtaining audit evidence is integral part of audit procedures.
  - ToC over preparation & maintenance of information.
- ❖ Evaluate whether the information is sufficiently precise and detailed for auditor's purposes.

SA 500

### **Selecting Items for Testing to Obtain Audit Evidence**

- ❖ When designing ToC and ToD.
- ❖ Determine means of selecting items for testing.
- ❖ That are effective in meeting purpose of audit procedures.
- ❖ **Means available:**
  - Selecting all items (100%).
  - Selecting specific items.
  - Audit sampling.

SA 500

	<b>100 %</b>	<b>Specific items</b>	<b>Sampling</b>
<b>Suitability</b>	<ul style="list-style-type: none"> <li>• Significant risk &amp; other means do not provide SAAE</li> <li>• Repetitive nature of calculation</li> <li>• Small number of large value items</li> </ul>	<ul style="list-style-type: none"> <li>• High value/ key items</li> <li>• All items over certain amount</li> <li>• Item to obtain information</li> </ul>	Guidance in SA 530
<b>Relevant factors</b>		<ul style="list-style-type: none"> <li>• Auditor's understanding of entity</li> <li>• Assessed RMM</li> <li>• Characteristics of population being tested</li> </ul>	

**SA 500**

### **Inconsistency/ Doubts wrt Reliability of Audit Evidence**

- ❖ If:
  - Audit evidence from one source inconsistent with that from another source; OR
  - Doubts over reliability of info to be used as audit evidence.
- ❖ Determine:
  - Modifications/ additions required to audit procedures.
  - Effect on other aspects of audit.
- ❖ Documentation as per SA 230 .

**SA 500**



# SA 501

## Audit Evidence – Specific Considerations for Selected Items

*Effective for Audits of financial statements for periods beginning on or after  
April 1, 2010*

## Overview of SA 501

- ❖ **Introduction**
  - Scope of this SA
  - Effective Date
- ❖ **Objective**
- ❖ **Requirements & Application**
  - Inventory
  - Litigation & Claims
  - Segment Information

SA 501

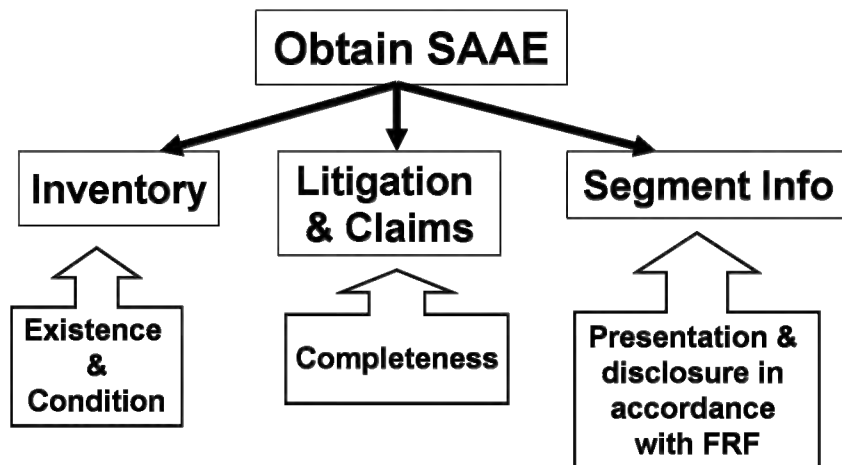
## **Scope**

- ❖ Deals with specific considerations by the auditor,
- ❖ In obtaining SAAE,
- ❖ W.r.t. certain aspects of:
  - Inventory
  - Litigation & claims
  - Segment information
- ❖ In an audit of financial statements.

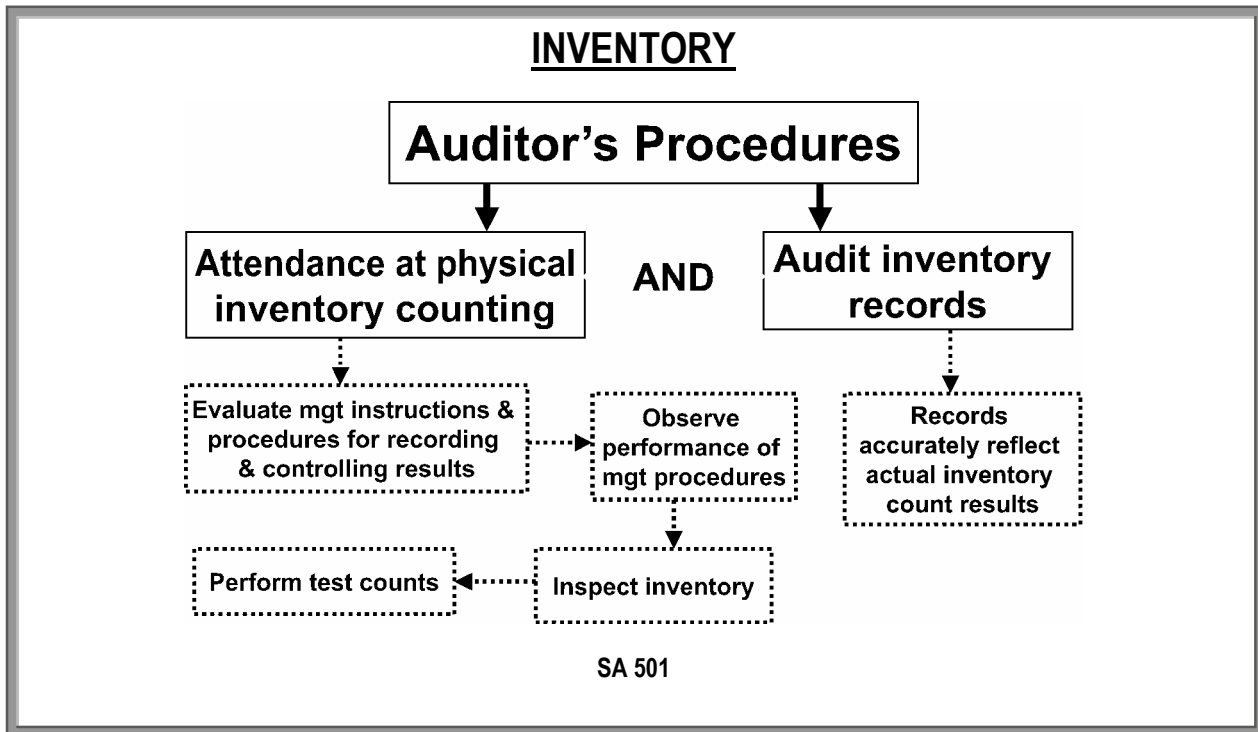
**SA 501**

- ❖ SAAE in accordance with SA 330, SA 500 & other relevant SAs.

## **Auditor's Objectives**



**SA 501**

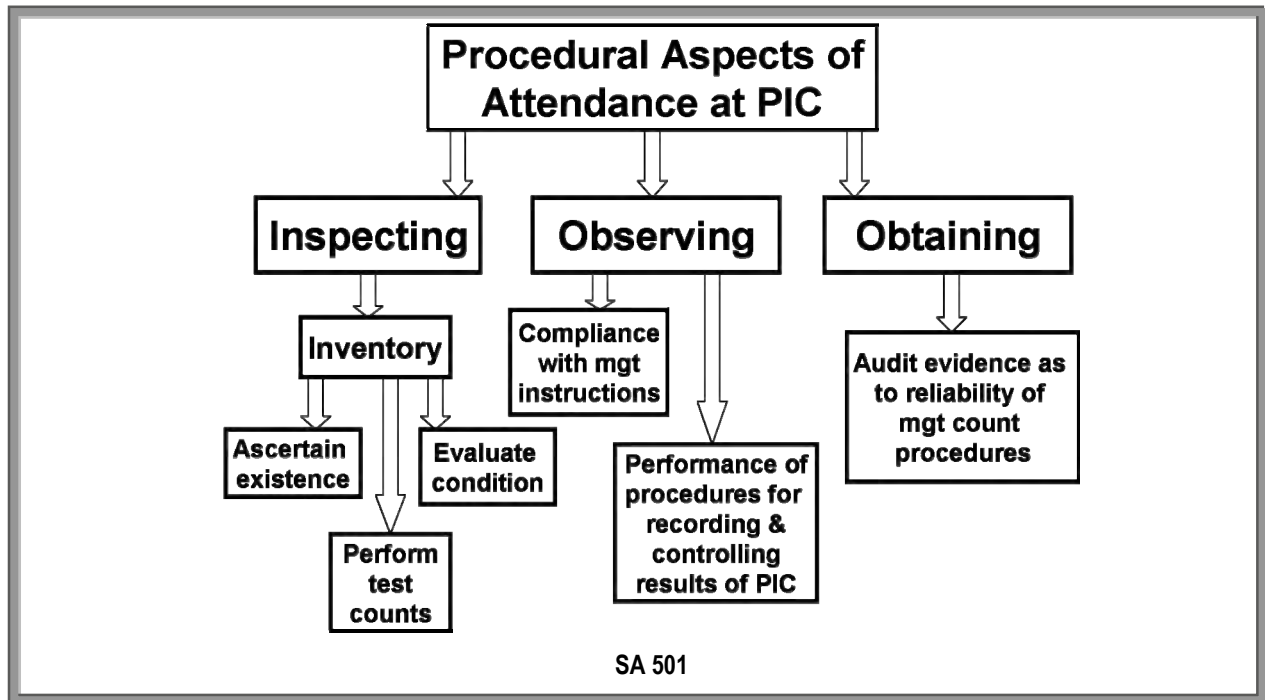


- ❖ This requirement applies when inventory is material to the financial statements. The sub-procedures under "Attendance at physical inventory counting" to be performed unless they are impracticable.

### **Attendance at Physical Inventory Count (PIC)**

- ❖ At least once a year by mgt to:
  - Form basis for FS preparation.
  - Ascertain reliability of perpetual inventory system.
- ❖ Planning the Attendance – *matters to consider*:
  - Nature of Inventory.
  - Stages of completion of WIP.
  - RMM related to inventory.
  - Nature of ICs related to inventory.
  - Expectation wrt adequate procedures & of proper instructions by mgt.
  - Timing of PIC.
  - Whether entity maintains perpetual inventory system.
  - Locations at which inventory is held.
  - Whether assistance of Auditor's Expert is needed.

**SA 501**



## Evaluating Mgt Instructions

### **Matters to consider:**

- ❖ Application of appropriate control activities.
- ❖ Accurate identification of:
  - Stage of completion of WIP.
  - Slow moving items.
  - Obsolete/ damaged items.
  - Items owned by 3<sup>rd</sup> party.
- ❖ Procedures to estimate physical quantities.
- ❖ Control over movement of inventory before & after cut-off date.

SA 501

### **Observing Performance of Mgt's Count Procedures**

- ❖ Mgt's count procedures, e.g., controls over inventory movement before, during and after the count, assists the auditor in obtaining audit evidence that mgt instructions and count procedures are adequately designed and implemented.
- ❖ Auditor may obtain copies of cutoff information to assist the auditor in performing audit procedures over the accounting for inventory movements at a later date.

**SA 501**

### **Inspection of Inventory**

**Assists auditor in:**

- ❖ Ascertaining the existence of inventory:
  - But not necessarily re ownership.
- ❖ Identifying obsolete/ damaged/ ageing inventory.

**SA 501**

## **Perform Test Counts**

- ❖ Provides evidence re completeness & accuracy of inventory records:
  - E.g., tracing select items from mgt count records to physical inventory & *vice versa*.
- ❖ Assists in performing subsequent audit procedures to determine whether entity's final inventory records accurately reflect actual inventory count results.

**SA 501**

## **PIC After the Date of FS – Additional Procedures**

- ❖ Obtain SAAE whether changes in inventory between the count date & FS date are properly recorded:
  - Effectiveness of design, implementation & maintenance of controls over change (refer SA 330).
- ❖ Perpetual inventory system:
  - Whether records are properly adjusted.
  - Reliability of the entity's perpetual inventory records.
  - Reasons for significant differences between the information obtained during physical inventory count and perpetual inventory records.

**SA 501**

- ❖ Where a perpetual inventory system is maintained, management may perform physical counts or other tests to ascertain the reliability of inventory quantity information included in the entity's perpetual inventory records. In some cases, management or the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively.

**Auditor unable to attend PIC:**

- Make/ observe PIC at some other date.
- Perform audit procedures on intervening transactions.

❖ **Attendance at PIC impracticable:**

- Perform alternative procedures to obtain SAAE.
- If these procedures are not possible, modify audit opinion (Ref SA 705).

**SA 501**

- ❖ PIC may be impracticable:
  - Nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor.
- ❖ Unacceptable Reasons:
  - General inconvenience to the auditor.
  - Difficulty, time, or cost involved.
- ❖ In some cases where attendance is impracticable, alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide SAAE about the existence and condition of inventory.
- ❖ In other cases, however, it may not be possible to obtain SAAE regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

**Inventory Under Control of 3<sup>rd</sup> Party – If material to FS****Obtain SAAE re existence & condition:**

- ❖ Request confirmation from 3<sup>rd</sup> party as to quantities & condition of inventory held on behalf of entity.  
AND/ OR
- ❖ Perform inspection or other audit procedures appropriate in the circumstances.

**SA 501**

- ❖ Where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. E.g.:
  - Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
  - Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
  - Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
  - Requesting confirmation from other parties when inventory has been pledged as collateral.

## **LITIGATION & CLAIMS**

- ❖ **Inquiry** - of management & others within the entity.
- ❖ **Review** – minutes of meetings of TCWG, communication between entity & external legal counsel.
- ❖ **Review** – legal expenses account.

If RMM re litigation/ claims is identified, auditor shall **ALSO** communicate directly with entity's external legal counsel.

### **SA 501**

#### **Direct communication with entity's external legal counsel:**

- ❖ The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor. If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.
- ❖ If Unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry the auditor may seek direct communication through a letter of specific inquiry.
  - A list of litigation and claims;
  - Where available, mgt's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
  - A request that the entity's external legal counsel confirm the reasonableness of mgt's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.
- ❖ In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, where:
  - The auditor determines that the matter is a significant risk.
  - The matter is complex.
  - There is disagreement between mgt and the entity's external legal counsel. Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.
- ❖ In accordance with SA 700, the auditor is required to date the auditor's report no earlier than the date on which the auditor has obtained SAAE on which to base the auditor's opinion on the financial statements. Audit evidence about the status of litigation and claims up to the date of the auditor's report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity's external legal counsel.



### **Need for Modified opinion (SA 705)**

- ❖ Mgt refuses to permit auditor to communicate/ meet with external legal counsel.
- ❖ External legal counsel refuses to respond appropriately/ prohibited from responding.
- ❖ Auditor unable to obtain SAAE by performing alternative audit procedures.

Request mgt & where appropriate, TCWG to provide **written representations** that:

- ❖ All known actual or possible L&C whose effects should be considered when preparing FS have been disclosed to the auditor; and
- ❖ Appropriately accounted for and disclosed in accordance with the applicable FRF.

**SA 501**

### **SEGMENT INFORMATION**

**Obtain SAAE re presentation & disclosure of segment info in accordance with applicable FRF:**

- ❖ Obtain understanding of methods used by mgt in determining segment info
  - Evaluating whether such methods are likely to result in disclosure in accordance with applicable FRF; and
  - Where appropriate, testing the application of such methods.
- ❖ Performing analytical procedures or other audit procedures appropriate in the circumstances.

**SA 501**

- ❖ Example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information include:
  - Sales, transfers and charges between segments, and elimination of inter-segment amounts.
  - Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
  - The allocation of assets and costs among segments.
  - Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

# SA 505

## External Confirmations

*Effective for Audits of financial statements for periods beginning on or after  
April 1, 2010*

### Overview

#### ❖ Introduction

- Scope
- External Confirmation Procedures to Obtain AE
- Effective Date

#### ❖ Objective

#### ❖ Definitions

#### ❖ Requirements & Application:

- External Confirmation Procedures
- Mgt refusal to allow auditor to send confirmation request
- Results of external confirmation procedures
- Negative confirmations
- Evaluating audit evidence

SA 505

### **Scope of SA**

- ❖ Auditor's use of external confirmation procedures (ECP).
- ❖ To obtain Audit Evidence (AE).
- ❖ In accordance with SA 330 & SA 500.

**Does not cover inquiries relating to litigations & claims.**

**SA 505**

## **ECP to Obtain AE**

- ❖ **SA 500:**
  - Reliability of AE influenced by source, nature & depends on circumstances under which obtained.
- ❖ **SA 330:**
  - Whether to perform ECP as substantive audit procedures.
- ❖ **SA 240:**
  - ECP may be used to obtain additional corroborative info as response to address assessed RMM at assertion level.

### **SA 505**

- ❖ **SA 500**
  - Generalizations applicable to audit evidence:
    - AE more reliable when obtained from independent sources outside the entity.
    - AE obtained directly by the auditor more reliable than AE obtained indirectly or by inference.
    - AE more reliable when it exists in documentary form, whether paper, electronic or other medium.
  - Corroborating info obtained from a source independent of the entity, such as, external confirmations, may increase the assurance the auditor obtains from evidence existing within the accounting records or from the representations made by the management.
- ❖ **SA 330**
  - Discusses the auditor's responsibility to design and implement overall responses to address the assessed RMM at the FS level, and to design and perform further audit procedures whose nature, timing and extent are based on, and are responsive to, the assessed RMM at the assertion level.
  - Irrespective of the assessed RMM, the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure.
  - Auditor to also consider whether external confirmation procedures are to be performed as substantive audit procedures.
  - Auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk. To do this, the auditor may increase the quantity of the evidence or obtain evidence that is more relevant or reliable, or both.
  - ECPs may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error.
- ❖ **SA 240**
  - Auditor may design confirmation requests to obtain additional corroborative information as a response to address the assessed RMM, whether due to fraud at the assertion level.

## **Auditor's Objective**

- ❖ When using ECPs,
  - To design & perform such procedures to obtain relevant & reliable AE.

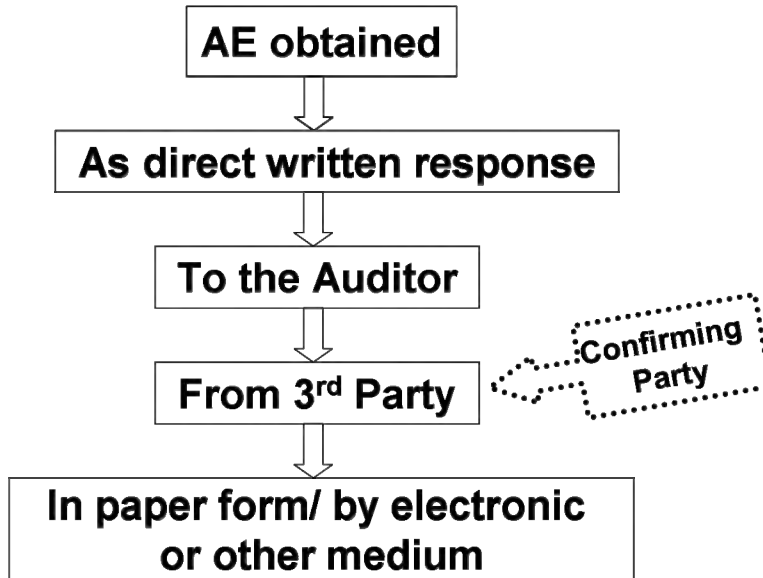
**SA 505**

## **Definitions**

- ❖ External Confirmation
- ❖ Positive Confirmation Request (PCR)
- ❖ Negative Confirmation Request (NCR)
- ❖ Non-response
- ❖ Exception

**SA 505**

### External Confirmation



SA 505

### PCR/ NCR

	PCR	NCR
Request to	Confirming party (CP)	Confirming party (CP)
Respond to	Directly to auditor	Directly to auditor
Expectation as to CP's response	ALWAYS	ONLY IF
What to respond	Whether CP agrees/ disagrees with info in request/ provide requested info	CP disagrees with info in request

SA 505

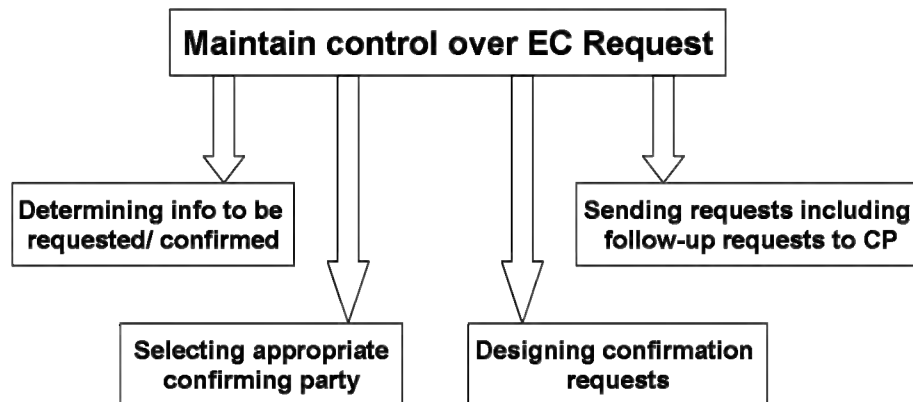
**Non – response**

- ❖ In case of PCR:
  - Failure of PCR to respond/ fully respond.
- OR
- ❖ Confirmation request returned undelivered.

**Exception**

- ❖ A response that indicates difference between info requested to be confirmed or contained in entity's records.  
*VIS A VIS*
- ❖ Info provided by Confirming Party.

SA 505

**I. External Confirmation Procedures**

SA 505

- ❖ Determining info to be confirmed/ requested.
  - To confirm:
    - Account balances & their elements.
    - Terms of agreements/ contracts/ transactions.
    - Absence of certain conditions such as "side agreements".
- ❖ Selecting appropriate confirming party:
  - Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is knowledgeable about the information to be confirmed.

## **Designing Confirmation Requests**

- ❖ Includes determining that:
  - Requests are properly addressed.
  - Contain return info for responses to be sent directly to auditor.
- ❖ Factors to consider in designing:
  - Assertion being addressed.
  - Specific identified RMM.
  - Layout & presentation of request.
  - Prior experience.
  - Method of communication.
  - Mgt authorisation/ encouragement to CPs to respond to auditor.
  - Ability of CP to provide/ confirm requested info.

**SA 505**

- ❖ Benefits & flip sides of different types of PCRs:
  - PCR asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party's agreement with the given information, or by asking the confirming party to provide information. A response to PCR ordinarily is expected to provide reliable audit evidence.
  - **Risk:** CP may reply to CR without verifying that info is correct.
  - **Reduce this risk:** PCR that do not state the amount (or other info) on CR, and ask CP to fill in the amount or furnish other info.
  - **Counter Risk:** This type of "blank" CR may result in lower response rates because additional effort is required from CP.
- ❖ Determining that requests are properly addressed includes testing the validity of some or all of the addresses on confirmation requests before they are sent out.

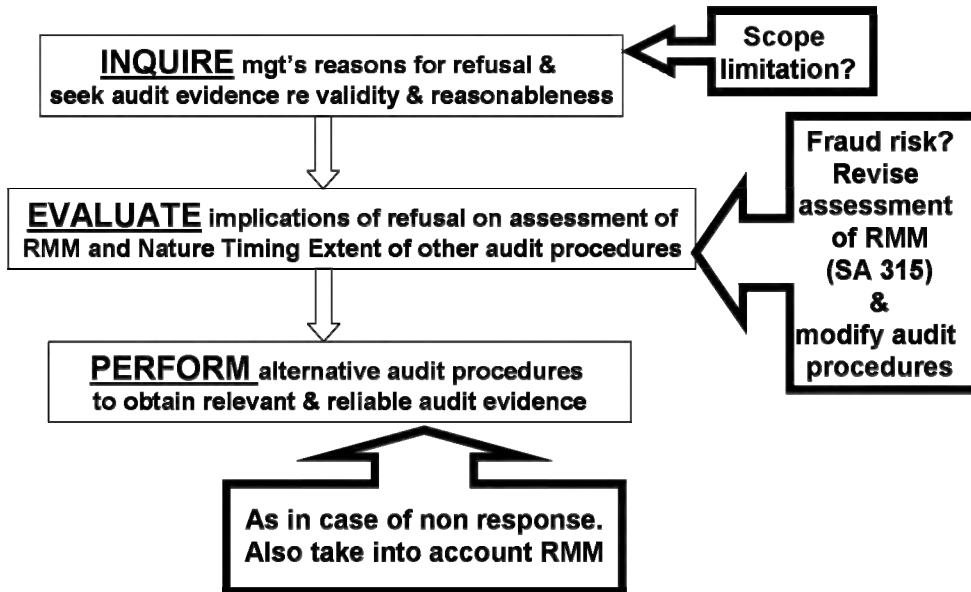
## **Sending the Requests**

May send additional request if reply to previous request not received within reasonable time.

**SA 505**



## II. Mgt Refusal to Allow Auditor to Send Confirmation Request



SA 505

- ❖ Auditor needs to find out the reason for the scope limitation. A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. The auditor is required to seek audit evidence as to the validity and reasonableness of the reasons because of the risk that management may be attempting to deny the auditor access to audit evidence that may reveal fraud or error.

## Auditor not Satisfied

- ❖ Auditor concludes:
  - Mgt refusal is unreasonable.
  - OR**
  - Auditor is unable to obtain relevant & reliable evidence from alternative procedures.
  - ↓
  - Communicate with TCWG (SA 260).
  - AND**
  - Determine implications on audit opinion (SA 705).

SA 505

### **III. Results of ECP**

- ❖ Factors raising doubt on reliability of response:
  - Obtain further audit evidence to resolve doubts.
- ❖ Response to request is not reliable:
  - Evaluate implications on assessment of RMM or related Nature, Timing, Extent of audit procedures.
- ❖ For each non - response:
  - Perform alternative procedures.
- ❖ Response to Positive confirmation is necessary for SAAE:
  - Alternative procedures will not provide the audit evidence required by auditor.
- ❖ Investigate exceptions to determine if they indicate misstatements.

#### **SA 505**

##### **Para 10, A11 – A16 --- Factors raising doubt on reliability of response**

- ❖ All responses carry some risk of interception/ alteration/ fraud.
- ❖ Factors raising doubts re reliability:
  - Response received indirectly by auditor.
  - Appears not to have come from originally intended confirming party.
- ❖ Responses received electronically, for example, by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of the respondent may be difficult to establish, and alterations may be difficult to detect.
- ❖ Auditor & responded to use process that creates secure environment for electronic responses
- ❖ Confirming party uses 3<sup>rd</sup> party to coordinate & provide responses to requests, auditor to perform procedures to address the risks:
  - Response may not be from proper source;
  - Respondent may not be authorised to respond; and
  - Integrity of transmission may be compromised.
- ❖ Oral response is not a confirmation:
  - Request confirming party to respond in writing directly to auditor.
  - If written response not received, seek other evidence to support oral confirm.

##### **Para 12 & A18 --- Non response**

- ❖ A non response may indicate previously unidentified RMM:
  - Revise assessed RMM at assertion level.
  - Modify planned audit procedures (SA 315, SA 240).
- ❖ Nature & extent of alternative procedures affected by account & assertion in question.

##### **Para 13 & A20 --- Positive CR necessary as SAAE**

- ❖ Circumstances include:
  - Info available to corroborate mgt.'s assertion only available outside the entity.
  - Specific fraud risk factors (eg, mgt override of controls) prevent the auditor from relying on evidence from the evidence entity.

##### **Para 14 & A21 – A22 --- Exceptions**

- When a misstatement is identified, the auditor is required by SA 240 to evaluate whether such misstatement is indicative of fraud.
- Exceptions may provide a guide to the quality of responses from similar confirming parties or for similar accounts.
- Exceptions also may indicate a deficiency, or deficiencies, in the entity's internal control over financial reporting.
- Some exceptions do not represent misstatements. For example, the auditor may conclude that differences in responses to confirmation requests are due to timing, measurement, or clerical errors in the external confirmation procedures.

## **IV. Negative Confirmations**

- ❖ Provide less persuasive audit evidence than positive confirmations.
- ❖ Not to use NCR as sole substantive audit procedure to address assessed RMM at assertion level unless all the following conditions are met:
  - Auditor assessed RMM as low & has obtained SAAE re operating effectiveness of controls relevant to assertion.
  - Population of relevant items comprises large number of small, homogeneous account balances/ transactions/ conditions.
  - Very low exception rate is expected.
  - Auditor not aware of any circumstances/ conditions that would cause recipients NCR to disregard the request.

**SA 505**

### **Provide less persuasive audit evidence than positive confirmations**

- ❖ The failure to receive a response to a negative confirmation request does not explicitly indicate:
  - Receipt by the intended confirming party of the confirmation request; or
  - Verification of the accuracy of the information contained in the request.
- ❖ Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favor, and less likely to respond otherwise.

## **V. Evaluating the Evidence Obtained**

- ❖ Whether the results of ECP provide relevant and reliable audit evidence.

**OR**

- ❖ Whether performing further audit procedures is necessary.
- ❖ Categorisation of results:
  - Agreement by confirming parties.
  - Responses deemed unreliable.
  - Non-response.
  - Response indicating exception.

**SA 505**

- ❖ The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether SAAE has been obtained or whether performing further audit procedures is necessary, as required by SA 330.

# SA 510

## Initial Audit Engagements-Opening Balances

*Effective for Audits of financial statements for periods beginning on or after  
April 1, 2010*

SA 510

## Overview of SA 510

- ❖ **Introduction**
  - Scope
  - Effective date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements**
  - Audit Procedures
  - Audit Conclusions and Reporting
- ❖ **Application and Other Explanatory Material on these aspects**
- ❖ **Appendix: Illustrations of Auditors' Report**

SA 510

## **Scope**

- ❖ Deals with Auditor's responsibility:
  - Relating to opening balances.
  - When conducting Initial Audit Engagement.
- ❖ Applicable to comparative financial information – Opening balances.
- ❖ SA 300 – Guidance relating to activities prior to an Initial Audit.
- ❖ Opening balances include:
  - FS amounts.
  - Matters requiring disclosure.

**SA 510**

## **Auditor's Objective**

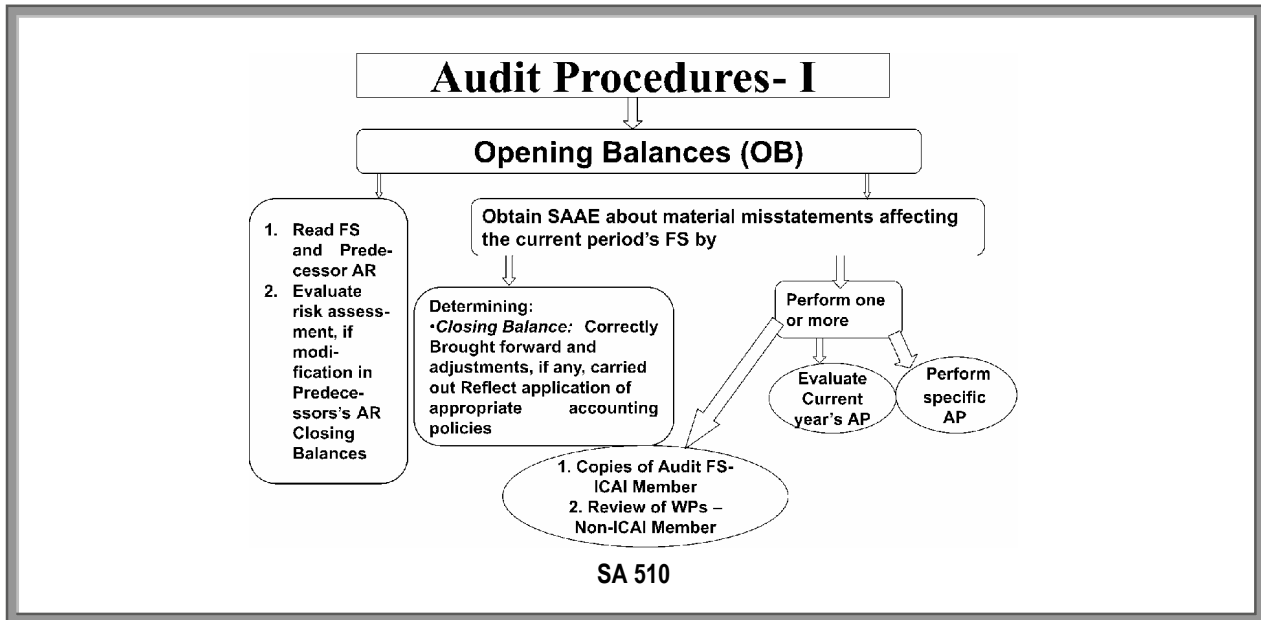
- ❖ Obtain SAAE in respect of opening balances about whether:
  - Material Misstatements affecting current period FS.
  - Consistent application of:
    - Appropriate Accounting Policies; OR
    - changes have been properly accounted for and presented in FS.

**SA 510**

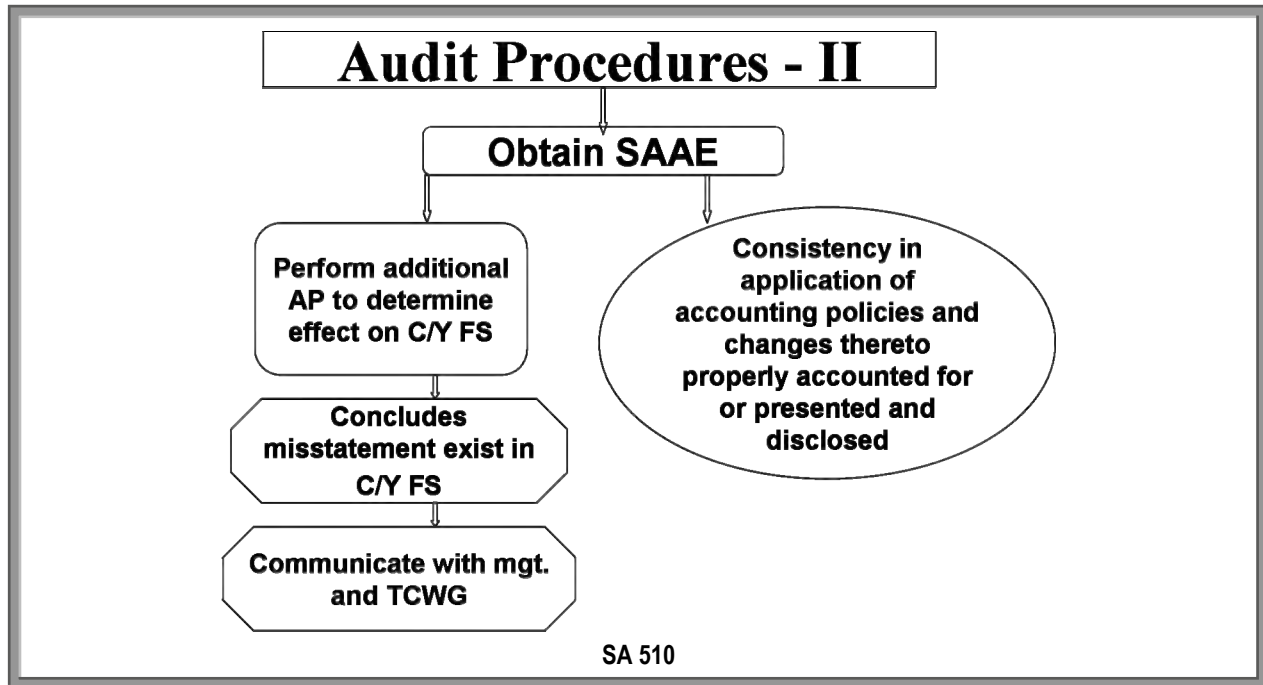
## **Definitions**

- ❖ Initial Audit Engagement – An engagement in which Prior Period FS:
  - Not audited; or
  - Audited by a predecessor auditor.
- ❖ Opening Balances – Accounting Balances existing at the beginning:
  - Closing balances of prior period – Reflect the effect of prior period transactions and events, and accounting policies applied.
  - Disclosure of accounts i.e., contingency and commitments.
- ❖ Predecessor auditor – The auditor from different audit firm:
  - Audited FS in the prior period.
  - Replaced by current auditor.

**SA 510**



- ❖ Factors to determine nature and extent of audit procedures:
  - Accounting Policies followed.
  - Nature of accounts and risk of material misstatement in current period's FS.
  - Material Misstatement in opening balances.
  - Modified report by predecessor auditor.
- ❖ Other Procedures includes:
  - Review of working papers of predecessor auditor - also consider professional competence of predecessor auditor if he is not a member of ICAI.
  - Evaluation of current year's audit procedures.
  - Specific audit procedures with regard to opening balance.
- ❖ For current assets and current liabilities, audit evidence is obtained as a part of current period audit. However for inventory additional procedure should be followed on:
  - Observing current physical inventory and reconciliation with the opening inventory.
  - Valuation of opening inventory.
  - Gross profit and cut-off.
- ❖ For fixed assets, investments, long-term debts, etc.:
  - Examine the records underlying the opening balances.
  - Obtain third party confirmation, where required.



## **Audit Conclusions and Reporting**

- ❖ Qualified or Disclaimer:
  - Unable to obtain SAAE re OB.
- ❖ Qualified or Adverse:
  - OB contain misstatements:
    - That materially affect current FS, and
    - Effect not properly accounted for or disclosed.
  - Accounting policies not consistently applied.
  - Accounting policies **changes** not properly accounted or disclosed.

SA 510

- ❖ In case of inability to obtain SAAE, auditor may give an opinion:
  - Qualified/disclaimer regarding results of operations & cash flows; and
  - Unqualified regarding State of Affairs.
- ❖ **Modification to the Opinion in the Predecessor Auditor's Report**
  - If the predecessor auditor's opinion regarding prior period's FS included a modification to the auditor's opinion that remains relevant and material to the current period's FS, the auditor shall modify the auditor's opinion on the current period's FS in accordance with SA 705 and SA 710 .



# SA 520

## Analytical Procedures

*Effective for Audits of financial statements for periods beginning on or after  
April 1, 2010*

## Overview of SA 520

- ❖ **Introduction**
  - Scope
  - Effective date
- ❖ **Objectives**
- ❖ **Definition**
- ❖ **Requirements & Application**
  - Substantive analytical procedures
  - Analytical procedures that assist when forming an overall conclusion
  - Investigating results of analytical procedures
- ❖ **Appendix**

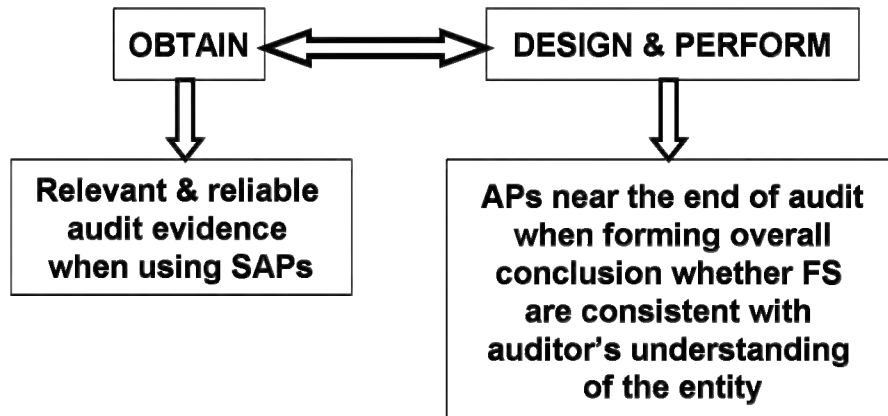
SA 520

## Scope of SA

- ❖ **Deals with auditor's use of AP as:**
  - Substantive procedures (SAPs)
  - Procedures near the end of audit to help in forming an overall conclusion on FS.
- ❖ SA 315 deals with APs as risk assessment procedures.
- ❖ SA 330 includes requirements & guidance re Nature, Timing, Extent of audit procedures in response to assessed risks.

SA 520

## Auditor's Objectives



SA 520

## **Definition – Analytical Procedures**

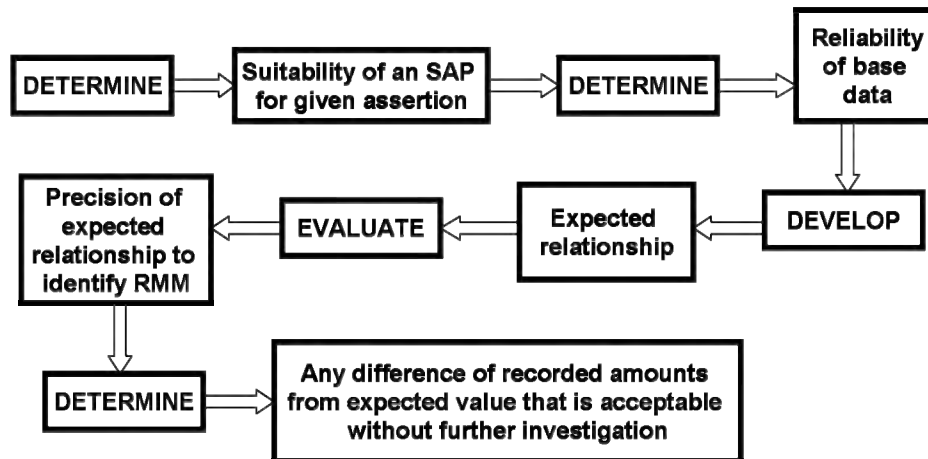
- ❖ Evaluations of financial information;
- ❖ Through analysis of;
- ❖ Plausible relationship among;
- ❖ Both financial & non financial data.
- ❖ Encompasses investigation as necessary of identified fluctuations/ relationships that are inconsistent with other relevant info or that differ from expected values by significant amount.
- ❖ Auditor's choice of procedures, methods & level of application is matter of professional judgment.

### **SA 520**

- ❖ AP include the consideration of comparisons of the entity's financial info, e.g.:
  - Comparable information for prior periods.
  - Anticipated results of the entity, such as, budgets or forecasts, or expectations of the auditor, such as, an estimation of depreciation.
  - Similar industry information, such as, a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.
- ❖ AP also include consideration of relationships, for example:
  - Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
  - Between financial information and relevant non-financial information, such as payroll costs to number of employees.
- ❖ Various methods may be used to perform analytical procedures - simple comparisons to performing complex analyses using advanced statistical techniques.
- ❖ Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

## I. Substantive Analytical Procedures

### **Flow of Auditor's Procedures**



SA 520

- ❖ SAPs can be performed alone or in combination with tests of details. (SA 330).

### Developing Suitability of SAP

- ❖ Also take into account assessed RMM & Tests of Details.
- ❖ SAPs more suitable to large volumes of transactions tending to be predictable over time.
- ❖ But suitability of AP influenced by:
  - Nature of assertion.
  - Auditor's assessment of APs effectiveness to identify material misstatement.
- ❖ In some cases unsophisticated predictive models may be useful.
- ❖ Different types of APs provide different levels of assurance.
- ❖ Particular SAP may be considered suitable when ToD are performed on same assertion.

SA 520

## **Reliability of Database**

- ❖ Factors determining reliability:
  - Source of info available.
  - Comparability of info available.
  - Nature & relevance of info available.
  - Controls over preparation of info:
    - Completeness, accuracy & validity is ensured.
- ❖ May consider testing operating effectiveness of controls.

SA 520

## **Precision to Identify Misstatement**

- ❖ Factors to consider:
  - Accuracy with which expected results of SAPs can be predicted.
  - Degree to which info can be disaggregated.
  - Availability of info – financial/ non - financial.

SA 520

### **Acceptance of Difference**

- ❖ Materiality and the consistency with the desired level of assurance.
- ❖ Possibility that a misstatement, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
- ❖ Obtain more persuasive audit evidence when auditor's assessment of risk is high.
- ❖ As assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence.

**SA 520**

### **II. APs when Forming an Overall Opinion**

- ❖ Design & perform APs.
- ❖ Near/ end of audit.
- ❖ When forming overall audit opinion.
- ❖ Whether FS are consistent with auditor's understanding of entity.  
May throw up previously unrecognised RMM, leading to revised risk assessment & modification in further audit procedures.

**SA 520**

### III. Investigating Results of APs

- ❖ Fluctuations/ inconsistencies/ significant variations thrown up by APs:
  - Inquiry of management.
  - Obtain appropriate evidence relevant to mgt response.
  - Perform other audit procedures as necessary.

#### SA 520

- ❖ **Evaluating mgt response** – take into account the auditor's understanding of the entity and its environment, and other audit evidence obtained during the course of the audit.
- ❖ **Further audit procedures** - For example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

## SA 530

### Audit Sampling

*Effective for audits of financial statements for periods beginning on or after  
April 1, 2009*

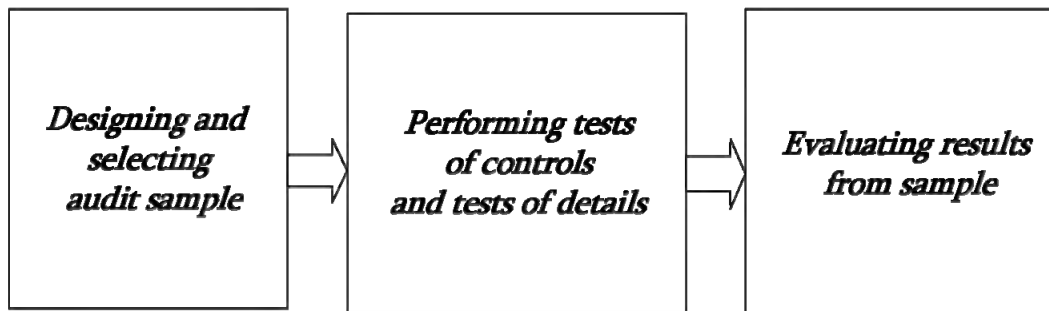
## Overview of SA 530

- ❖ **Introduction**
  - Scope
  - Effective Date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements**
  - Sample Design, Size and Selection of Items for Testing
  - Performing Audit Procedures
  - Nature and Cause of Deviations and Misstatements
  - Projecting Misstatements
  - Evaluating Results of Audit Sampling
- ❖ **Application and Other Explanatory Material on these Aspects**
- ❖ **Appendices**

SA 530

## Scope

- ❖ Applies when auditor decides to use audit sampling in performing audit procedures.
- ❖ Deals with auditor's use of statistical and non-statistical sampling when:



- ❖ Complements SA 500.

SA 530



## **Objective**

- ❖ Objective of Auditor when using Audit Sampling is:
  - To provide a reasonable basis.
  - To draw conclusions.
  - About population from which sample is selected.

SA 530

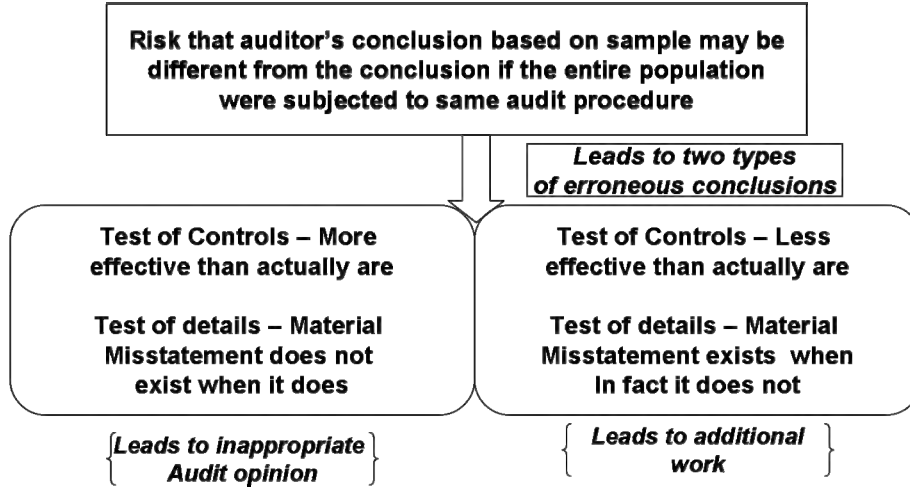
## **Definitions- I**

- ❖ **Audit sampling:**
  - Application of audit procedures to less than 100% of items within a population of audit relevance.
  - Such that all sampling units have a chance of selection.
  - To provide a reasonable basis on which to draw conclusions about entire population.
- ❖ **Population:**
  - Entire set of data from which sample is selected and about which auditor wishes to draw conclusions.

SA 530

## Definitions - II

❖ **Sampling risk:**



SA 530

## Definitions- III

❖ **Non-sampling risk:**

- Risk that auditor reaches an erroneous conclusion for any reason not related to sampling risk (e.g., inappropriate audit procedures/misinterpretation of evidence/failure to recognise a misstatement/deviation).

❖ **Anomaly:**

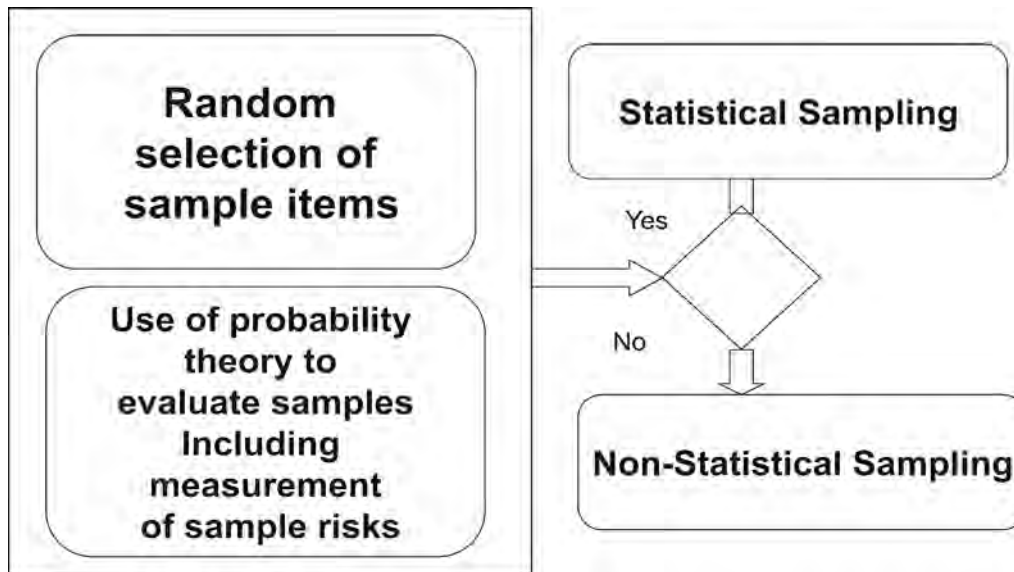
- Misstatement or deviation.
- Demonstrably not representative of misstatements or deviations in a population.

❖ **Sampling Unit:**

- Individual items constituting a population (physical items or monetary units).

SA 530

### Definitions - IV



SA 530

### Definitions - V

❖ **Stratification:**

- Process of dividing a population into sub-populations.
- Each of which is a group of sampling units.
- Having similar characteristics (often monetary value).

❖ **Tolerable misstatement:**

- Monetary amount set by auditor.
- In respect of which auditor seeks appropriate level of assurance.
- That monetary amount set is not exceeded by the actual misstatement in the population (May be equal to or less than performance materiality as defined in SA 320).

SA 530

## **Definitions -VI**

❖ **Tolerable rate of deviation:**

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

**SA 530**

## **Sample Design, Size and Selection of Item** **(A) Sample Design**

- ❖ Consider:
  - Purpose of audit procedure.
  - Characteristics of population.
- ❖ To design audit sample & determine sample size:
  - Tests of controls – Assessment of expected rate of deviation.
  - Tests of details – Assessment of expected misstatement.
- ❖ May determine that stratification or value-weighted selection is appropriate.
- ❖ Decision to use statistical or non-statistical is a matter for auditor's judgment – sample size is not a valid criterion.

**SA 530**

- ❖ Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn.
- ❖ In designing the audit sample, the auditor's consideration includes:
  - Specific purpose to be achieved.
  - Combination of audit procedures that is likely to best achieve that purpose.
  - Nature of the audit evidence sought.
  - Possible deviation or misstatement conditions or other characteristics relating to that audit evidence.
  - A clear understanding of what constitutes a deviation or misstatement.

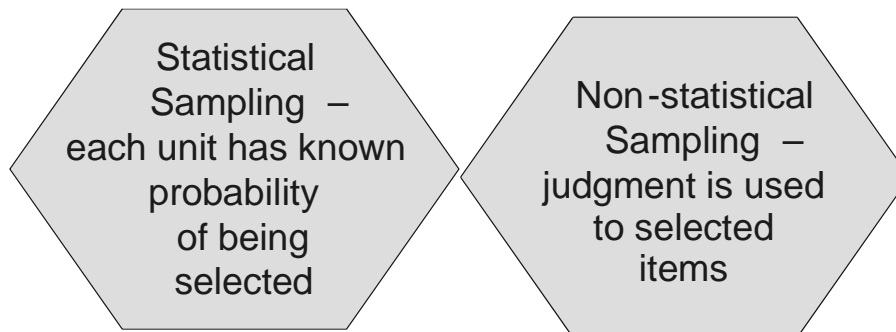
### **(B) Sample Size**

- ❖ Auditor to determine sample size sufficient to reduce sampling risk to an acceptably low level:
  - Lower the risk auditor willing to accept, greater the sample size.
- ❖ Sample size determined by application of:
  - Statistically based formula, or
  - Exercise of professional judgment.
- ❖ Appendices to this SA - Identify Influence that various factors typically have on determination of sample size.

SA 530

### **(C) Selection of Items for Testing**

- ❖ Auditor to select representative sample – Each sampling unit in the population has a chance of selection:



SA 530

### **Methods of selecting sample**

<b>Random selection</b>	Applied through random generators, e.g., random number tables.
<b>Systematic selection</b>	Number of sampling units / sample size = sampling interval.
<b>Monetary unit sampling</b>	Type of value weighted selection – sample size, evaluation results in monetary amounts.
<b>Haphazard selection</b>	Selection without following structured technique.
<b>Block selection</b>	Selection of blocks of contiguous items from within the population.

SA 530

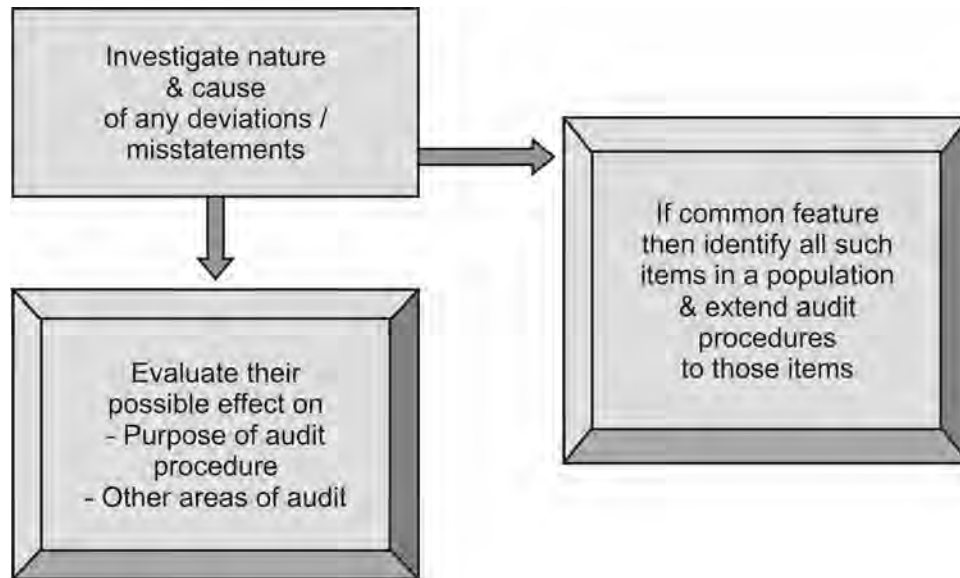
### **Performing Audit Procedures**

- ❖ Perform audit procedures, appropriate to the purpose, on each item selected.
- ❖ If procedure not applicable to selected item, perform on replacement item (e.g., cancelled cheque).
- ❖ If unable to apply procedure/ alternative procedures, then deviation or misstatement (e.g., documentation relating to item lost).

SA 530

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

## Nature & Cause of Deviations and Misstatements- I



SA 530

## Nature & Cause of Deviations and Misstatements- II

- ❖ In extremely rare circumstances, if deviation/misstatement is an anomaly:
  - Obtain high degree of certainty that it is not representative of population.
  - By performing additional audit procedures to obtain SAAE that misstatement/deviation does not affect remainder of population.

SA 530

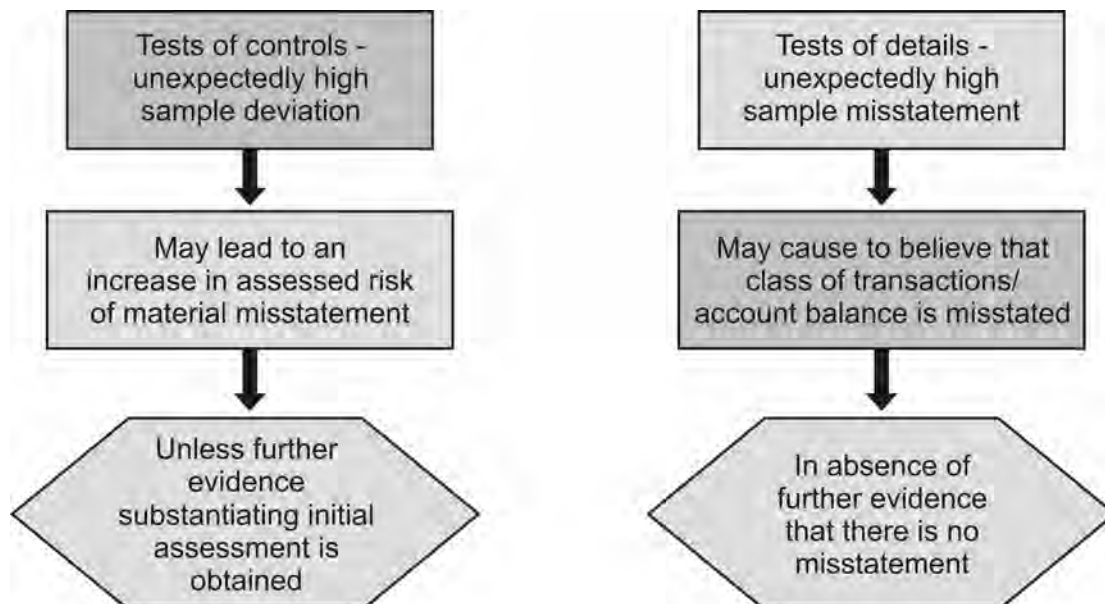
## Projecting Misstatements

- ❖ **Tests of details** – project misstatements to population:
  - Gives broad view of scale of misstatement but insufficient to determine amount to be recorded.
  - Exclude anomaly, however consider effect of uncorrected misstatement.
- ❖ **Tests of controls** - no explicit projection necessary:
  - Sample deviation rate is also projected deviation rate.

SA 530

## Evaluating Results of Audit Sampling – I

- ❖ Auditor shall evaluate:
  - Results of sample.
  - Use of audit sampling provides a reasonable basis of conclusion.



SA 530



## **Evaluating Results of Audit Sampling - II**

- ❖ Tests of details:
  - If (projected misstatement + anomalous misstatement) > tolerable misstatement then sample does not provide reasonable basis for conclusions.
  - Closer (projected misstatement + anomalous misstatement) is to tolerable misstatement, the more likely that actual misstatement may exceed tolerable misstatement.
  - Risk may be reduced if additional audit evidence is obtained.

### **SA 530**

- ❖ If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:
  - Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or
  - Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

## **SA 540**

### **Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures**

*Effective for audits of financial statements for periods beginning on or after  
April 1, 2009*

## **Overview of SA 540 - I**

- ❖ **Introduction**
  - Scope
  - Effective date
- ❖ **Objectives**
- ❖ **Definitions**
- ❖ **Requirements:**
  - Risk Assessment Procedures and Related Activities
  - Identifying and Assessing the Risks of Material Misstatement
  - Responses to the Assessed Risks of Material Misstatement

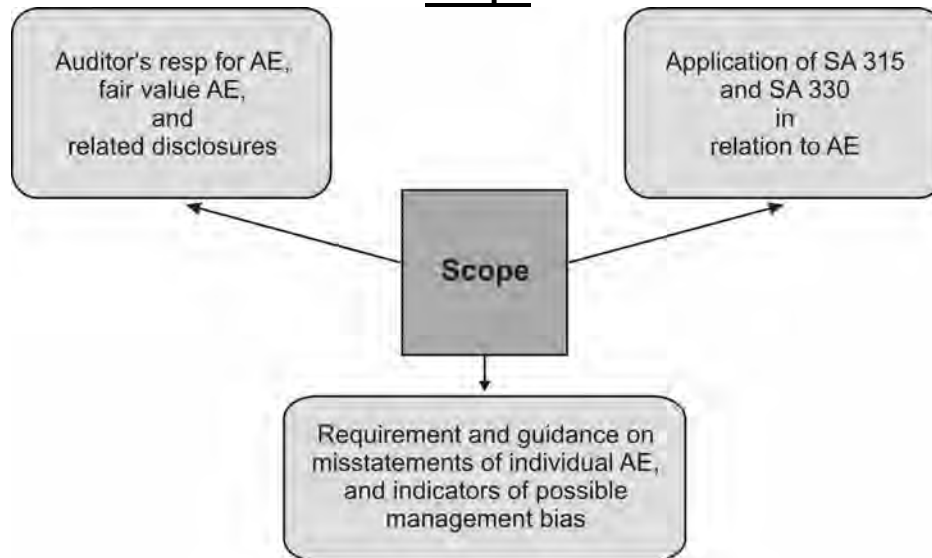
**SA 540**

## **Overview of SA 540- II**

- Further Substantive Procedures to Respond to Significant Risk
- Evaluating the Reasonableness of the Accounting Estimates (AE), and Determining Misstatements
- Disclosures Related to Accounting Estimates
- Indicators of Possible Management Bias
- Written Representations
- Documentation
- ❖ **Application and Other Explanatory Material on these Aspects**
- ❖ **Appendix**

**SA 540**

### Scope



SA 540

### Nature of Accounting Estimates

- ❖ FS items that cannot be measured precisely but can only be estimated.
- ❖ Measurement objective for some AE - To forecast the outcome of one or more transactions, events or conditions.
- ❖ Measurement objective for fair value AE - Expressed in terms of the value of a current transaction or FS item based on conditions prevalent at measurement date.
- ❖ Difference between outcome of an AE and amount originally disclosed in FS does not necessarily represent a misstatement of FS, particularly for fair value AE.

SA 540

- ❖ The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias.
- ❖ Lower the estimation uncertainty, lower will be the risk of material misstatement or higher the estimation uncertainty, higher will be the risk.
- ❖ Not all FS items requires fair value due to non-availability of reliable information.
- ❖ Mgt. bias difficult to detect or can be detected when considered in the aggregate of groups of AE or all AE , or over a period of time.

### **Accounting Estimates - Examples**

- ❖ Allowance for doubtful accounts.
- ❖ Inventory obsolescence.
- ❖ Warranty obligations.
- ❖ Depreciation method or asset useful life.
- ❖ Provision against the carrying amount of an investment.
- ❖ Outcome of long term contracts.
- ❖ Financial Obligations/ Costs arising from litigation settlements and judgments.

**SA 540**

### **Fair value Accounting Estimates - Examples**

- ❖ Complex financial instruments, which are not traded in an active and open market.
- ❖ Share-based payments.
- ❖ Property or equipment held for disposal.
- ❖ Certain assets or liabilities acquired in a business combination, including goodwill and intangible assets.
- ❖ Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration.

**SA 540**

## Objective

- ❖ Obtain SAAE in context of applicable FRF:
  - AE including fair value AE in the FS are reasonable.
  - Related disclosures in the FS are adequate.

SA 540

## Definitions - I

- ❖ **Accounting estimate** - Approximation of a monetary amount in the absence of a precise means of measurement.
- ❖ **Auditor's point estimate or auditor's range** - Amount or range of amounts derived from audit evidence for use in evaluating mgt's point estimate
- ❖ **Estimation uncertainty** - susceptibility of an AE and related disclosures to an inherent lack of precision in its measurement.
- ❖ **Management bias** – A lack of neutrality by mgt in the preparation and presentation of information.

SA 540

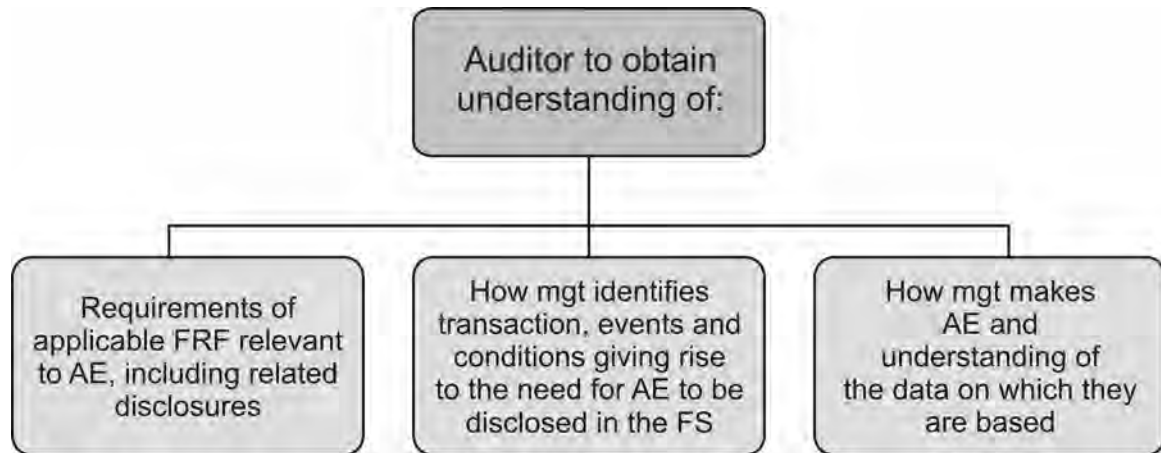
- ❖ The term, "Accounting Estimate" is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where this SA addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used.

## **Definitions - II**

- ❖ **Management's point estimate** – Amount selected by mgt for recognition or disclosure in the FS as an AE.
- ❖ **Outcome of an AE** - Actual monetary amt which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the AE.

SA 540

## Risk Assessment Procedures and Related Activities- I



- ❖ **Small Entities:** Limited Business activities and less complex transactions.

### SA 540

- ❖ In obtaining the understanding on how mgt. identifies transactions/events/conditions, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
- ❖ Understanding of applicable financial reporting framework assists the auditor in determining certain conditions for the recognition, or methods for the measurement, of AE, specifies certain conditions that permit or require measurement at a fair value, required disclosures.
  - Provides the auditor with a basis for discussion with management about how management has applied those requirements relevant to the accounting estimate, and the auditor's determination of whether they have been applied appropriately.
  - Provide guidance for management on determining point estimates where alternatives exist.
- ❖ Management's identification of transactions, events and conditions that give rise to the need for accounting estimates is likely to be based on:
  - Management's knowledge of the entity's business and the industry in which it operates.
  - Management's knowledge of the implementation of business strategies in the current period.
  - Where applicable, management's cumulative experience of preparing the entity's financial statements in prior periods.

#### **Obtaining an Understanding of How Management Makes the Accounting Estimates**

- ❖ Management is responsible for establishing financial reporting processes for making accounting estimates, including adequate internal control. Such processes include the following:
  - Selecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation methods, including, where applicable, models.
  - Developing or identifying relevant data and assumptions that affect accounting estimates.
  - Periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary.
- ❖ Matters auditor may consider in obtaining an understanding of how management makes the accounting estimates include, for example:
  - The types of accounts or transactions to which the accounting estimates relate (for example, whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions).
  - Whether and, if so, how management has used recognised measurement techniques for making particular accounting estimates.
  - Whether the accounting estimates were made based on data available at an interim date and, if so, whether and how management has taken into account the effect of events, transactions and changes in circumstances occurring between that date and the period end.

## **Risk Assessment Procedures- II**

### **Manner of Making AE**

- ❖ Method, including where applicable the use of model: Internally developed modules are riskier.
- ❖ Relevant controls.
- ❖ Whether management has used an expert.
- ❖ Assumptions underlying the AE.
- ❖ Change in the methods for making the AE.
- ❖ Whether and, if so, how management has assessed the effect of estimation uncertainty.

#### **SA 540**

#### **Method of Measurement, Including the Use of Models**

- ❖ When the applicable financial reporting framework does not prescribe a particular method/model to be used in the circumstances, matters to be considered by the auditor include, for example:
  - How management selects a particular method considering the nature of the asset or liability being estimated.
  - Whether the entity operates in a particular business, industry or environment in which there are methods commonly used to make the particular type of accounting estimate.
- ❖ Greater risks of material misstatement, in cases mgt has internally developed model or is departing from a method commonly used in a particular industry or environment.

#### **Relevant Controls**

- ❖ Matters include the experience and competence of those who make the accounting estimates, and controls related to:
  - How management determines the completeness, relevance and accuracy of the data used to develop accounting estimates.
  - The review and approval of accounting estimates, including the assumptions or inputs used in their development.
  - The segregation of duties between those committing the entity to the underlying transactions and those responsible for making the AE.
  - May also include, for example, those established over:
    - The design and development, or selection, of a particular model for a particular purpose.
    - The use of the model.
    - The maintenance and periodic validation of the integrity of the model.

#### **Management's Use of Experts**

- ❖ Need may arise because of the specialised nature of the matter requiring estimation, technical nature of the models required to meet the relevant requirements of the FRF, unusual or infrequent nature of the condition/ transaction/ event.

#### **Assumptions**

- ❖ Matters include:
  - The nature of the assumptions.
  - How management assesses whether the assumptions are relevant and complete.
  - Where applicable, how management determines that the assumptions used are internally consistent.
  - Whether the assumptions relate to matters within the control of management, and how they conform to the entity's business plans and the external environment, or to matters that are outside its control.
  - The nature and extent of documentation, if any, supporting the assumptions.
- ❖ May be made or identified by an expert.
- ❖ Management may support assumptions with different types of information drawn from internal and external sources, the relevance and reliability of which will vary.
- ❖ With respect to fair value accounting estimates, assumptions or inputs vary in terms of their source and bases, as follows:
  - Those that reflect what marketplace participants would use in pricing an asset or liability developed based on market data obtained from sources independent of the reporting entity (sometimes referred to as "observable inputs" or equivalent).
  - Those that reflect the entity's own judgments about what assumptions marketplace participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

#### **Changes in Methods for making Accounting Estimates**

- ❖ Understand whether there has been or ought to have been a change from the prior period in the methods for making the AE.

#### **Estimation Uncertainty**

- ❖ Matters include:
  - Whether and, if so, how management has considered alternative assumptions or outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the assumptions on an accounting estimate.
  - How management determines the accounting estimate when analysis indicates a number of outcome scenarios.
  - Whether management monitors the outcome of accounting estimates made in the prior period, and whether management has appropriately responded to the outcome of that monitoring procedure.



### **Risk Assessment Procedures and Related Activities- III**

- ❖ Auditor to review outcome of AE included in prior period FS, or, where applicable, their subsequent re-estimation for purpose of current period.

#### **SA 540**

- ❖ The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time.
- ❖ Auditor may obtain:
  - Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
  - Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
  - Audit evidence of matters, such as, estimation uncertainty, that may be required to be disclosed in the financial statements.
- ❖ Review assists in identifying circumstances/conditions that increase the susceptibility of AE, or indicate the presence of, possible management bias. The auditor's attitude of professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.
- ❖ Retrospective Reviews to identify risk of material misstatements due to fraud.
- ❖ High estimation uncertainty - more detailed review.
- ❖ A difference between the outcome of an accounting estimate and the amount recognised in the prior period financial statements does not necessarily represent a misstatement of the prior period financial statements.

## **Identifying and Assessing the Risks of Material Misstatement**

- ❖ Auditor to:
  - Evaluate degree of estimation uncertainty associated with an AE.
  - Determine whether any of the AE having high estimation uncertainty give rise to significant risks.

### **SA 540**

- ❖ The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:
  - The extent to which the accounting estimate depends on judgment.
  - The sensitivity of the accounting estimate to changes in assumptions.
  - The existence of recognised measurement techniques that may mitigate the estimation uncertainty.
  - The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
  - The availability of reliable data from external sources.
  - The extent to which the accounting estimate is based on observable or unobservable inputs.
- ❖ Matters that the auditor considers in assessing the risks of material misstatement may also include:
  - The actual or expected magnitude of an accounting estimate.
  - The recorded amount of the accounting estimate (that is, management's point estimate) in relation to the amount expected by the auditor to be recorded.
  - Whether management has used an expert in making the accounting estimate.
  - The outcome of the review of prior period accounting estimates.
- ❖ Examples of AE having high estimation uncertainty include, judgmental AE, AE not calculated through recognised measurement techniques, substantial difference between the original AE and actual outcome. Fair AE for which a highly specialised entity-developed model is used.
- ❖ Where the auditor determines that an accounting estimate gives rise to a significant risk, the auditor is required to obtain an understanding of the entity's controls, including control activities.
- ❖ Check for Going Concern assumption as per SA 570.

## **Responses to the Assessed Risks of Material Misstatement- I**

### **Auditor shall determine:**

- ❖ Whether mgt has appropriately applied requirement of applicable FRF relevant to AE.
- ❖ Whether methods for making AE are appropriate and have been applied consistently, and changes in AE or in the method for making them from the prior period are appropriate.

### **SA 540**

- ❖ In some situations, additional audit procedures, such as the inspection by the auditor of the current physical condition of an asset, may be necessary to determine whether management has appropriately applied the requirements of the applicable FRF.
- ❖ The application of the requirements of the applicable FRF requires management to consider changes in the environment or circumstances that affect the entity.
- ❖ Arbitrary changes in an AE result in inconsistent FS over time and may give rise to a FS misstatement or be an indicator of possible management bias.
- ❖ Use professional judgment in determining good reasons for change in AE.

## **Response to Assessed Risk- II**

- ❖ Consider events up to the date of AR.
- ❖ Evaluate appropriateness of management's method of measurement.
- ❖ Evaluate reasonableness of management's assumption.
- ❖ Test the operating effectiveness of controls.
- ❖ Develop a point or range of estimates.

### **SA 540**

- ❖ Develop a point estimate or a range to evaluate management's point estimate. For this purpose:
  - When the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate.
  - When the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.
- ❖ Consider whether specialised skills or knowledge in relation to one or more aspects of AE are required in obtaining SAAE.
- ❖ The auditor's decision as to which response, individually or in combination, to undertake to respond to the risks of material misstatement may be influenced by the nature of AE, the procedure(s) applied is expected to provide the auditor with SAAE, the assessed risk of material misstatement.
- ❖ Determining whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate may be an appropriate response when such events are expected to:
  - Occur; and
  - Provide audit evidence that confirms or contradicts the accounting estimate. (Apply procedures given in SA 560)
- ❖ When the applicable financial reporting framework does not prescribe the method of measurement, evaluating whether the method used, including any applicable model, is appropriate in the circumstances is a matter of professional judgment. Matters to be considered include:
  - Management's rationale for the method selected is reasonable.
  - Management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method.
  - The method is appropriate in the circumstances given the nature of the asset or liability being estimated and the requirements of the applicable financial reporting framework relevant to accounting estimates.
  - The method is appropriate in relation to the business, industry and environment in which the entity operates.
- ❖ Matters that the auditor may consider in evaluating the reasonableness of the assumptions used by management include, for example:
  - Whether individual assumptions appear reasonable.
  - Whether the assumptions are interdependent and internally consistent.
  - Whether the assumptions appear reasonable when considered collectively or in conjunction with other assumptions, either for that accounting estimate or for other accounting estimates.
  - In the case of fair value accounting estimates, whether the assumptions appropriately reflect observable market place assumptions.
- ❖ The assumptions on which accounting estimates are based may reflect what management expects will be the outcome of specific objectives and strategies.
- ❖ The reasonableness of the assumptions used may depend on management's intent and ability to carry out certain courses of action.
- ❖ Further, fair value accounting estimates may comprise observable inputs as well as unobservable inputs. Where fair value accounting estimates are based on unobservable inputs, matters that the auditor may consider include, for example, how management supports the following:
  - The identification of the characteristics of marketplace participants relevant to the accounting estimate.
  - Modifications it has made to its own assumptions to reflect its view of assumptions marketplace participants would use.
  - Whether it has incorporated the best information available in the circumstances.
  - Where applicable, how its assumptions take account of comparable transactions, assets or liabilities.
- ❖ Testing the operating effectiveness of the controls is required when:
  - The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls over the process are operating effectively; or
  - Substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.
- ❖ Developing a point estimate or a range may be an effective or efficient response to the assessed risks.
- ❖ The ability of the auditor to make a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable FRF.

## **Further Substantive Procedures to Respond to Significant Risks**

- ❖ Evaluation of estimation uncertainty:
  - How mgt. has considered alternative assumption/ outcomes and why he has rejected them.
  - How mgt has addressed estimation uncertainty in making AE.
  - Whether significant assumptions used by mgt are reasonable.
  - Mgt's intent to carry out specific courses of action and its ability to do so.
  - Development of a range with which to evaluate the reasonableness of the AE.

### **SA 540**

- ❖ Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. (e.g., one possible method used by management is to undertake a sensitivity analysis)
- ❖ Where management has not considered alternative assumptions or outcomes, it may be necessary for the auditor to discuss with management, and request support for, how it has addressed the effects of estimation uncertainty on the AE.
- ❖ Support for significant assumptions derived from management's knowledge may be obtained from management's continuing processes of strategic analysis and risk management.
- ❖ The auditor may view the efforts of management for addressing the effects of estimation uncertainty as inadequate. This may be the case, for example, where, in the auditor's judgment:
  - SAAE could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.
  - It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate.
  - It is unlikely that other audit evidence can be obtained.
  - Indicators of management bias in the making of accounting estimates may exist.
- ❖ The auditor's range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is misstated.

## **Substantive Procedure**

### **Recognition and Measurement Criteria**

- ❖ Auditor shall obtain SAAE whether the following are in accordance with the requirement of applicable FRF:
  - Mgt's decision to recognise, or to not recognise, the AE in the FS; and
  - Selected measurement basis for AE.

#### **SA 540**

- ❖ The focus of the auditor's evaluation is on whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable FRF.
- ❖ For non-recognized AE, the focus of the auditor's evaluation is on whether the recognition criteria of the applicable financial reporting framework have in fact been met. When the auditor concludes that this treatment is appropriate:
  - Disclosure in the notes to the FS.
  - Heed to add Emphasis of Matter Para. in the auditor's report.
- ❖ With respect to fair value AE, some financial reporting frameworks presume that fair value can be measured reliably as a pre-requisite to either requiring or permitting fair value measurements and disclosures. In some cases, this presumption may be overcome then the focus of the auditor's evaluation is on whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.

### **Evaluating the Reasonableness of AE and Determining Misstatements**

- ❖ Determine difference between management's estimate and auditor's estimate.
- ❖ Arbitrary change of AE by management.
- ❖ Misstatements may be caused by selection of accounting policies or on account of sampling or factual misstatements.

SA 540

### **Disclosures Related to Accounting Estimates**

- ❖ Obtain SAAE to ensure that:
  - Disclosures in the FS related to AE are in accordance with the requirements of the applicable FRF.
  - Evaluate adequacy of disclosure of estimation uncertainty.
  - Assumption; Method of Estimation; Basis for selection of method; Effect of change; Range of outcomes; FVAE; Qualitative & Quantitative Disclosures.
  - Evaluate the adequacy of the disclosure in respect of AE giving rise to significant risk of their estimation uncertainty in the FS in the context of the applicable FRF.

SA 540

## **Indicators of Possible Management Bias**

- ❖ Review the judgments and decisions made by mgt in making of AE to identify whether there are indicators of possible management bias.
- ❖ Indicators of possible management bias do not themselves constitute misstatements for purposes of drawing conclusions on reasonableness of individual AE.

**SA 540**

- ❖ Examples of indicators of possible management bias with respect to accounting estimates include:
  - Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.
  - Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
  - Selection or construction of significant assumptions that yield a point estimate favourable for management objectives.
  - Selection of a point estimate that may indicate a pattern of optimism or pessimism.

## **Written Representations**

- ❖ Obtain written representations from mgt and, where appropriate, TCWG whether they believe significant assumptions used in making AE are reasonable.
- ❖ Appropriateness of measurement process.
- ❖ Assumption reflect management's intent.
- ❖ Disclosures are complete and appropriate.
- ❖ No subsequent events require adjustment.

**SA 540**

- ❖ For those accounting estimates not recognised or disclosed in the FS, written representations may also include representations about:
  - The appropriateness of the basis used by management for determining that the recognition or disclosure criteria of the applicable FRF have not been met.
  - The appropriateness of the basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's applicable FRF, for those AE not measured or disclosed at fair value.



## **Documentation**

- ❖ Basis for the auditor's conclusions about the reasonableness of AE and their disclosure that give rise to significant risks; and
- ❖ Indicators of possible management bias, if any.

**SA 540**

# **SA 550**

## **Related Parties (RP)**

*Effective for audits of financial statements for periods beginning on or after April 1, 2010*

## **Overview of SA 550**

- ❖ **Introduction**
  - Scope
  - Effective Date
- ❖ **Objectives**
- ❖ **Definitions**
- ❖ **Requirements**
  - Risk Assessment Procedures and Related Activities
  - Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions
  - Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions
  - Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions
  - Written Representations
  - Communication with Those Charged with Governance
  - Documentation
- ❖ **Application & Other Explanatory Material on these aspects.**

SA 550

## **Scope**

- ❖ Deals with Auditor's responsibilities:
  - Regarding RP relationships and transactions,
  - When performing audit of FS.
- ❖ Provides application guidance:
  - Wrt risk of material misstatements associated with RP relationships and transactions, *vis-à-vis* SA 315, SA 330 and SA 240.

SA 550

### **Responsibilities of Auditor**

- ❖ Perform procedures to identify, assess and respond to RMM on account of failure to account for or disclose RP relationship, transaction and balances as laid down by FRF.
- ❖ Evaluate presence of fraud risk factors as per SA 240.
- ❖ Even if FRF establishes minimal or no requirements:
  - Conclude whether FS achieve a true & fair view; and
  - Are not misleading.
- ❖ Auditor's inability to detect material misstatements is greater in case of RP relationship/Transactions.

SA 550

### **Auditor's Objectives**

- ❖ Obtain an understanding of RP relationships & transactions (**irrespective of whether FRF establishes RP requirements**) sufficient to be able to:
  - Recognize fraud risk factors.
  - Conclude whether FS:
    - Achieve a true and fair presentation; and
    - Are not misleading.
- ❖ **Where FRF establishes RP requirements:**
  - Obtain SAAE whether RP relationships & transactions have been,
  - Appropriately identified, accounted for & disclosed in FS in accordance with FRF.

SA 550

## Definitions

❖ **Arm's length transaction:**

- Transaction conducted on such terms & conditions;
- As between a willing buyer and willing seller;
- Who are unrelated; and
- Acting independently and pursuing their own best interests.

❖ **Related Party:**

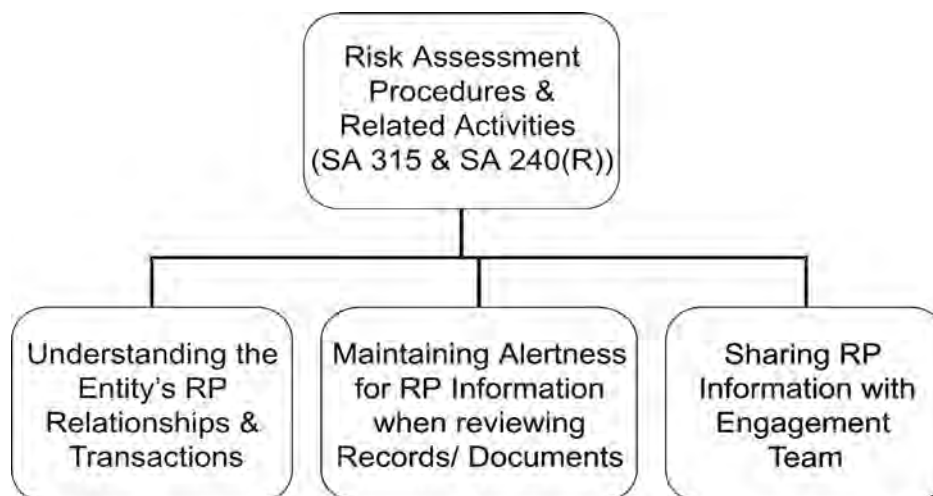
- A related party as defined in applicable FRF (AS 18).

**OR**

- Where applicable FRF establishes minimal or no RP requirements:
  - A person/entity having control/significant influence, directly or indirectly, over reporting entity;
  - Entity over which reporting entity has control/significant influence, directly or indirectly; and
  - Entity under common control with reporting entity.

SA 550

## Risk Assessment Procedures (RAPs) & Related Activities



SA 550

## **Understanding Entity's RP Relationships & Transactions**

- ❖ SA 315 & SA 240 require Engagement Team discussion.
- ❖ Auditor to inquire management regarding:
  - Identity of entity's RP, changes from prior period.
  - Nature of relationships between entity and RP.
  - Type & purpose of transactions with RP during the period.
- ❖ Perform appropriate RAPs to obtain understanding whether managements has established controls to:
  - Identify, account for and disclose RP relationships & transactions.
  - Authorise & approve significant transactions/arrangements with RP.
  - Authorise & approve significant transactions/arrangements **outside normal course of business.**

### **SA 550**

- ❖ Considerations Specific to Smaller Entities:
  - Role of governance undertaken by owner-manager.
  - No documented process to identify RP.
  - Auditor to obtain understanding through inquiries, observation and inspection of documentation.

## **Maintaining Alertness for RP Information when reviewing records/documents**

- ❖ Auditor to remain alert when inspecting records/documents:
  - Wrt arrangements/information indicating existence of RP relationships or transactions.
  - Not previously identified or disclosed to auditor.
- ❖ If auditor identifies significant transactions outside entity's normal course of business:
  - Inquire of management about:
    - Nature of these transactions, and
    - Whether RP could be involved.

### **SA 550**

- ❖ In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:
  - Bank, legal and third party confirmations obtained as part of the auditor's procedures;
  - Minutes of meetings of shareholders and of TCWG; and
  - Such other records or documents considers necessary by auditor in circumstances of entity.

## **Identification/Assessment of Risks of Material Misstatement associated with RP**

- ❖ Auditor to identify & assess risks of material misstatement associated with RP relationships & transactions:
  - Determine whether risks are significant.
  - Identified significant RP transactions outside normal course of business – giving rise to significant risk.
- ❖ If fraud risk factors identified:
  - Consider such information when identifying & assessing risks of material misstatement due to fraud in accordance with SA 240.

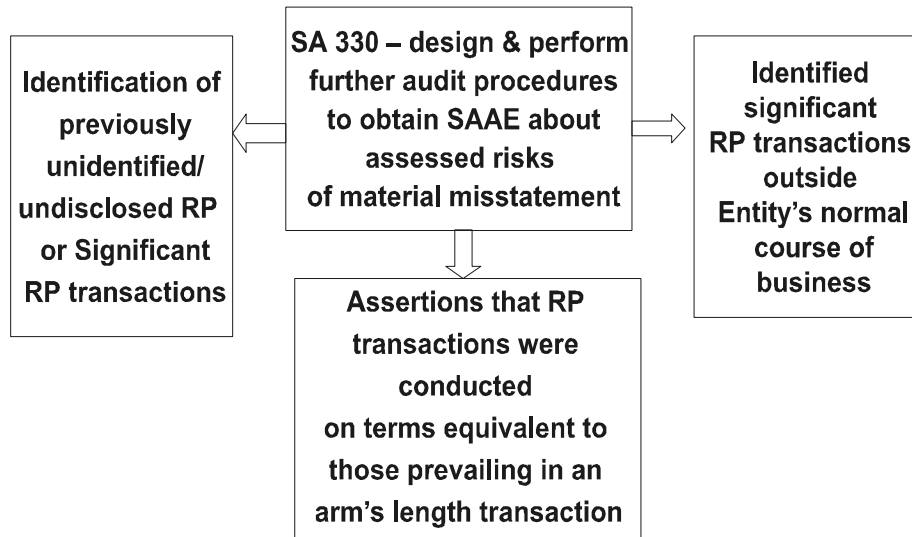
**SA 550**

## **Fraud Risk Factors associated with RP with Dominant influence**

- ❖ Domination of mgmt by a single person or small group of persons without compensating controls is a fraud risk factor.
- ❖ Indicators of dominant influence:
  - RP has vetoed significant business decisions taken by mgmt or TCWG.
  - Significant transactions are referred to RP for final approval.
  - No/ little debate among mgmt or TCWG regarding business proposal initiated by RP.
  - Transactions involving the RP (or a close family member of RP) are rarely independently reviewed/approved.

**SA 550**

## **Responses to Risks of Material Misstatement associated with RP**



SA 550

## **Identification of unidentified/ undisclosed RP or RP transactions**

- ❖ Determine whether underlying circumstances confirm existence of relationship/transaction.
- ❖ If auditor identifies, unidentified/ undisclosed RP or RP transactions:
  - Promptly communicate relevant info to other members of engagement team.
  - Where FRF establishes RP requirements:
    - Request mgt to identify all transactions with newly identified RP for further evaluation.
    - Inquire reason for failure of entity's controls to identify/disclose RP relationships & transactions.
  - Perform appropriate substantive audit procedures relating to newly identified RP or significant RP transactions.
  - Re - consider risk that other RP or significant RP transactions may exist that mgt has not previously identified/ disclosed.
  - If non-disclosure by mgt appears intentional, evaluate implications for audit.

SA 550

### **Significant RP Transactions outside normal course of business**

- ❖ Inspect underlying contracts/agreements and evaluate whether:
  - Business rationale (or lack thereof) suggests that transactions entered to engage in fraudulent financial reporting or to conceal misappropriation of assets.
  - Terms of transactions consistent with management's explanations.
  - Transactions appropriately accounted for/disclosed in accordance with FRF.
- ❖ Obtain evidence that transactions appropriately authorised & approved.

**SA 550**

### **Arm's length transaction assertion**

- ❖ When mgt has made an assertion in FS that RP transaction was conducted on terms equivalent to those prevailing in arm's length transaction.
  - Auditor to obtain SAAE about the assertion.
- ❖ Mgt support for assertion may include:
  - Comparing terms to those of identical/ similar transaction or to known market terms.
  - Engaging an external expert to determine market value & to confirm market terms & conditions.

**SA 550**



## **Evaluation of Accounting & Disclosure of Identified RP Relationships and Transactions**

- ❖ In forming opinion in accordance with SA 700, evaluate:
  - Whether Identified RP relationships & transactions have been appropriately accounted for/ disclosed in accordance with FRF.
  - Whether effects of RP relationships/ transactions:
    - Prevent FS from achieving true & fair presentation; or
    - Cause FS to be misleading.

SA 550

## **Written Representations**

- ❖ Where FRF establishes RP requirements:
  - Obtain written representations from mgt and TCWG that they have:
    - Disclosed to auditor identity of entity's RP and all RP relationships & transactions of which they are aware.
    - Appropriately accounted for & disclosed such relationships and transactions in accordance with FRF.

SA 550

## **Communication with TCWG**

- ❖ Unless all TCWG involved in managing entity:
  - Communicate with TCWG significant matters in connection with entity's RP.

**SA 550**

## **Documentation**

- ❖ To meet documentation requirements of SA 230 and other SAs:
  - Include names of identified RP; and
  - Nature of RP relationships.

**SA 550**

# SA 560

## Subsequent Events (SE)

*Effective for audits of financial statements for periods beginning on or after April 1, 2009*

## Overview of SA 560

- ❖ **Introduction**
  - Scope
  - Effective date
- ❖ **Objectives**
- ❖ **Definitions**
- ❖ **Requirements**
  - Events occurring between the date of the Financial Statements and the date of the Auditor's Report
  - Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued
  - Facts Which Become Known to the Auditor After the Financial Statements have been Issued
- ❖ **Application and Other Explanatory Material on these Aspects**

SA 560

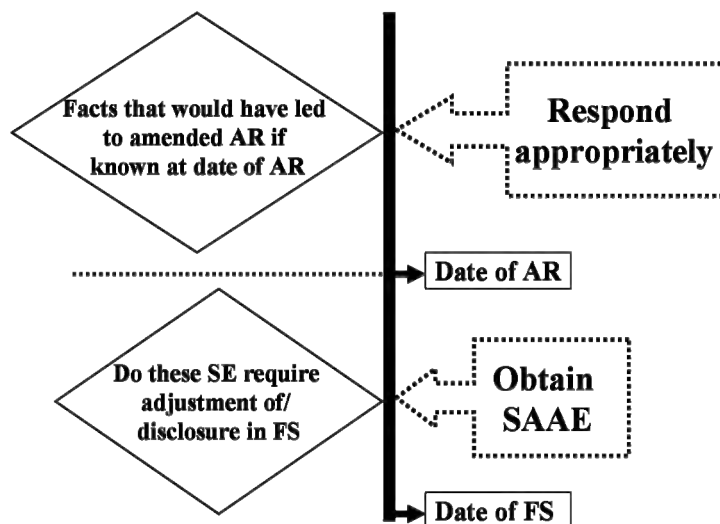
## Scope

- ❖ **Auditor's responsibilities relating to SE in audit of FS:**
  - Consider additional responsibilities if audited FS included in other documents after the issuance of FS.
- ❖ **SE:**
  - TYPE 1: provide evidence of conditions that existed at date of FS.
  - TYPE 2: provide evidence of conditions that arose after date of FS.

SA 560

- ❖ **Other Documents:**
  - For example, the auditor may be required to perform additional audit procedures to the date of the final offering document. These procedures may include those referred to in paragraphs 6 and 7 performed up to a date at or near the effective date of the final offering document, and reading the offering document to assess whether the other information in the offering document is consistent with the financial information with which the auditor is associated.
- ❖ **SEs:**
  - SE can affect FS. Many FRFs provide for SEs.

## Objectives



SA 560

- ❖ The Thick Line depicts subsequent events.

## Definitions

❖ **Date of FS:**

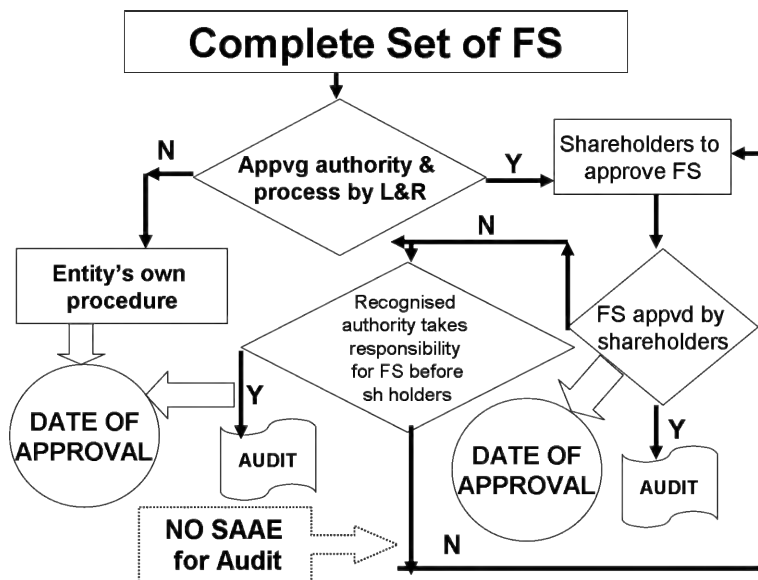
- Date of end of latest period covered by FS.

❖ **Date of Approval of FS:**

Date on which

- Complete set of FS including the related notes prepared; and
- Appropriate persons assert responsibility for above complete set of FS.

SA 560



SA 560

❖ **Date of Auditor's Report:**

- Date of AR on FS in accordance with SA 700.
- Cannot be before SAAE obtained to form opinion.
- Cannot be earlier than the date of approval of FS.

❖ **Date of Issuance of FS:**

- When AR & audited FS made available to 3<sup>rd</sup> parties.

**SA 560**

❖ **Date of AR:**

- A time period may elapse due to administrative issues between date of AR & date the AR is provided to entity. (this time period has significance in the context of date of issuance of FS).

❖ **Date of Issuance of FS:**

- Depends on the regulatory environment of an entity.
- Only be at or later than the date of auditor's report and also be at or later than the date the auditor's report is provided to the entity.
- In case of certain entities, may be date of presentation of audited financial statements to the legislature or otherwise made public.

## **Subsequent Events**

❖ **Events** that occur between:

- The date of FS; **and**
- The date of AR

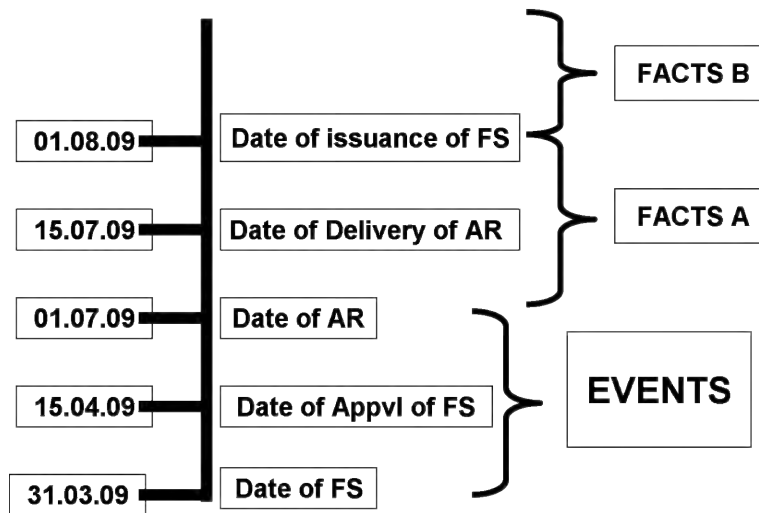
AND

❖ **Facts** that become known to auditor after date of AR.

**SA 560**

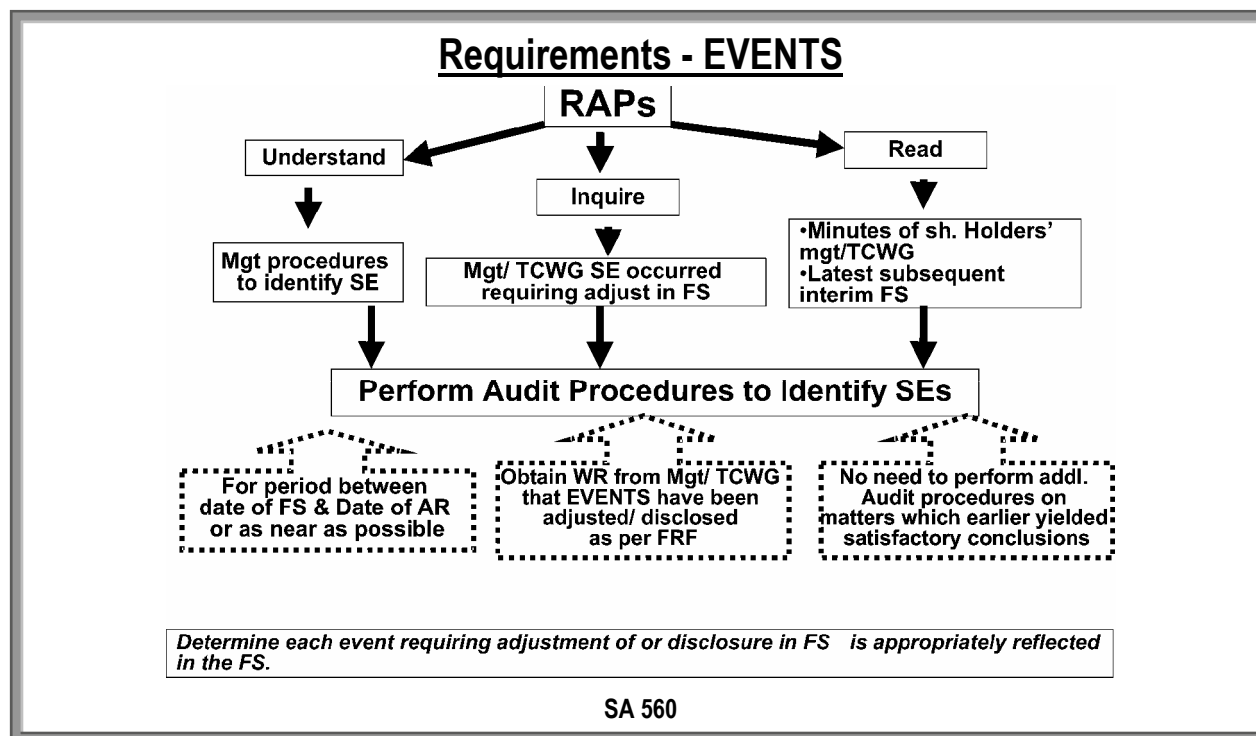
- ❖ Note that the definition uses two distinct expressions, viz., EVENTS *vis a vis* FACTS. In respect of the time period between the date of FS & date of AR, the term used is EVENTS implying that something happens during that period. As against this, the expression used for the period after the date of AR, is FACTS, implying that it is not necessary that something should have happened in that period. It means that something could have happened or existed even before the date of AR but which became known to the auditor only after the AR has been signed.
- ❖ This also implies that the auditor does not have any responsibility w.r.t. events happening after the date of AR.

### Dates covered by SA 560



SA 560

- ❖ To consider **Events** only if they require adjustment/ disclosure in FS.
- ❖ To consider **Facts** only if they would have impacted the AR.



**Reading:**

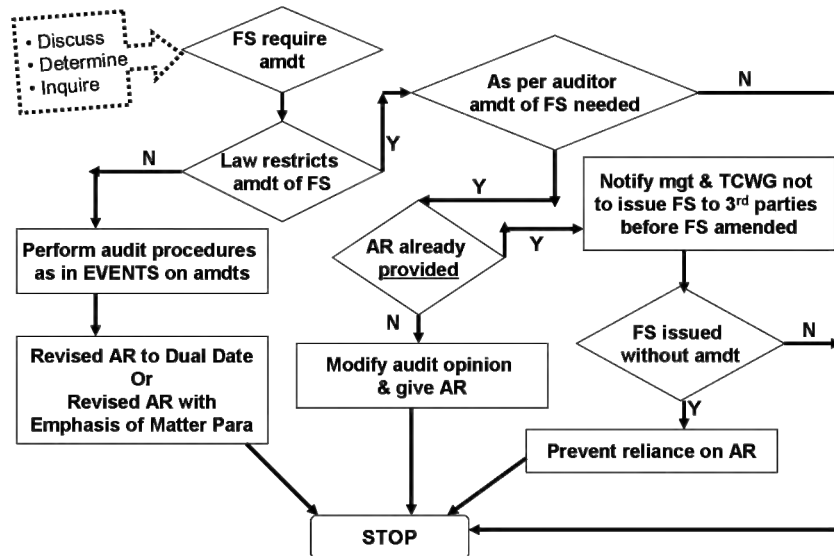
- ❖ If no interim financial info / minutes of mtgs available, inspect available books & records including bank statements. Additional matters to consider:
  - Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements;
  - Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims; or
  - Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.
  - In case of certain entities, auditor may read the official records of relevant proceedings of the legislature and inquire about the matters addressed in proceedings for which official records are not yet available.

**Inquiry of Mgt/ TCWG:**

- ❖ The auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters:
  - Whether new commitments, borrowings or guarantees have been entered into.
  - Whether sales or acquisitions of assets have occurred or are planned.
  - Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
  - Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
  - Whether there have been any developments regarding contingencies.
  - Whether any unusual accounting adjustments have been made or are contemplated.
  - Whether any events have occurred or are likely to occur that will bring into question the appropriateness of accounting policies used in the financial statements, as would be the case, for example, if such events call into question the validity of the going concern assumption.
  - Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
  - Whether any events have occurred that are relevant to the recoverability of assets.



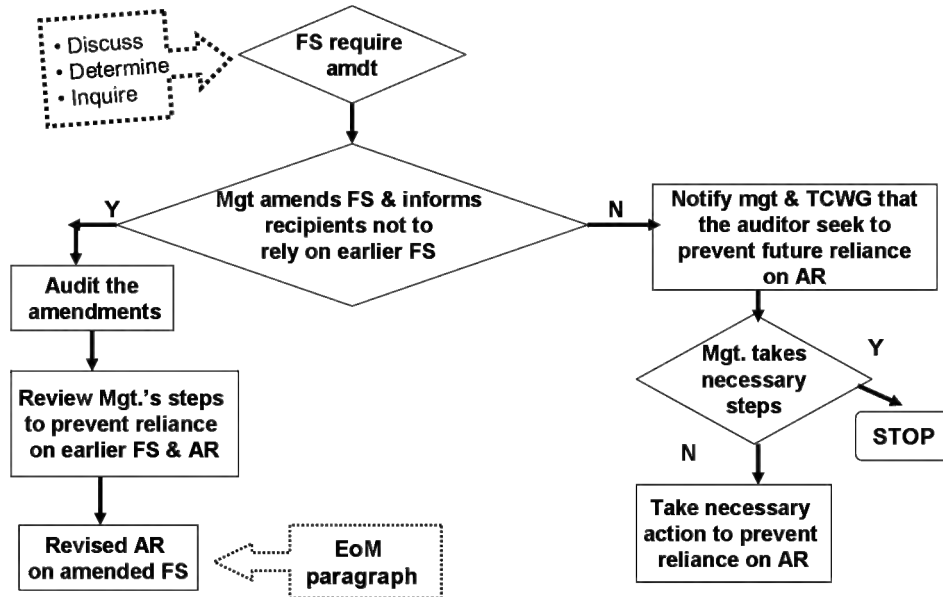
## Requirements – FACTS A



SA 560

- ❖ No obligation to perform audit procedures re FS after date of AR.
- ❖ **Discuss** : matter with mgt/ TCWG.
- ❖ **Determine** : if FS need amdt, if yes then.
- ❖ **Inquire** : how mgt intends to address the matter in FS.
- ❖ Mgt needs to inform the auditor about all the relevant facts of which it become aware during the period from the date of AR and date of FS are issued.
- ❖ **Dual Dating** - When, the auditor amends the auditor's report to include an additional date restricted to that amendment, the date of the auditor's report on the financial statements prior to their subsequent amendment by management remains unchanged because this date informs the reader as to when the audit work on those financial statements was completed. However, an additional date is included in the auditor's report to inform users that the auditor's procedures subsequent to that date were restricted to the subsequent amendment of the financial statements.
- ❖ When management has issued the financial statements despite the auditor's notification not to issue the financial statements to third parties, the auditor may consider to seek legal advice.

## Requirements – FACTS B



SA 560

- ❖ **Discuss** : matter with mgt/ TCWG.
- ❖ **Determine** : if FS need amdt, if yes then.
- ❖ **Inquire** : how mgt intends to address the matter in FS.
- ❖ When the auditor believes that management, or those charged with governance, have failed to take the necessary steps to prevent reliance on the auditor's report on financial statements previously issued by the entity despite the auditor's prior notification, the auditor may consider it appropriate to seek legal advice.

# SA 570

## Going Concern (GC)

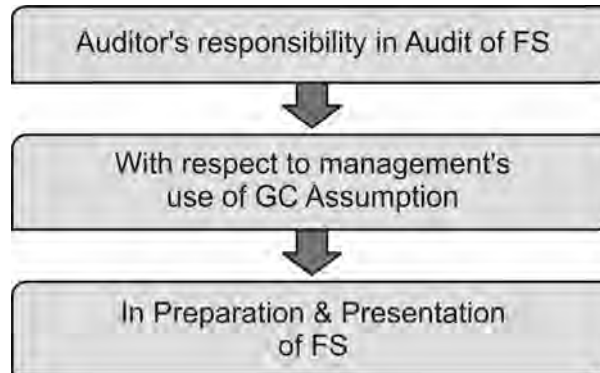
*Effective for audits of financial statements for periods beginning on or after April 1, 2009*

## Overview of SA 570

- ❖ **Introduction**
  - Scope
  - Effective Date
- ❖ **Objectives**
- ❖ **Requirements**
  - Risk Assessment Procedures and Related Activities
  - Evaluating Management's Assessment
  - Period Beyond Management's Assessment
  - Additional Audit Procedures when Events or Conditions are Identified
  - Audit Conclusions and Reporting
  - Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists
  - Use of Going Concern Assumption Inappropriate
  - Management Unwilling to Make or Extend Its Assessment
  - Communication with Those Charged with Governance
  - Significant Delay in the Approval of the Financial Statements
- ❖ **Application & Other Explanatory Material on these Aspects**

SA 570

### Scope of this SA



SA 570

- ❖ GC Assumption:
  - Entity is viewed as continuing in business for the foreseeable future.

### Responsibilities of Management

- ❖ GC - a fundamental principle in preparation of Financial Statements.
- ❖ Management to make a specific assessment of GC Assumption.
- ❖ Judgment about inherently uncertain future outcome of events/conditions:
  - Period- at least 12 months from date of FS.
  - Based on – information available at particular point of time.
  - Affected by – size & complexity of entity, Nature & Condition of business.

SA 570

#### **Responsibilities of Management:**

- ❖ The financial reporting framework may require the mgt to make an assessment of the entity's ability to continue as a GC and prepare the financial statements on a GC basis unless the management intends to liquidate the entity or cease operations, or has no realistic alternative but to do so. In case in other financial reporting framework, there is no such explicit requirement for the mgt., mgt. is still required to prepare and present FS on GC basis.
- ❖ Appropriate disclosure together with the reason thereof, in case the FS are not prepared on a GC basis.
- ❖ The detailed requirements may also be set out in law or regulation.

## Responsibilities of Auditor

**Obtain Sufficient Appropriate Audit Evidence (SAAE) about appropriateness of management's use of GC assumption**



**Conclude whether there is material uncertainty about entity's ability to continue as GC**

*Absence of any GC uncertainty reference in Auditor's report not to be viewed as guarantee to entity's ability to continue as GC*

SA 570

## Auditor's Objective

- ❖ **Obtain SAAE:**
  - About appropriateness of use of GC Assumption in preparation & presentation of FS.
- ❖ **Conclude, based on evidence:**
  - Whether a material uncertainty exists that may cast significant doubt on entity's ability to continue as GC.
- ❖ **Determine:**
  - Implications for the auditor's report.

SA 570

## **Risk Assessment Procedures- I**

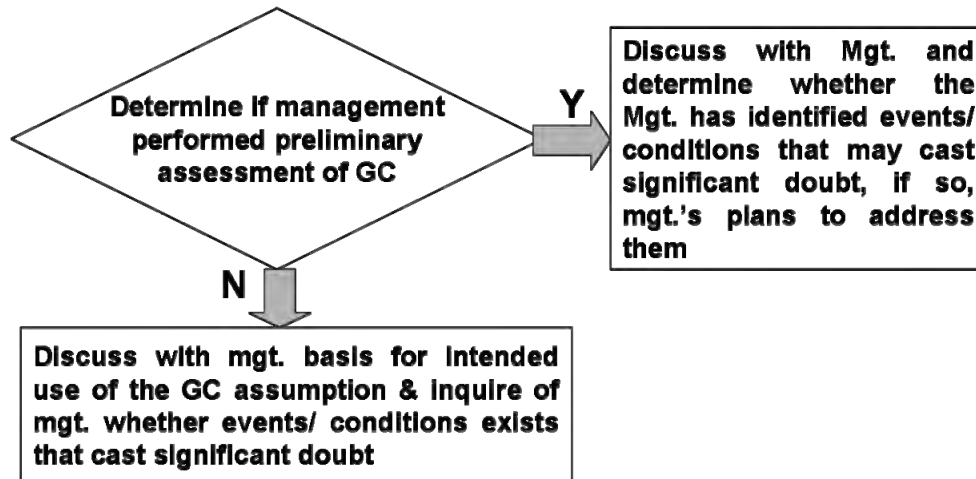
- ❖ Determine events/conditions that cast doubt on entity's ability to continue as GC:
  - Financial, Operating, Other.
- ❖ Auditor to remain alert throughout audit for these events /conditions.
- ❖ Smaller Entities:
  - Ability to withstand or respond quickly but may lack resources to sustain operations.
  - Risk of possible loss of principal supplier, major customer, key employee, right to operate under a license or withdrawal of support by banks or lending agencies.

### **SA 570**

#### **Examples of Events/ Conditions**

- ❖ **Financial:**
  - Net liability or net current liability position.
  - Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
  - Indications of withdrawal of financial support by creditors.
  - Negative operating cash flows indicated by historical or prospective financial statements.
  - Adverse key financial ratios.
  - Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
  - Arrears or discontinuance of dividends.
  - Inability to pay creditors on due dates.
  - Inability to comply with the terms of loan agreements.
  - Change from credit to cash-on-delivery transactions with suppliers.
  - Inability to obtain financing for essential new product development or other essential investments.
- ❖ **Operating:**
  - Management intentions to liquidate the entity or to cease operations.
  - Loss of key management without replacement.
  - Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
  - Labour difficulties.
  - Shortages of important supplies.
  - Emergence of a highly successful competitor.
- ❖ **Other:**
  - Non-compliance with capital or other statutory requirements.
  - Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
  - Changes in law or regulation or government policy expected to adversely affect the entity.
  - Uninsured or underinsured catastrophes when they occur.
- ❖ **Procedures under SA 315 and SA 330 need to be followed.**

## Risk Assessment Procedures- II



SA 570

## Evaluating Management's Assessment

- ❖ Evaluate management's assessment of entity's ability to continue as GC.
- ❖ Assessment period:
  - Cover same period as that used by management as per the FRF; or longer period if required by law/regulation.
  - If period less than 12 months from the date of FS then request management to extend it to at least 12 months from that date.
- ❖ Consider whether assessment includes all relevant information of which auditor is aware as result of audit.

SA 570

- ❖ Auditor is not responsible for rectifying the lack of analysis by mgt. to support its assessment for concluding whether management's use of the going concern assumption is appropriate in the circumstances. In this case, the auditor's evaluation of the appropriateness of management's assessment may be made without performing detailed evaluation procedures if the auditor's other audit procedures are sufficient to enable the auditor to conclude whether mgt.'s use of the going concern assumption in the preparation of the financial statements is appropriate in the circumstances.
- ❖ Evaluation may include:
  - Evaluation of the process management followed to make its assessment.
  - Assumptions on which the assessment is based and management's plans for future action.
  - Whether management's plans are feasible in the circumstances.

### **Smaller Entities**

- ❖ Evaluate management's assessment of entity's ability to continue as GC:
  - Discuss medium and long-term financing of entity with management – *consistent with auditor's understanding*.
  - Assess supporting documentation.
- ❖ Evaluate owner-manager's ability to meet the obligation under support arrangement.

**SA 570**

### **Period beyond Management's Assessment**

- ❖ Inquire of management as to its knowledge of events/conditions beyond period of management's assessment:
  - If events/conditions identified - request management to evaluate potential significance.
  - No responsibility to perform any other audit procedure except inquiry.

**SA 570**



## Additional Audit Procedures - I

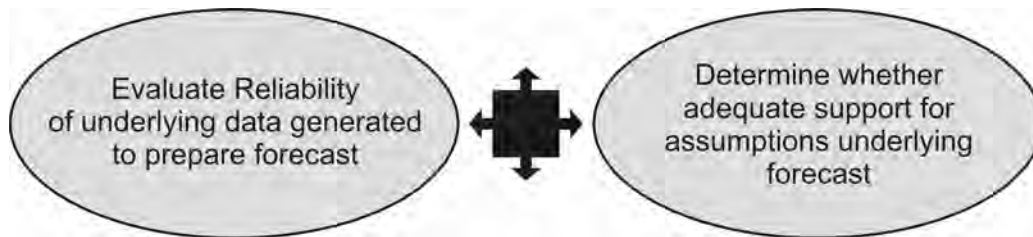
- ❖ Request mgt. to make GC assessment if not yet performed.
- ❖ Evaluate mgt's plans for future actions (*e.g., restructuring, expenditure reduction*):
  - Outcome likely to improve situation.
  - Feasible in the circumstances.
- ❖ Consider whether any additional facts/information available since date of mgt assessment.

### SA 570

- ❖ **Additional audit procedures may include the following:**
  - Analysing and discussing cash flow, profit and other relevant forecasts with management.
  - Analysing and discussing the entity's latest available interim financial statements.
  - Reading the terms of debentures and loan agreements and determining whether any have been breached.
  - Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
  - Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
  - Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
  - Evaluating the entity's plans to deal with unfilled customer orders.
  - Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.
  - Confirming the existence, terms and adequacy of borrowing facilities.
  - Obtaining and reviewing reports of regulatory actions.
  - Determining the adequacy of support for any planned disposals of assets.

## Additional Audit Procedures - II

- ❖ Analysis of cash flow forecast prepared by the entity.



- ❖ Request Written Representations from mgt. or, where appropriate, TCWG regarding plans for future action and their feasibility.

SA 570

### ❖ **The Period of Management's Assessment:**

- In addition to the procedures required to evaluate mgt's plans for future actions, the auditor may compare:
  - The prospective financial information for recent prior periods with historical results; and
  - The prospective financial information for the current period with results achieved to date.
- Where management's assumptions include continued support by third parties and such support is important to an entity's ability to continue as a GC, auditor may need to:
  - Consider requesting written confirmation from those third parties; and
  - Obtain evidence of their ability to provide such support.

## Audit Conclusions and Reporting

- ❖ Conclude whether in Auditor's judgment material uncertainty exists related to events/conditions which individually/collectively casts significant doubt on GC assumption.
  - **Material uncertainty** – Magnitude of potential impact & likelihood of occurrence is such that, in auditor's judgment, appropriate disclosure of nature and implications of uncertainty is necessary for disclosure of true and fair view.

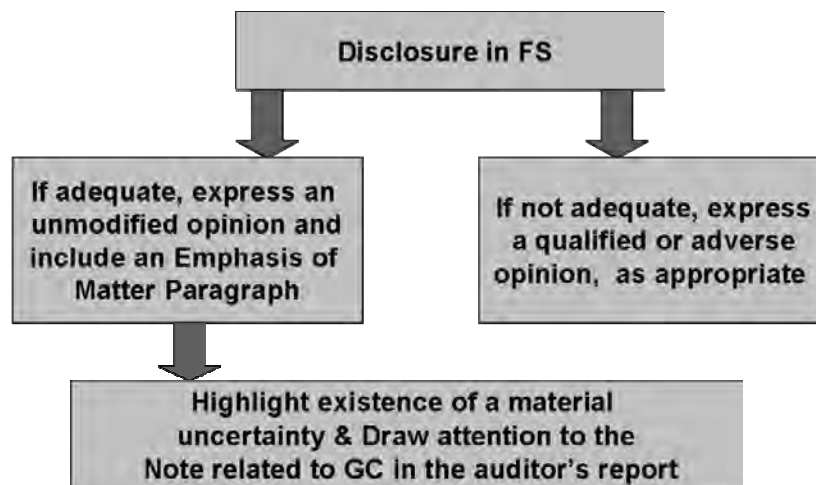
SA 570

## **Use of GC assumption appropriate but material uncertainty exists- I**

- ❖ Determine whether FS:
  - Adequately describe principal events/conditions that cast significant doubt on entity's ability to continue as GC & Mgt's plans to deal with these events/conditions.
  - Disclose clearly that there is material uncertainty:
    - Entity may be unable to realise its assets and discharge its liabilities in the normal course of business.

SA 570

## **Use of GC assumption appropriate but material uncertainty exists-II**



SA 570

- ❖ In situations involving multiple material uncertainties that are significant to the financial statements as a whole, the auditor may consider it appropriate in extremely rare cases to express a disclaimer of opinion instead of adding an Emphasis of Matter paragraph.

### **Use of GC Assumption Inappropriate**

- ❖ If FS prepared on a GC basis but, in auditor's judgment, use of GC assumption in FS is inappropriate:
  - Express an adverse opinion.
- ❖ If mgmt is required/elects to prepare FS – then FS may be prepared on an alternative basis (e.g. liquidation basis):
  - Express unmodified opinion along with emphasis of matter paragraph highlighting alternative basis provided disclosure is adequate.

**SA 570**

### **Management unwilling to Make or Extend its Assessment**

- ❖ Failure to obtain SAAE.
- ❖ Management unwilling to make or extend assessment of entity's ability to continue as GC:
  - Consider implications for the auditor's report:
    - Qualified opinion or Disclaimer of opinion.

**SA 570**

## **Communication with Those Charged with Governance**

- ❖ Unless all TCWG involved in managing entity, communicate with TCWG events/conditions that cast significant doubt on GC assumption:
  - Whether events/conditions constitute material uncertainty.
  - Whether use of GC assumption appropriate in preparation and presentation of FS.
  - Adequacy of related disclosures in FS.

SA 570

## **Significant Delay in Approval of FS**

**Significant Delay In approval of FS by mgt. or TCWG  
after date of FS**



**Auditor to Inquire reasons for delay**



**If delay related to events/conditions relating to GC  
assessment, auditor to perform additional audit  
procedures and consider effect on auditor's conclusion  
regarding existence of material uncertainty**

SA 570

# SA 580

## Written Representations

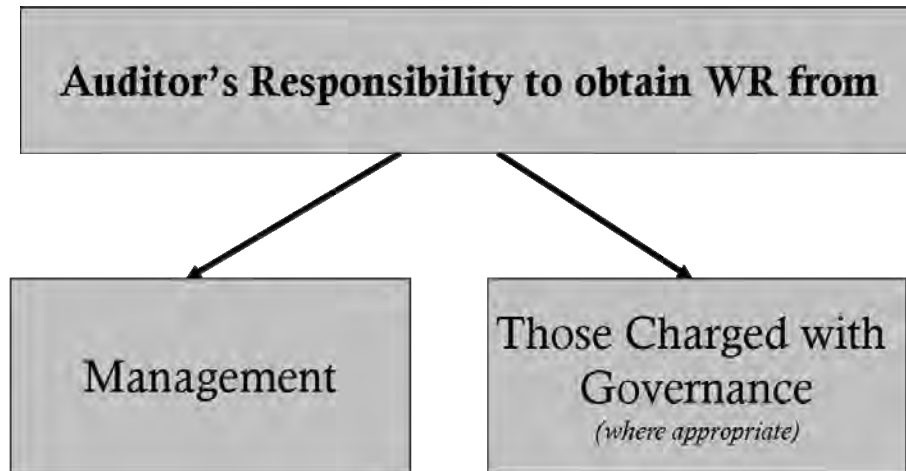
*Effective for audits of financial statements for periods beginning on or after April 1, 2009*

## Overview of SA 580

- ❖ **Introduction**
  - Scope
  - Written Representations (WR) as Audit Evidence
  - Effective Date
- ❖ **Objectives**
- ❖ **Definitions**
- ❖ **Requirements**
  - Management from whom WR Requested
  - WR about Management's Responsibilities
  - Other WR
  - Date of and Period(s) Covered by WR
  - Form of WR
  - Doubt as to the Reliability of WR and Requested WR Not Provided
- ❖ **Application & Other Explanatory Material on these Aspects**

SA 580

## Scope



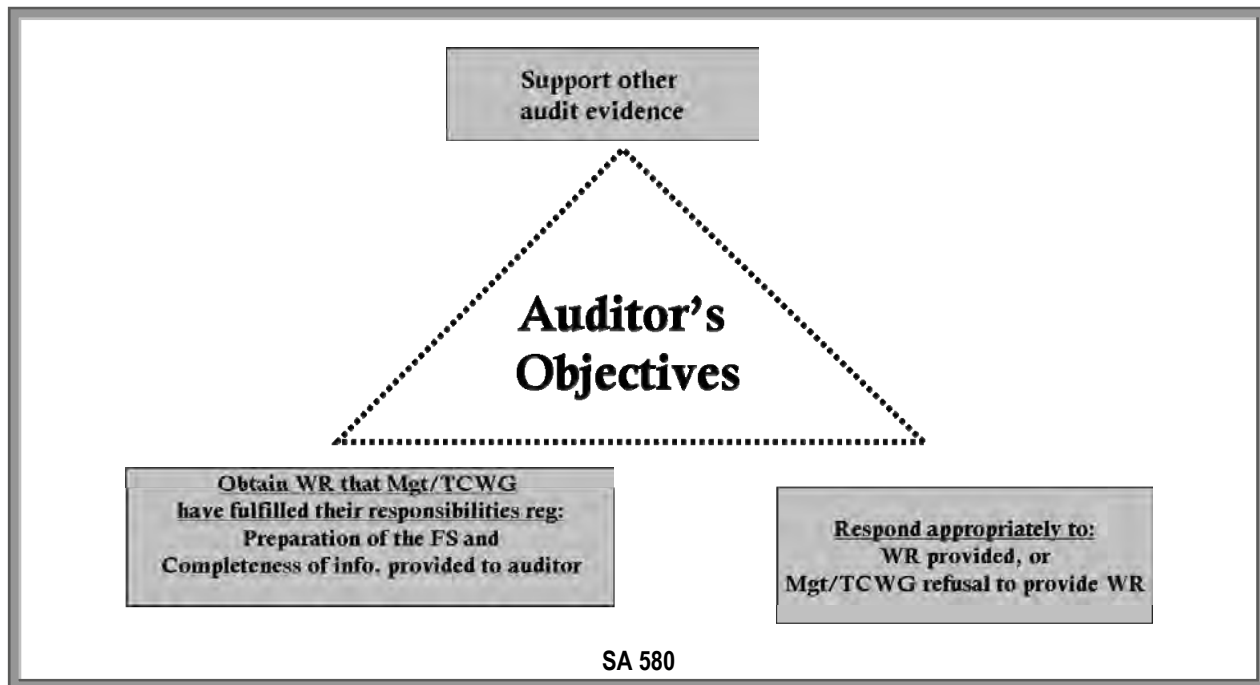
SA 580

## WR as Audit Evidence

- ❖ WR are necessary audit evidence:
  - But not sufficient appropriate audit evidence.
- ❖ WR do not dilute auditor's responsibility to obtain other audit evidence for matters covered by WR.
- ❖ Management *modifies* or *does not* provide the requested WR - possibility of existence of one or more significant issues.

SA 580

- ❖ WR are necessary information that the auditor requires in connection with the audit of the entity's financial statements.
- ❖ WR will enhance the quality of the representation.



## Definitions

### **Written Representations:**

- ❖ Written statement by management.
- ❖ Provided to the auditor.
- ❖ To confirm certain matters or to support other audit evidence.
- ❖ Do not include:
  - Financial statements
  - The assertions therein
  - Supporting books and records.

SA 580



## **Management from Whom Written Representations Requested- I**

Management with:

- ❖ Appropriate responsibilities for the financial statements; and
- ❖ Knowledge of the matters concerned.

### **(Responsible Party)**

- Depending on the governance structure of the entity and relevant law and regulation.
- Sufficient knowledge of financial reporting process.
- TCWG may also be responsible for preparation and presentation of the FS.
- Management may approach relevant experts – actuaries, internal counsel, staff engineers.

**SA 580**

- ❖ Mgt. (rather than TCWG) is often the responsible party, WR may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as TCWG, are also responsible for the preparation and presentation of the FS.

## **Management from whom Written Representations Requested- II**

- ❖ Management's use of "To the best of knowledge & belief" in WR is acceptable.
- ❖ Auditor may request mgt to include in the WR, confirmation that it has made such inquiries as it considered appropriate.

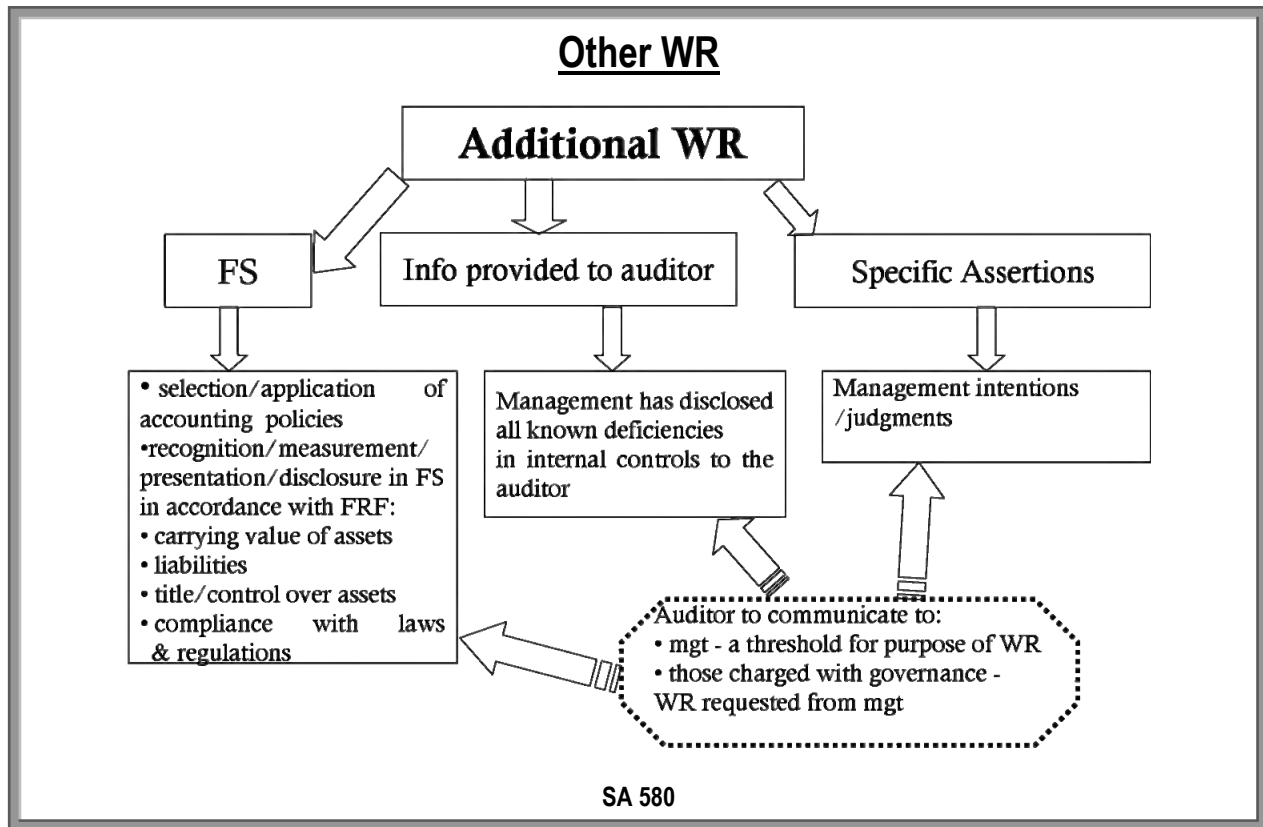
**SA 580**

## **WR about Management's Responsibilities**

- ❖ Preparation of the FS:
  - Compliance with applicable FRF.
- ❖ Information provided & completeness of transactions:
  - Has provided all relevant information and access as agreed in terms of audit engagement.
  - All transactions recorded & reflected in FS.
- ❖ Description of management's responsibilities in WR.

### **SA 580**

- ❖ The auditor may also ask management to re-confirm its acknowledgement and understanding of those responsibilities in written representations. This is particularly appropriate when:
  - Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
  - The terms of the audit engagement were prepared in a previous year;
  - There is any indication that management misunderstands those responsibilities; or
  - Changes in circumstances make it appropriate to do so.

**WR about Specific Assertions**

- ❖ When obtaining evidence about, or evaluating, judgments and intentions, the auditor may consider one or more of the following:
  - The entity's past history in carrying out its stated intentions.
  - The entity's reasons for choosing a particular course of action.
  - The entity's ability to pursue a specific course of action.
  - The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent.

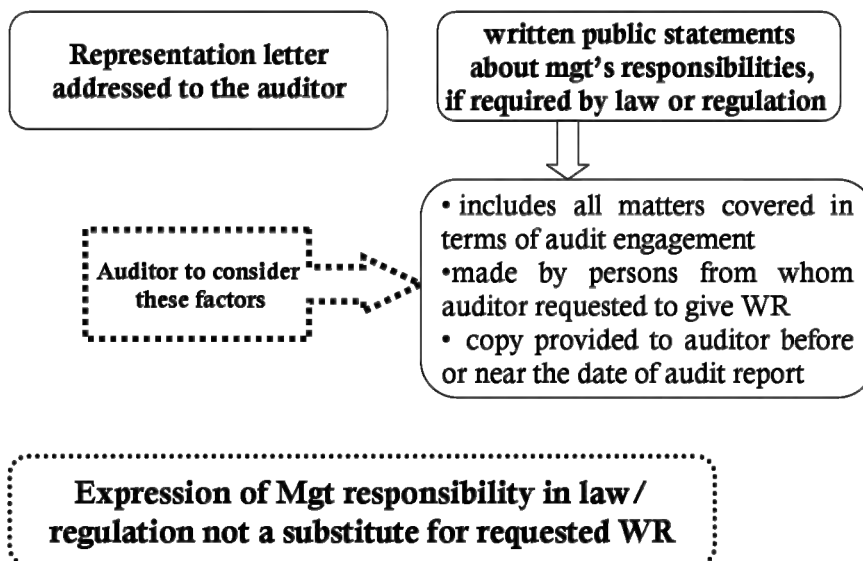
## Date of and Period(s) Covered by WR

- ❖ As near as practicable to, but not after the date of the auditor's report.
- ❖ For all FS and period(s) referred to in the auditor's report.
- ❖ Change in management does not diminish their responsibilities for the FS as a whole and the auditor can request from new management a WR that cover the whole of the relevant period(s).

SA 580

- ❖ If WR obtained about a specific assertion in the FS during the course of the audit, request for an updated WR.
- ❖ WR are for all periods referred to in the auditor's report because management needs to re-affirm that the written representations it previously made with respect to the prior periods remain appropriate.

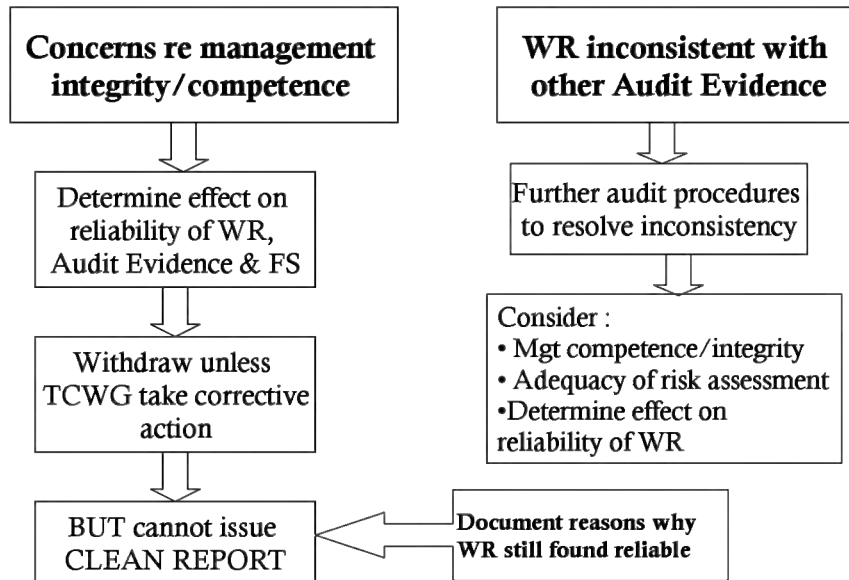
## Form of WR



SA 580

- ❖ Matters covered by public statement need not to be covered by the WR.

### Doubt on Reliability of WR



SA 580

### Requested WR not Provided

- ❖ Discuss matter with management.
- ❖ Re-evaluate integrity of management.
- ❖ Evaluate effect on reliability of representations & audit evidence.
- ❖ Take appropriate actions:
  - Including determining possible effect on audit opinion.

SA 580

## **WR About Management Responsibility**

### **Disclaimer of an opinion if:**

- ❖ Sufficient doubt about the integrity of mgt such that the WR wrt following aspects are not reliable:
  - Preparation & presentation of FS.
  - Info to be provided to auditor.
- ❖ Mgt does not provide WR for above aspects.

**SA 580**

## **600 -699 – Using Work of Others**

- ❖ SA 600, "Using the Work of Another Auditor" (April 1, 2002)
- ❖ SA 610, "Using the Work of Internal Auditors" (April 1, 2010)
- ❖ SA 620, "Using the Work of an Auditor's Expert" (April 1, 2010)

# SA 600

## Using the Work of Another Auditor

*Effective for all audits relating to accounting periods beginning on or after April 1, 2002*

- ❖ Issued in September, 2002.

## Introduction

- ❖ Genesis Para 9 of SA 200 (AAS 1).
- ❖ Establishes standards for application in situations where auditor uses the work of another auditor.
- ❖ Does not cover:
  - Joint audits.
  - Relationship with predecessor auditor.
- ❖ Consider how other auditor's work affects the audit.

## SA 600

- ❖ SA 200 (AAS 1) states as follow:  
 "When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 1956 the auditor's report should expressly state the fact of such reliance".
- ❖ Work of the other auditor may relate to financial information of one or more components included in the financial information of the entity.
- ❖ SA 600 not applicable if principal auditor concludes that financial information of the component is immaterial.

## **Definitions**

- ❖ **Principal Auditor (PA)** : Auditor responsible for financial information (FI) of an entity when it includes FI of one or more components audited by another auditor.
- ❖ **Other Auditor (OA)** : Auditor, other than PA, who is responsible for reporting on FI of a component which is included in FI audited by the PA.
- ❖ **Component** : Division, branch, subsidiary, joint venture, associated enterprise or any other entity whose FI is included in FI audited by PA.

**SA 600**

## **PA's Procedures**

- ❖ Consider the professional competence of OA, if OA is not a member of ICAI.
- ❖ Visit component and examine books of account, if essential.
- ❖ Obtain sufficient appropriate evidence, that work of OA is adequate for PA's purposes.
- ❖ Discuss audit procedures applied by OA.
- ❖ Review a written summary of OA's procedures and findings through questionnaires/checklist.
- ❖ Consider significant findings of OA:
  - Discuss audit findings with OA and Mgt. of component.
  - Perform supplemental tests if necessary.
- ❖ In case OA is not a professionally qualified auditor - for instance, where a component is situated in foreign country:
  - Procedures mentioned above assume added importance.

**SA 600**

- ❖ Normally PA entitled to rely on the work of OA unless special circumstances make it essential to visit the component and examine the books of accounts. In certain situations, the right to visit a component may be conferred by the statute governing the entity.
- ❖ Areas requiring special consideration include:
  - Identification of inter-component transactions.
  - Time-table for completion of audit.
- ❖ Sufficient appropriate audit evidence:
  - Inform OA about the use of his work.
  - Coordination of efforts at planning stage.
  - Advise OA of significant accounting, auditing and reporting requirements, obtain representation as to compliance with them.



## **Documentation**

- ❖ Components whose FS are audited by OA and their significance to the financial information of the entity as a whole.
- ❖ Names of the other auditors.
- ❖ Any conclusions reached that individual components are not material.
- ❖ Procedures performed regarding components.
- ❖ Conclusions reached.
- ❖ Manner of dealing with Modified Report of OA while finalising PA's Report.

**SA 600**

## **Co-ordination Between Auditors**

- ❖ Sufficient liaison/co-ordination between PA and OA.
- ❖ PA may require OA to answer a detailed questionnaire.
- ❖ OA should coordinate with PA:
  - Adhering to time-table.
  - Bringing to the attention of PA any significant finding.
  - Compliance with relevant statutory requirements.
  - Respond to detailed questionnaire.

**SA 600**

## **Reporting Considerations**

- ❖ Express a qualified/disclaimer of opinion because of scope limitation:
  - If PA concludes that he cannot use the work of OA; and
  - PA unable to perform sufficient additional procedures regarding FI of the component audited by OA.
- ❖ Report should state clearly division of responsibility between PA and OA.

### **SA 600**

- ❖ The division of responsibility should be stated by indicating extent to which FI of components audited by OA have been included in FI of the entity.

## **SA 610**

### **Using the Work of Internal Auditors**

*Effective for Audits of financial statements for periods beginning on or after April 1, 2010*

## Overview of SA 610

- ❖ **Introduction**
  - Scope
  - Effective Date
- ❖ **Objectives**
- ❖ **Definitions**
- ❖ **Requirements**
  - Determining Whether and to What extent to use the work of the Internal Auditors
  - Using Specific Work of the Internal Auditors
  - Documentation
- ❖ **Application and Other Explanatory Material on these aspects**

**SA 610**

## Scope

- ❖ Deals with external auditor's responsibility:
  - Regarding work of internal auditor.
  - When external auditor has determined in accordance with SA 315.
  - That internal audit function is likely to be relevant to audit:
    - Nature of internal audit function's responsibilities & activities are related to entity's financial reporting; AND
    - Auditor expects to use internal auditor's work to modify nature, timing & extent of audit procedures.
- ❖ Does not deal with cases where internal auditors provide direct assistance to external auditors.

**SA 610**

- ❖ Where the law does not permit the internal auditor to share his working papers with third parties, external auditor would not be able to apply this Standard.
- ❖ Where the external auditor decides not to use the work of the internal auditors to affect the nature, timing or extent of the external auditor's procedures, the external auditor's further application of this SA may not be necessary.

## **Relationship between Internal Audit Function & External Auditor**

- ❖ Role & objectives of internal audit function determined by Mgt/ TCWG.
- ❖ Notwithstanding Degree of autonomy /objectivity, internal audit function is not independent of entity.
- ❖ External auditor has sole responsibility for audit opinion, and
  - that responsibility not reduced by use of work of internal auditors.

**SA 610**

- ❖ Activities of Internal Audit function may include one or more of following:
  - Monitoring of internal control.
  - Examination of financial and operating information.
  - Review of operating activities.
  - Review of compliance with laws and regulations.
  - Risk management.
  - Governance.

## **Auditor's Objectives**

- ❖ If external auditor determines internal audit function likely to be relevant to audit, Determine:
  - Whether & to what extent to use specific work of internal auditors; and
  - If so, whether such work is adequate for external audit purpose.

**SA 610**

## Definitions

❖ **Internal audit function:**

- Appraisal activity.
- Established/ provided.
- As a service to entity.

Its functions include examining, evaluating & monitoring adequacy & effectiveness of ICs.

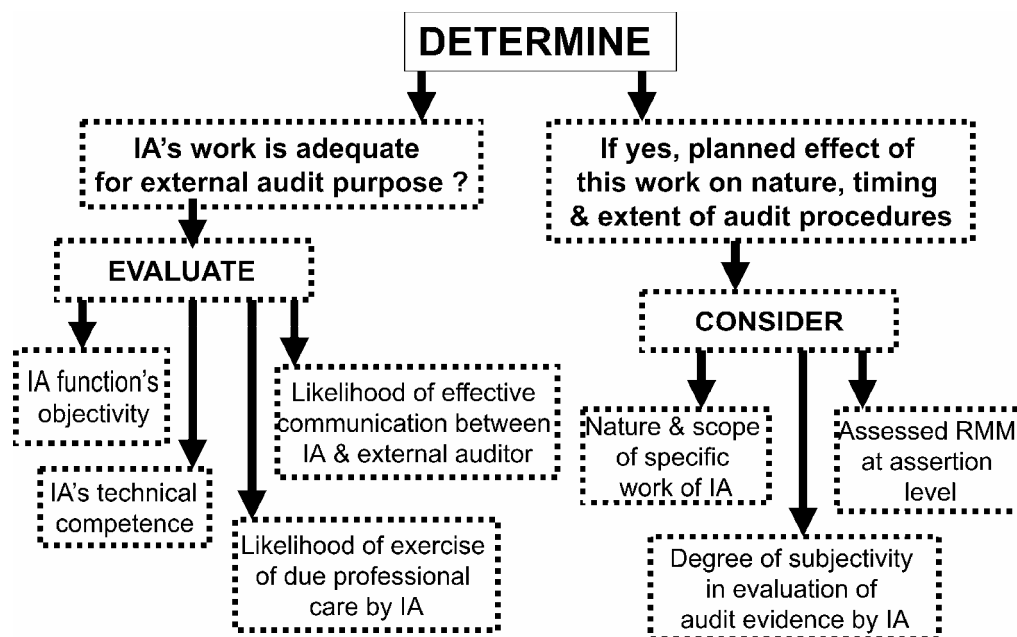
❖ **Internal Auditors:**

- Individuals who perform activities of IA function
- May belong to IA department/ equivalent function

### SA 610

- ❖ The Preface to the Standards on Internal Audit, issued by the Institute of Chartered Accountants of India in November 2004 describes internal audit as “an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system. Internal audit, therefore, provides assurance that there is transparency in reporting, as a part of good governance.”

## Determining If & Extent to Use IA's Work



SA 610

- ❖ **Objectivity:**
  - Status of IA function within the entity and effect of status on IA's ability to be objective.
  - Whether IA function reports to TCWG or officer with appropriate authority, and whether IAs have direct access to TCWG.
  - Whether IAs are free of any conflicting responsibilities.
  - Whether TCWG oversee employment decisions related to IA function.
  - Constraints or restrictions on IA function by Mgt or TCWG.
  - Whether, and extent of, management acts on the recommendations of IA function, and how such action is evidenced.
- ❖ **Technical competence:**
  - Whether IA is member of relevant professional bodies.
  - Whether IA has adequate technical training and proficiency as IA;
    - Compliance with the mandatory/ recommendatory Standards on Internal Audit (SIAs) issued by Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI).
  - Established policies for hiring and training IA.
- ❖ **Due professional care:**
  - Whether activities of IA function are properly planned, supervised, reviewed and documented.
  - Existence and adequacy of audit manuals or other similar documents, work programs and IA dox.
- ❖ **Communication:**

Communication between EA and IA most effective when IA are free to communicate openly with EA, and:

  - Meetings are held at appropriate intervals throughout the period;
  - EA is advised of and has access to relevant IA reports and is informed of any significant matters that come to the attention of IA when such matters may affect the work of EA; and
  - EA informs IA of any significant matters that may affect IA function.
- ❖ Where IA's work is a factor in determining nature, timing, extent of EA procedures, useful to agree in advance the following matters with IA:
  - Timing of such work;
  - Extent of audit coverage;
  - Materiality for FS as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality;
  - Proposed methods of item selection;
  - Documentation of work performed; and
  - Review and reporting procedures.

### **Using Specific Work of IA**

- ❖ Evaluate & perform audit procedures on the work to determine its adequacy:
  - Work was performed by IA having adequate technical training & proficiency.
  - Work was properly supervised, reviewed & documented.
  - Adequate audit evidence obtained by IA.
  - Conclusions reached are appropriate & IA reports are consistent with results of work.
  - Exceptions/ unusual matters disclosed by IA are properly resolved.

**SA 610**

- ❖ Audit procedures may include:
  - Examination of items already examined by the internal auditors.
  - Examination of other similar items.
  - Observation of procedures performed by the internal auditors.

### **Documentation**

- ❖ Conclusions regarding evaluation of adequacy of IA's work
- ❖ Audit procedures performed on IA's work

**SA 610**

# SA 620

## Using the Work of An Auditor's Expert

*Effective for Audits of financial statements for periods beginning on or after April 1, 2010*

### Overview

#### ❖ Introduction

- Scope
- The auditor's responsibility for the audit opinion
- Effective date

#### ❖ Objectives

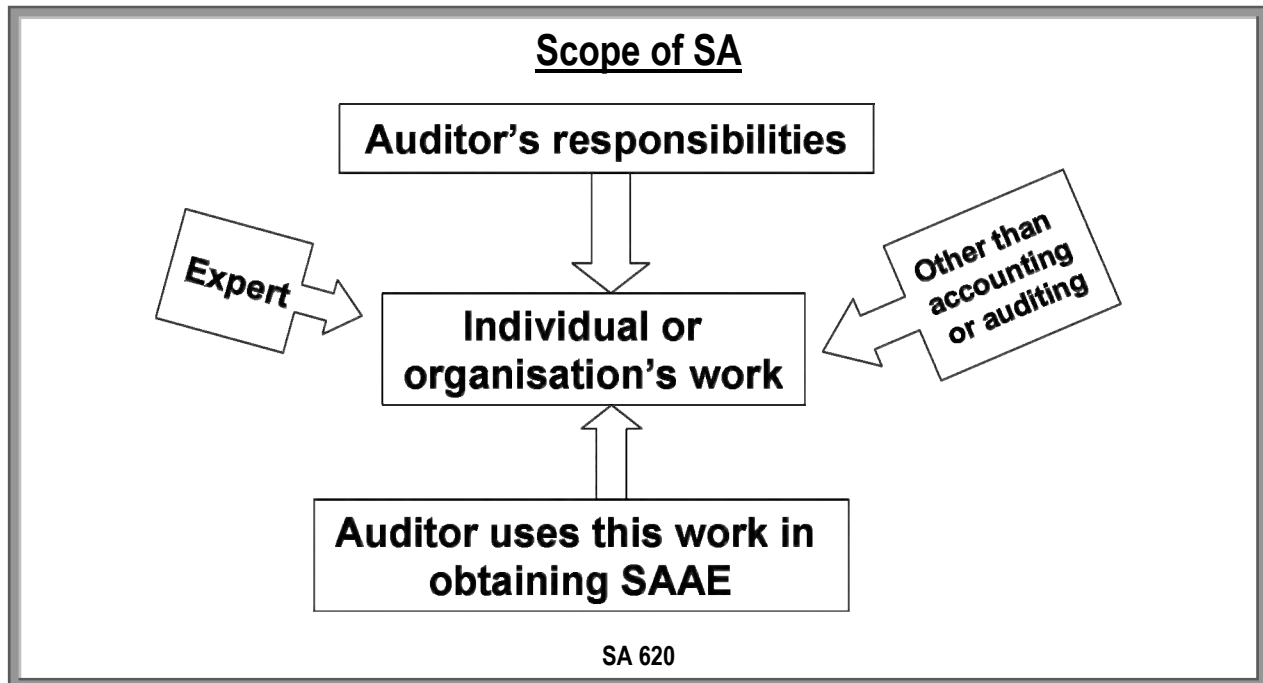
#### ❖ Definitions

#### ❖ Requirements & Application

- Determining the need for an auditor's expert
- Nature, timing & extent of audit procedures
- Competence, capabilities & objectivity of the auditor's expert
- Obtaining an understanding of field of expertise of auditor's expert
- Agreement with the auditor's expert
- Evaluating the adequacy of the auditor's expert's work
- Reference to the auditor's expert in audit report

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- ❖ The **trigger point** for the SA is where the auditor uses the expert's work to assist him in obtaining SAAE.
- ❖ **Does not deal** with following situations:
  - Engagement team member is expert in a specialised area of accounting/ auditing (**SA 220, para A20**)
  - Auditor uses the work of an expert whose work in that field is used by entity to prepare FS (Management's Expert) (**SA 500 para A43-A48**).

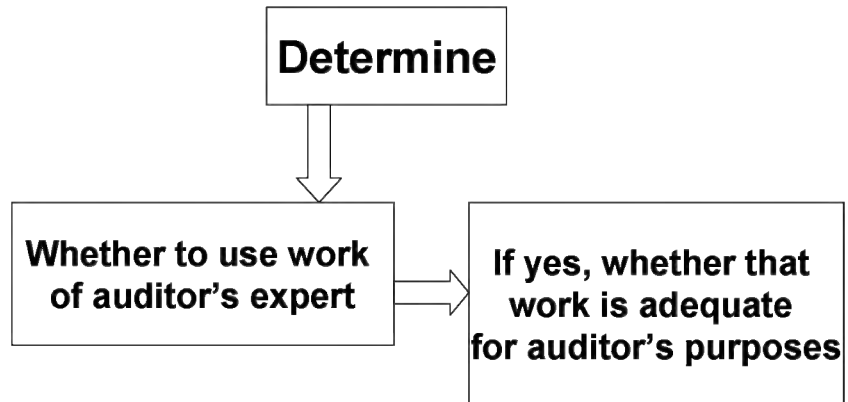
### **Responsibility for Audit Opinion**

- ❖ Audit opinion is the sole responsibility of the auditor:
  - If requirements of this SA are followed & auditor concludes expert's work is adequate, auditor may accept that work as SAAE.

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- ❖ Reiteration of a well established fundamental principle.
- ❖ Responsibility of the auditor is not reduced merely because of use of work of auditor's expert.

## Auditor's Objectives



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## Definitions

	<b>Auditor's Expert</b>	<b>Management's Expert</b>
<b>Status</b>	Individual/ organisation	Individual/ organisation
<b>Expertise</b>	Other than accounting/ auditing	Other than accounting/ auditing
<b>Beneficiary</b>	Auditor	Entity
<b>Use of work</b>	Obtain SAAE	Prepare FS

### SA 620

- ❖ Auditor's Expert:
  - Internal: partner/ staff/ auditor's firm/ network firm.
  - External.
- ❖ Examples of matters for expert's use:
  - The valuation of complex financial instruments, land and buildings, plant and machinery, jewelry, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.
  - The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.
  - The estimation of oil and gas reserves.
  - The valuation of environmental liabilities, and site clean-up costs.
  - The interpretation of contracts, laws and regulations.
  - The analysis of complex or unusual tax compliance issues.

## **Expertise - skills, knowledge and experience in particular field**

<b>Expert</b>	<b>Not an “Expert”</b>
Expert in Taxation law	Expert in application of AS on Deferred Taxes
Expert in complex modeling for valuing Financial Instruments	Expert in accounting for Financial Instruments

- ❖ Use professional judgment if distinction is difficult.
- ❖ Consider:
  - Applicable professional rules.
  - Education standards.
  - Competency requirements.

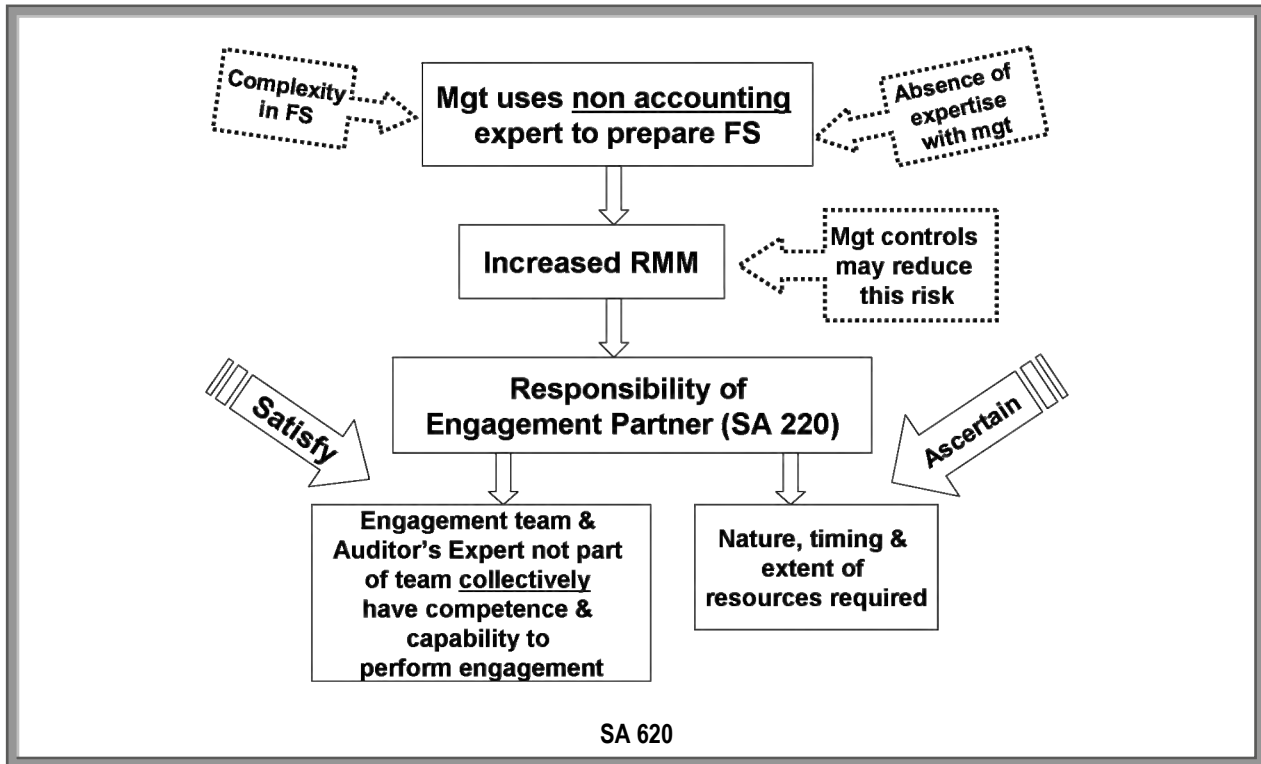
**SA 620**

## **I. Determining the Need**

- ❖ If expertise in field other than accounting/ auditing is necessary to obtain SAAE, auditor to determine whether to use work of auditor's expert:
  - Helps in meeting requirements of SA 220 wrt Engagement Partner.
  - Determination may undergo revision with changing circumstances.

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- ❖ An auditor's expert may be needed to assist the auditor in one or more of the following:
  - Obtaining an understanding of the entity and its environment, including its internal control.
  - Identifying and assessing the risks of material misstatement.
  - Determining and implementing overall responses to assessed risks at the financial statement level.
  - Designing and performing further audit procedures to respond to assessed risks at the assertion level, comprising tests of controls or substantive procedures.
  - Evaluating the sufficiency and appropriateness of audit evidence obtained in forming an opinion on the financial statements.



- ❖ But it is not always necessary that the auditor to engage an auditor's expert in such circumstances. The auditor may have obtained sufficient understanding of the field to perform audit of FS without auditor's expert. This understanding may have come from:
- Experience in auditing entities that require such expertise in the preparation of their FS.
  - Education or professional development in the particular field.
  - Discussion with auditors who have performed similar engagements.

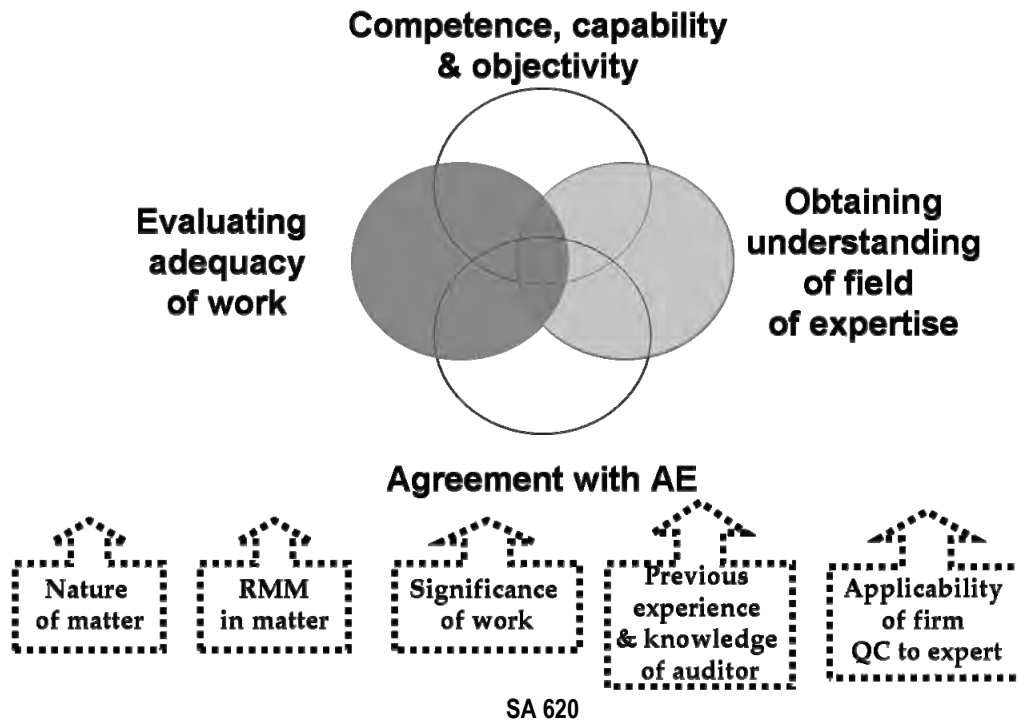
## **Factors to consider in making Determination**

- ❖ Whether mgt has used mgt expert in preparing FS.
- ❖ Nature & significance of matters & its complexity.
- ❖ RMM in matter.
- ❖ Expected nature of procedures to respond to identified risks:
  - Auditor's knowledge & experience with the work of experts in such matters.
  - Availability of alternative sources of audit evidence.

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- ❖ If mgt has used an expert to prepare FS, the following factors may also affect the auditor's decision on whether to use an auditor's expert:
  - Nature, scope and objectives of the ME's work.
  - Whether ME is employed by the entity, or is a party engaged by it to provide relevant services.
  - Extent to which management can exercise control or influence over the work of ME.
  - The ME's competence and capabilities.
  - Whether ME is subject to technical performance standards or other professional or industry requirements
  - Any controls within the entity over ME's work.

## II. Nature, Timing & Extent of Audit Procedures (wrt Auditor's Expert)



- ❖ The rigour of the Nature, Timing & Extent of audit procedures will vary depending on the circumstances. Influencing factors:
    - AE's work relates to a significant matter that involves subjective and complex judgments.
    - Auditor has not previously used AE's work and has no prior knowledge of his competence, capabilities and objectivity.
    - AE performs procedures that are integral to the audit, rather than being consulted to provide advice on an individual matter.
    - AE is auditor's external expert and is not, therefore, subject to the firm's quality control policies and procedures.
  - ❖ AE and Firm QC:
    - If AE is a partner/ staff he/ she would be subject to firm QC and similarly in case he is from a network firm, the QC policies may be common.
    - If AE is external expert:
      - he is not a member of engagement team
      - Not subject to firm QC.
- Some jurisdictions may require the external AE to be also treated as part of Engagement team and subject to firm QC policies including independence policies.
- ❖ Engagement team's reliance on firm QC policies:
    - Entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise.
    - Extent of reliance varies with the circumstances, and may affect the nature, timing and extent of the auditor's procedures with respect to such matters as:
      - Competence and capabilities, through recruitment and training programs.
      - Objectivity. Auditor's internal experts are subject to relevant ethical requirements, including those pertaining to independence.
      - The auditor's evaluation of the adequacy of the auditor's expert's work.
      - Adherence to regulatory and legal requirements, through monitoring processes.
      - Agreement with the auditor's expert.

Such reliance does not reduce the auditor's responsibility to meet the requirements of this SA.

### **III. Competence, Capabilities & Objectivity of Auditor's Expert**

- ❖ **Evaluate competence, capability & objectivity of expert:**
  - If External expert - inquire into interests and relationships that threaten objectivity.
- ❖ **Competence:**
  - Nature & level of expertise.
- ❖ **Capability:**
  - Ability to exercise competence in circumstances of engagement.
- ❖ **Objectivity:**
  - Possible effects that bias/ conflict of interest/ influence of others may have on professional/ business judgment.

#### **SA 620**

- ❖ Sources of info on Competence, Capabilities & Objectivity:
  - Personal experience with previous work of that expert.
  - Discussions with that expert.
  - Discussions with other auditors or others who are familiar with that expert's work.
  - Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
  - Published papers or books written by that expert.
  - The auditor's firm's quality control policies and procedures



### **Matters relevant for evaluation**

- ❖ Whether AE's work is subject to technical performance/ professional/ industry requirements?
- ❖ Relevance of competence to the matter.
- ❖ Competence wrt accounting & auditing requirements.
- ❖ Need for reconsideration of initial evaluation.
  - Unexpected events / changes in conditions/ Audit evidence.
- ❖ Threats to objectivity *vis a vis* safeguards .
  - Reduction of threats to acceptable level.
- ❖ Auditor may need to obtain written representation from Expert re interests/ relationships with the entity that expert is aware.

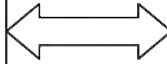
#### **SA 620**

#### **Evaluation of objectivity.**

- ❖ Inquire the entity re any known interests/ relationships that entity has with AE that may affect objectivity.
- ❖ Discuss with AE any applicable safeguards, including any professional requirements and evaluate whether the safeguards are adequate to reduce threats to an acceptable level. Interests and relationships that may be relevant to discuss with the AE include:
  - Financial interests.
  - Business and personal relationships.
  - Provision of other services by AE.
  - In some cases, it may also be appropriate for the auditor to obtain a written representation from the AE expert about any interests or relationships with the entity of which that expert is aware.

#### IV. Obtaining an Understanding of Field of Expertise

**DETERMINE nature, scope  
& objectives of AE's work  
for purpose of auditor**



**EVALUATE adequacy  
of that work for  
auditor's purpose**

- ❖ Aspects to evaluate:
  - Whether AE's field has areas of specialty within it that are relevant to audit.
  - Applicability of professional/ other standards/ L&R.
  - Assumptions/ methods/ models used:
    - Their general acceptability in field of expertise.
    - Their appropriateness for financial reporting purpose.
  - Nature of internal & external data/ info used by AE.

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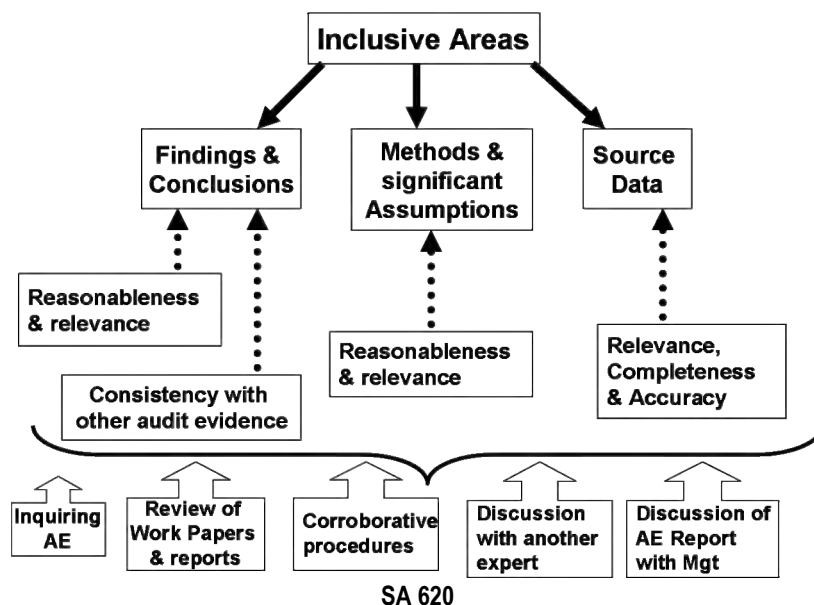
## V. Agreement with Auditor's Expert

- ❖ Agreement on:
  - Nature, scope & objectives of AE's work (may include relevant technical standards or other professional and industry requirements).
  - Respective roles & responsibilities of auditors & AE.
  - Nature, timing & extent of communication, including form of report.
  - Need for AE to observe confidentiality requirements under ethical requirements or L & R.
- ❖ Agreement necessary even if AE is internal.
- ❖ Level of detail/ formality may vary.
- ❖ May be in writing, if appropriate.

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- ❖ Agreement is often in the form of an engagement letter. The Appendix lists matters that the auditor may consider for inclusion in such an engagement letter.
- ❖ **Situations needing written agreement:**
  - AE will have access to sensitive or confidential entity information.
  - Respective roles or responsibilities of auditor and AE are different from those normally expected.
  - Multi-jurisdictional legal or regulatory requirements apply.
  - The matter to which AE's work relates is highly complex.
  - Auditor has not previously used work performed by that expert.
  - Extent of the auditor's expert's work, and its significance in the context of the audit.
- ❖ When there is no written agreement between the auditor and the auditor's expert, evidence of the agreement may be included in, for example:
  - Planning memoranda, or related working papers such as the audit program.
  - The policies and procedures of the auditor's firm:
    - In the case of internal expert, the established policies and procedures to which that expert is subject may include particular policies and procedures in relation to that expert's work.
    - The extent of documentation in the auditor's working papers depends on the nature of such policies and procedures.
- ❖ Agreement on the respective roles and responsibilities of the auditor and the auditor's expert may include:
  - Whether the auditor or the auditor's expert will perform detailed testing of source data.
  - Consent for the auditor to discuss the auditor's expert's findings or conclusions with the entity and others, and to include details of that expert's findings or conclusions in a modified auditor's report, if necessary.
  - Any agreement to inform the auditor's expert of the auditor's conclusions concerning that expert's work.
  - Agreement about access to, and retention of, each other's working papers.
    - Internal: WP form part of the audit documentation.
    - External: Subject to any agreement to the contrary, WP are their own and do not form part of the audit documentation.

## VI. Evaluating Adequacy of AE's Work



- ❖ **Evaluating relevance & reasonableness of findings/ conclusions** ----- factors include:
  - Presented as per profession or industry standards applicable to AE.
  - Clearly expressed.
    - reference to the objectives agreed with the auditor;
    - scope of work performed;
    - standards applied.
  - Based on an appropriate period and take into account subsequent events.
  - Subject to any reservation, limitation or restriction on use, and if so whether this has implications for the auditor; and
  - Based on appropriate consideration of errors or deviations encountered by AE.
- ❖ **Evaluation of methods & assumptions:**
  - **Situation 1:** AE's work is to evaluate underlying assumptions/ methods/ models used by management in developing an accounting estimate.  
**Audit Procedures:** Primarily directed to evaluating whether AE has adequately reviewed those assumptions and methods.
  - **Situation 2:** AE's work is to develop point estimate or range for comparison with management's estimate.  
**Audit procedures:** Primarily directed to evaluating the assumptions and methods, including models where appropriate, used by the auditor's expert.
- ❖ Auditor can also take help of SA 540 in making this evaluation.
- ❖ When AE's work involves the use of significant assumptions and methods, factors relevant for include whether they are:
  - Generally accepted within the AE's field;
  - Consistent with requirements of the applicable FRF;
  - Dependent on use of specialised models; and
  - Consistent with those of mgt, and if not, the reason for, and effects of, the differences.
- ❖ **Evaluation of Source Data** - Procedures to test that data include:
  - Verifying the origin of the data
    - including obtaining an understanding of,
    - where applicable testing, the internal controls over the data and,
    - where relevant, its transmission to the expert.
  - Reviewing the data for completeness and internal consistency.
- ❖ **Highly technical source data** - AE may test the source data.
  - Auditor to:
    - Inquiring AE, or
    - Supervise/ review AE's tests

### **AE's work not adequate for audit purposes**

- ❖ Agree with AE on nature & extent of further work to be done by AE.
  - ❖ Perform further audit procedures appropriate in circumstances.
    - Includes engaging another expert.
- If above cannot resolve inadequacy, MODIFIED opinion MAY be required.

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### **VII. Reference to AE in Audit Report**

- ❖ Unmodified Audit Report:
    - No reference unless required by L&R.
  - ❖ Modified Audit Report:
    - Refer to make modification more clear.
- In any case, audit report to clarify that reference does not reduce auditor's responsibility.

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## **700-799 – Audit Conclusions & Reporting**

- ❖ SA 700, "Forming an Opinion and Reporting on Financial Statements" (April 1, 2011)
- ❖ SA 705, "Modifications to the Opinion in the Independent Auditor's Report" (April 1, 2011)
- ❖ SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" (April 1, 2011)
- ❖ SA 710, "Comparative Information – Corresponding Figures and Comparative Financial Statements" (April 1, 2011)
- ❖ SA 720, "The Auditor's Responsibilities in Relation to Other Information in Documents containing Audited Financial Statements" (April 1, 2010)

### **Note:**

The Council of the ICAI, in partial modification of the decision taken by it at its 291<sup>st</sup> meeting held in December 2009, has decided that the effective date/applicability of the three standards viz SA 700, SA 705 and SA 706 be postponed by one year and consequently the said Standards shall now be effective/applicable for audits of financial statements for periods beginning on or after 1st April, 2012 (instead of audits of financial statements for periods beginning on or after 1st April, 2011 as was earlier decided).

# **SA 700**

## **Forming an Opinion and Reporting on Financial Statements**

*Effective for Audits of financial statements for periods beginning on or after April 1, 2011*

## **Overview of SA 700**

- ❖ **Introduction**
  - Scope
  - Effective Date
- ❖ **Objectives**
- ❖ **Definitions**
- ❖ **Requirements**
  - Forming an opinion on FS
  - Form of opinion
  - Auditor's report
  - Supplementary information presented with FS

**SA 700**

- ❖ **Application:**
  - Qualitative aspects of accounting practices
  - Disclosure of effect of material transactions & events on information conveyed in FS
  - Description of applicable FRF
  - Form of opinion
  - Auditor's report
  - Supplementary information presented with FS
- ❖ **Appendix:**
  - Illustrative auditor's report

**SA 700**

## **Scope**

- ❖ Auditor's responsibility to form an opinion on the financial statements.
- ❖ Form & content of auditor's report issued as a result of an audit of FS.
- ❖ Modified opinion, EMP, OMP dealt with by SA 705 & 706.
- ❖ SA 700 is in the context of general purpose FS:
  - FS under special purpose framework are dealt by SA 800 & SA 805.
- ❖ Promotes consistency in audit reports.

### **SA 700**

- ❖ This SA promotes consistency in the auditor's report. Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognised standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

## **Auditor's Objectives**

- ❖ Form an opinion on FS based on evaluation of conclusions drawn from audit evidence
- AND**
- ❖ Express clearly that opinion through a written report that also describes the basis for opinion

### **SA 700**



## Definitions

❖ **General Purpose FS:**

- FS prepared in accordance with a general purpose framework.

❖ **Unmodified Opinion:**

- Opinion expressed by the auditor when auditor concludes that FS are prepared, in all material respects, in accordance with applicable FRF.

**SA 700**

❖ **General Purpose Framework:**

- A FRF designed to meet common financial info needs of a wide range of users.

<b>Fair Presentation Framework</b>	<b>Compliance Framework</b>
<ul style="list-style-type: none"> <li>• Refers to FRF that requires compliance with requirements of the framework.</li> <li>• Acknowledges explicitly/ implicitly that the following may be necessary for fair presentation of FS:               <ul style="list-style-type: none"> <li>▪ Mgt may need to provide disclosures beyond those specifically required by FRF.</li> <li>▪ Mgt to depart (in extremely rare situations) from a requirement of framework.</li> </ul> </li> </ul>	<p>Refers to FRF that requires compliance with requirements of the framework but does not contain the acknowledgement as in Fair Presentation Framework.</p>

**SA 700**

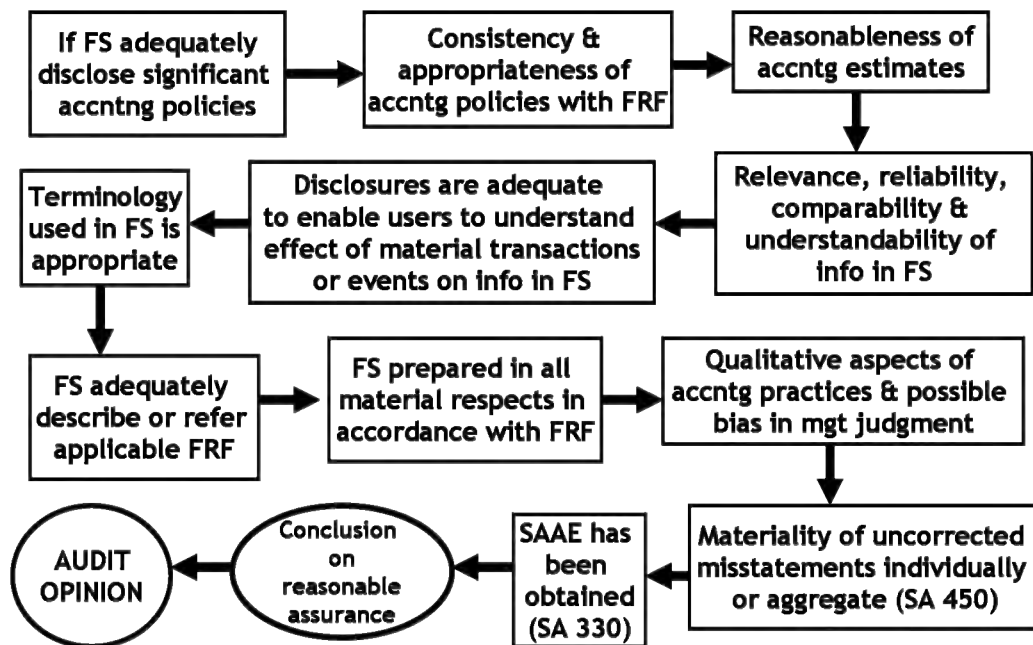
- ❖ Reference to "financial statements" in this SA means "a complete set of general purpose financial statements, including the related notes."
- ❖ The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information.
- ❖ The requirements of the applicable FRF determine the form and content of the financial statements, and what constitutes a complete set of financial statements.
- ❖ "Financial Reporting Standards" means:
- Accounting Standards promulgated by Accounting Standards Board (ASB) of ICAI, or
  - Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, or
  - Accounting Standards for Local Bodies promulgated by the Committee on Accounting Standards for Local Bodies (CASLB) of ICAI.,
- as may be applicable.

## Forming an Opinion on FS

- ❖ Whether FS are prepared in all material respects in accordance with applicable FRF.
- ❖ To form this opinion, auditor needs to conclude whether he/ she has obtained reasonable assurance that FS as a whole are free of material misstatements (fraud/ error).

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## Evaluations to Conclude on Reasonable Assurance



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- ❖ For FS based on Fair presentation Framework, evaluations to also include whether the financial statements achieve fair presentation. To consider:
  - The overall presentation, structure and content of the financial statements; and
  - Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

### **FS prepared as per applicable FRF**

- ❖ Qualitative aspects of accounting practices covered in SA 260:
  - Become aware of possible bias in mgt's decision.
  - Conclude that cumulative effect of uncorrected misstatement & lack of neutrality is material.
- ❖ Indicators of lack of neutrality:
  - Selective correction of misstatements brought to mgt attention by auditor.
  - Mgt bias in making accounting estimates (SA 540):
    - Indicators of possible mgt bias do not constitute misstatements for evaluating reasonableness of individual accounting estimates.
    - May affect the auditor's evaluation of whether the FS as a whole are free from material misstatement.

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### **Description of/ reference to FRF in FS**

- ❖ Mgt/TCWG responsibility for FS in accordance with applicable FRF:
  - Description of FRF necessary for users of FS.
- ❖ Description wrt application of an FRF:
  - Appropriate only if FS comply with all in force requirements of that FRF.
  - If contains imprecise qualifying/ limiting language is not adequate description of that FRF and may mislead users of FRF.

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## **Reference to more than one FRF**

- ❖ FS to comply with each FRF:
  - Individually.
  - Simultaneously.
  - Without any need for reconciliation statements.
- ❖ FS may be prepared as per one applicable FRF and, in addition, describe in the notes to FS the extent of compliance with another FRF:
  - This description is supplementary financial information and is considered an integral part of the FS and, accordingly, covered by the auditor's opinion.

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- ❖ In practice, simultaneous compliance is unlikely unless the jurisdiction has adopted the other FRF as its own national FRF, or has eliminated all barriers to compliance with it.
- ❖ FS prepared in accordance with one FRF and that contain a note or supplementary statement reconciling the results to those that would be shown under another FRF, are not prepared in accordance with that other FRF. This is because the financial statements do not include all the information in the manner required by that other FRF.

## **Form of Opinion**

- ❖ **Unmodified Opinion:**
    - Auditor concludes FS are prepared in all material respects as per applicable FRF.
  - ❖ **Modified Opinion (SA 705):**
    - Based on audit evidence, auditor concludes FS as a whole are not free from material misstatements.
- OR
- Auditor unable to obtain SAAE that FS as a whole are free from material misstatements.

### **SA 700**

**Fair Presentation FRF – FS do not achieve fair presentation:**

- ❖ Discuss matter with mgt.
- ❖ Determine need to modify opinion depending upon:
  - Requirements of FRF; &
  - How matter is resolved.

**Compliance FRF:**

- ❖ No need to evaluate if FS achieve fair presentation.
- ❖ If in rare circumstances, auditor concludes FS are misleading, determine whether & how to communicate in audit report after:
  - Discuss with mgt.
  - How matter is resolved.

**SA 700**

**FRF Presentation FRF – FS do not achieve fair presentation**

- ❖ It may be possible for management to:
  - Include additional disclosures in FS beyond those specifically required by the framework or,
  - In extremely rare circumstances, to depart from a requirement in the framework in order to achieve fair presentation of the financial statements.

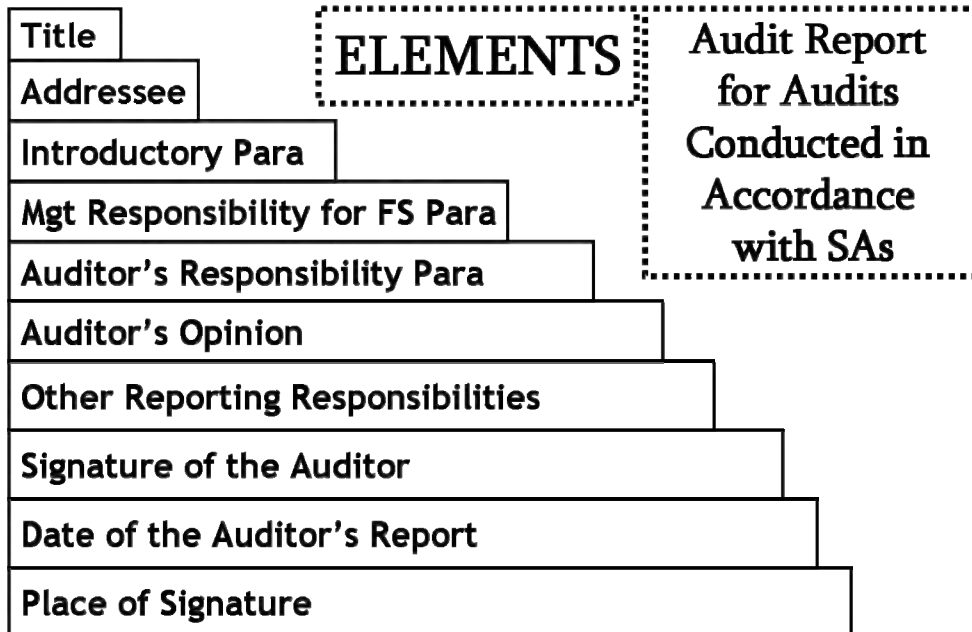
**Compliance FRF,**

- ❖ It will be extremely rare for the auditor to consider financial statements that are prepared in accordance with a compliance framework to be misleading if, in accordance with SA 210, the auditor determined that the framework is acceptable.

**Auditor's Report**

- ❖ Shall be in writing.
- ❖ Written report encompasses reports issued:
  - In hard copy format, and
  - Using electronic medium.

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### Title

- ❖ AR to have a title clearly stating that it is a report of an independent auditor:
  - Affirms that auditor has met all ethical requirements re independence.
  - Distinguishes AR from reports issued by others.

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## **Addressee**

- ❖ AR to be addressed as required by circumstances of the engagement:
  - Applicable L&R may specify “addressee”.
  - AR normally addressed to those for whom AR is prepared – shareholders/ TCWG.

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## **Introductory Para**

**Should:**

- Identify the entity whose FS have been audited.
- State that FS have been audited.
- Identify title of each statement that comprises FS.
- Refer to summary of significant accounting policies & other explanatory info.
- Specify date of period covered by each FS comprising FS.

**SA 700**

- ❖ When the auditor is aware that audited FS will be included in a document that contains other information, such as an annual report, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the audited financial statements are presented. This helps users to identify the financial statements to which the auditor's report relates.
- ❖ The auditor's opinion covers the complete set of financial statements as defined by FRF.
  - In case of some entities, additional information might also be considered to be an integral part of the financial statements.

## **Mgt Responsibility for FS**

- ❖ Describe responsibility of Mgt (others) responsible for preparation of FS:
  - Similarly as described in Terms of Engagement.
- ❖ SA 200 – premise relating to audit – responsibilities of Mgt:
  - Describe additional responsibilities as per L&R.
- ❖ Further guidance in SA 210.
- ❖ Include a heading “*Mgt (other appropriate term) Responsibility for FS*”.

### **SA 700**

- ❖ In the case of many general purpose frameworks, management is responsible for preparation of FS that fairly present the state of affairs, statement of profit & loss and cash flows of the entity in accordance with those frameworks.
- ❖ Responsibility includes the design, implementation and maintenance of internal control relevant to the preparation of financial statements that are free from material misstatement, whether due to fraud or error.
- ❖ In some cases, law or regulation prescribing management’s responsibilities may specifically refer to a responsibility for the adequacy of accounting books and records, or accounting system.
- ❖ As books, records and systems are an integral part of internal control (as defined in SA 315) no specific reference is made to them in paragraph 26 for the description of management’s responsibilities.
- ❖ SA 200 – premise relating to audit – responsibilities of mgt
- ❖ SA 210 – Terms of Audit Engagement
- ❖ SA 580 – Written Representations
- ❖ Where FS are prepared in accordance with a fair presentation framework, the explanation of mgt responsibility for FS in the auditor’s report shall refer to “the preparation and fair presentation of these FS” or “the preparation of FS that give a true and fair view,” as appropriate in the circumstances.



## **Auditor's Responsibility**

- ❖ Include a heading: "Auditor's Responsibility".
- ❖ *State:* Auditor's responsibility:
  - Express opinion on FS based on audit evidence.
- ❖ *State:* Audit conducted in accordance with SAs,
  - Explain requirement of SAs re:
    - Compliance with ethical requirements.
    - Planning & performing audit to obtain reasonable assurance whether FS are free of material misstatements.

**SA 700**

- ❖ Describe audit:
  - Involves performing procedures to obtain audit evidence.
  - Selection of procedures depends upon auditor's judgment.
  - Includes evaluation of:
    - Appropriateness of accounting policies used;
    - Reasonableness of mgt's accounting estimates; and
    - Overall presentation of FS.
- ❖ State whether auditor believes that audit evidence is sufficient & appropriate to provide basis for auditor's opinion.

**SA 700**

- ❖ Where the financial statements are prepared in accordance with a fair presentation framework, the description of the audit in the auditor's report shall refer to "the entity's preparation and fair presentation of the financial statements" or "the entity's preparation of financial statements that give a true and fair view", as appropriate in the circumstances.

## **Auditor's Opinion**

- ❖ Include heading: "Auditor's Opinion".
- ❖ Unmodified opinion expressed as:  
*Fair presentation framework:*
  - FS present fairly in all material respects in accordance with {applicable FRF}.

**OR**

  - FS give a true & fair view of in accordance with {applicable FRF}.*Compliance Framework:*
  - FS are prepared in all material respects in accordance with [applicable FRF].

**SA 700**

- ❖ Refer SA 210, para 21.
- ❖ Refer SA 700 paras A26 – A32a.

## **Other Reporting Responsibilities**

- ❖ Include a sub heading: "Report on Other Legal & Regulatory Requirements".
- ❖ If audit report contains a separate section on other reporting responsibilities, then introductory para, mgt responsibility para and auditor's responsibility para to be under main head "**Report on the FS**".
- ❖ "Report on Other Legal & Regulatory Requirements" para follows "Report on the FS" para.

**SA 700**

### **Auditor's Signature**

- ❖ Audit report to be signed.
- ❖ To be signed in auditor's personal name.
- ❖ Where firm appointed as auditor, report signed in personal name & in name of audit firm.
- ❖ Also mention membership number of ICAI.
- ❖ Include, wherever applicable, the registration number of the firm, allotted by ICAI.

**SA 700**

### **Date of Audit Report**

- ❖ Not earlier than date on which auditor has obtained SAAE on which to base auditor's opinion:
  - All statements that comprise FS including related notes that have been prepared.
  - Those with recognised authority have asserted that they have taken responsibility for those FS.

**SA 700**

- ❖ The date of the auditor's report informs the user of the auditor's report that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. (SA 560)

## **Place of Signature**

- ❖ Name specific location:
  - Ordinarily the city where audit report is signed.

**SA 700**

## **Audit Report Prescribed by L&R**

- ❖ AR to refer to SA only if AR includes, at a minimum, the elements as described in previous slides.

**SA 700**

## **AR for Audits Conducted as per SAs & ISAs**

### **Refer to SAs & ISAs only if:**

- ❖ No conflict between requirements of SAs & ISAs:
  - Different opinion?
  - Emphasis of Matter Para?
- ❖ AR contains each of the elements of AR.

**SA 700**

## **Supplementary Info Presented with FS**

- ❖ Supplementary info presented but not required by FRF:
  - Evaluate whether Supp Info clearly differentiated from audited FS.
  - If not, ask mgt to change presentation of unaudited Supp Info.
  - If mgt refuses, explain in AR that Supp Info is unaudited.
- ❖ If such Supp Info is nevertheless integral part of FS due to its nature & how it is presented, auditor to cover it in his audit opinion.

**SA 700**

**Material Modification**  
**vis a vis ISA 700**

- ❖ Reference to IFRS changed to Indian scenario.
- ❖ Place of signature changed from jurisdiction in which auditor practices to place where AR is signed.
- ❖ Person eligible to sign AR has been modified to suit Indian scenario.

SA 700

**SA 705**

**Modifications to the Opinion in the Independent Auditor's Report**

*Effective for Audits of financial statements for periods beginning on or after April 1, 2011*

## **Overview of SA 705**

- ❖ **Introduction**
  - Scope
  - Effective Date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements & Application**
  - Circumstances when modification of auditor's opinion is required
  - Determining type of modification to audit opinion
  - Form & content of audit report with modified opinion
  - Communication with TCWG

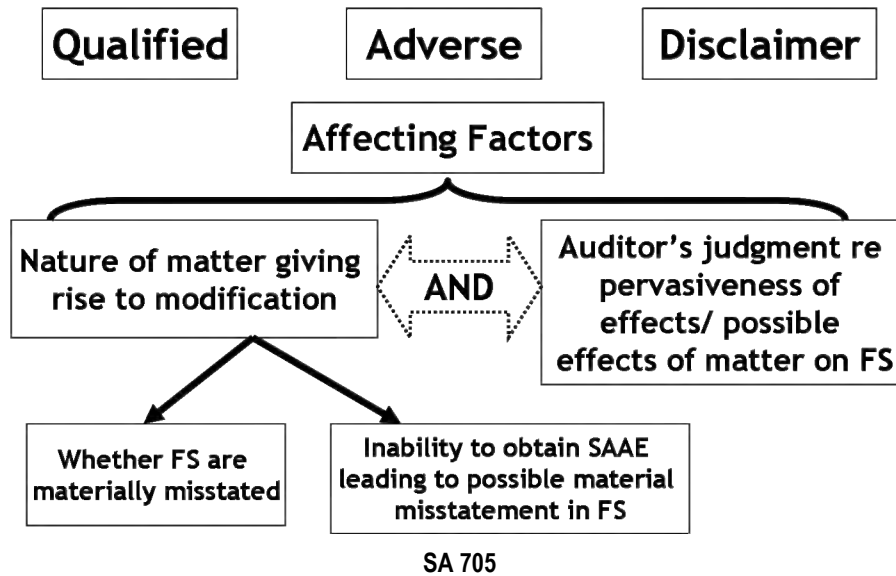
**SA 705**

## **Scope of SA**

- ❖ Auditor's responsibility to,
- ❖ Issue an appropriate report in circumstances when,
- ❖ In forming an opinion as per SA 700,
- ❖ Auditor concludes a modification to auditor's opinion is necessary.

**SA 705**

## Types of Modified Opinion

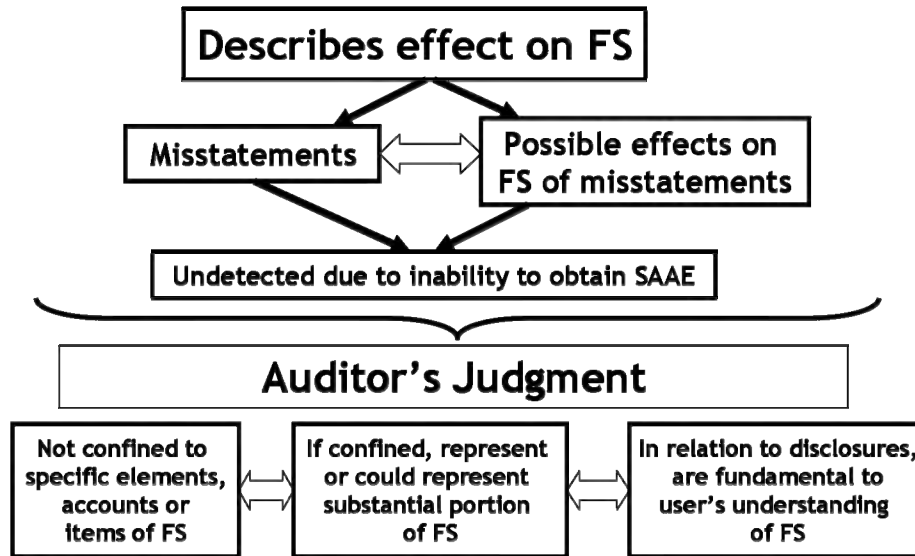


## Auditor's Objective

- ❖ Express clearly an appropriately modified opinion on FS that is necessary when auditor:
  - CONCLUDES (based on audit evidence obtained) that FS are as a whole not free from material misstatements.
  - OR**
  - UNABLE to obtain SAAE to conclude that FS as a whole are free of material misstatements.

SA 705



**Definition – Pervasive**

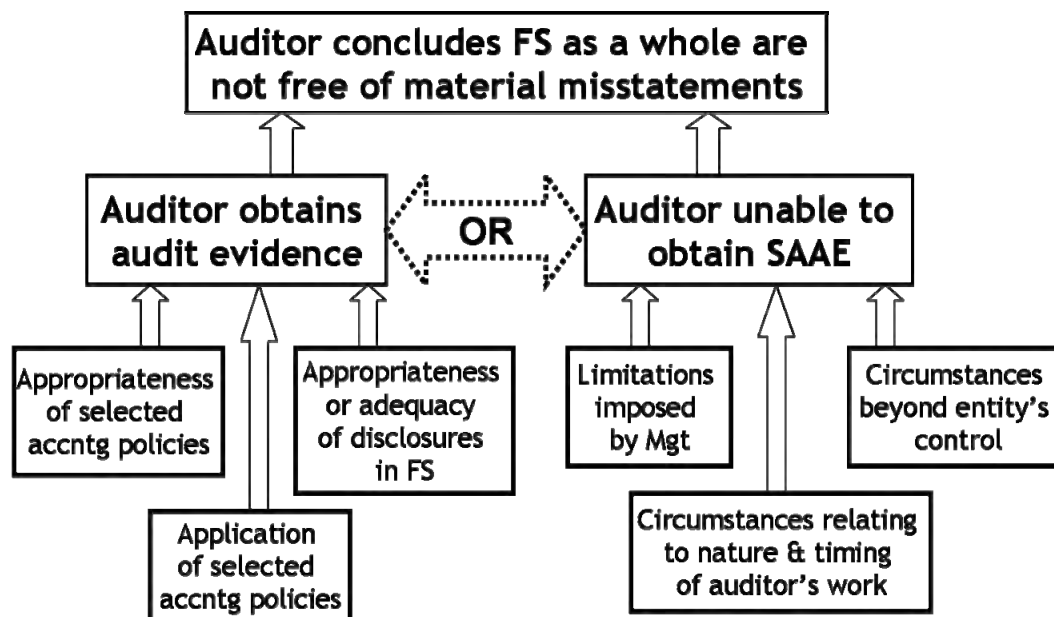
SA 705

**Definition – Modified Opinion**

- ❖ Qualified opinion.
- Or
- ❖ Adverse opinion.
- Or
- ❖ Disclaimer of Opinion.

SA 705

## Circumstances When Modification to Audit Opinion is Required



SA 705

- ❖ **Misstatement-** Difference between the amount, classification, presentation, or disclosure of a reported FS item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with applicable FRF ([SA 450](#)). Accordingly, a material misstatement of the financial statements may arise in relation to:
  - The appropriateness/ application of the selected accounting policies; or
  - The appropriateness or adequacy of disclosures in the financial statements.
- ❖ **Inability to obtain SAAE:**
  - Inability to perform specific procedure is not inability to obtain SAAE if by performing alternate procedures SAAE is obtained.
  - Limitations imposed by mgt may have other implications such as on fraud risk assessment & engagement continuance.
- ❖ **Limitations Imposed by Mgt** ---- examples:
  - Mgt prevents the auditor from:
    - Observing the counting of the physical inventory; or
    - Requesting external confirmation of specific account balances.
- ❖ **Circumstances relating to nature or timing of auditor's work** --- examples:
  - The entity is required to use the equity method of accounting for an associated entity, and the auditor is unable to obtain SAAE about the latter's financial information to evaluate whether the equity method has been appropriately applied.
  - The timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories.
  - The auditor determines that performing substantive procedures alone is not sufficient, but the entity's controls are not effective.
- ❖ **Circumstances beyond entity's control** ---- examples,
  - The entity's accounting records have been destroyed.
  - The accounting records of a significant component have been seized indefinitely by governmental authorities.

### **Appropriateness of the Selected Accounting Policies**

**RMM:**

- Selected accounting policies not consistent with applicable FRF.
- FS (including related notes) do not represent the underlying transactions & events in a manner that achieves fair presentation.
- Non/ inadequate disclosure of change in accounting policies.

SA 705

### **Application of the Selected Accounting Policies**

**RMM:**

- ❖ Inconsistency in selected policy *vis a vis* FRF in application of accounting policies.
- ❖ Inappropriate method of application of selected accounting policies.

SA 705

## Appropriateness/ Adequacy of Disclosures in FS

**RMM:**

- ❖ FS do not include all disclosures as required by FRF.
- ❖ Disclosures not presented in accordance with FRF.
- ❖ FS do not provide disclosures necessary to achieve fair presentation.

SA 705

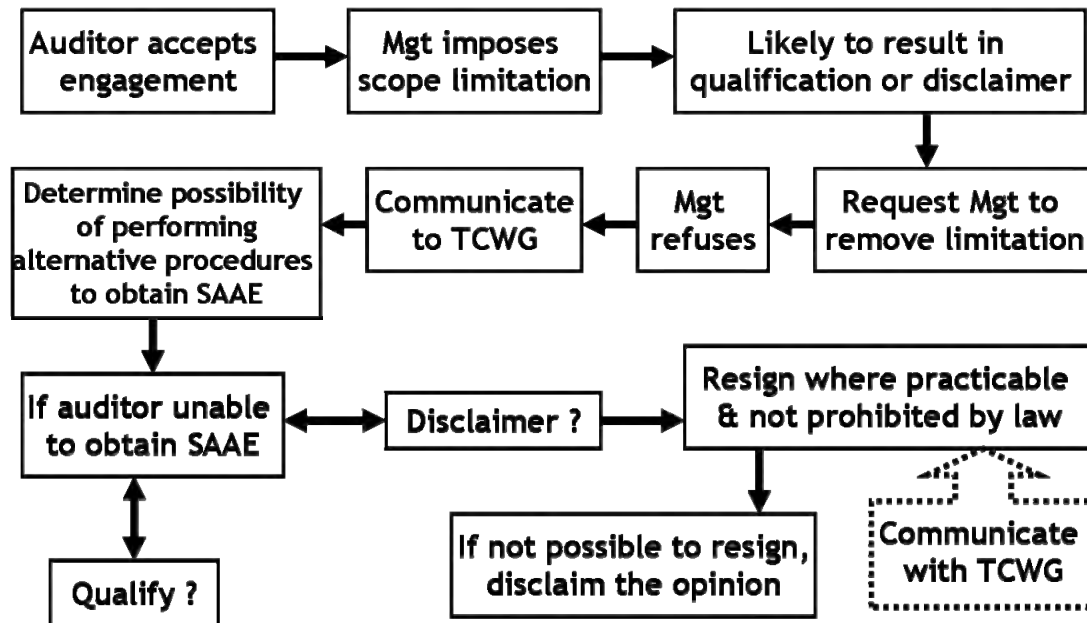
## Determining the Type of Modification to Auditor's Opinion

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the FS	
	<i>Material but Not Pervasive</i>	<i>Material and Pervasive</i>
<i>FS are materially misstated</i>	Qualified opinion	Adverse opinion
<i>Inability to obtain SAAE</i>	Qualified opinion	Disclaimer of opinion

SA 705

- ❖ The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

### Subsequent Scope Limitation



SA 705

#### Auditor unable to obtain SAAE:

- ❖ **QUALIFY**, if the auditor concludes that the possible effects on FS of undetected misstatements, if any, could be material but not pervasive
- ❖ **DISCLAIMER**, if the auditor concludes that the possible effects on the FS of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation.
- ❖ Before resigning, auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

## **Adverse/ Disclaimer – Other Considerations**

- ❖ Audit report not to include unmodified opinion wrt same FRF on a single FS or one or more specific elements, accounts or items of FS:
  - Otherwise audit opinion is contradicted on FS as a whole.

**SA 705**

- ❖ The following are examples of reporting circumstances that would not contradict the auditor's adverse opinion or disclaimer of opinion:
  - The expression of an unmodified opinion on financial statements prepared under a given financial reporting framework and, within the same report, the expression of an adverse opinion on the same financial statements under a different financial reporting framework.
  - The expression of a disclaimer of opinion regarding the results of operations, and cash flows, where relevant, and an unmodified opinion regarding the financial position (see SA 510). In this case, the auditor has not expressed a disclaimer of opinion on the financial statements as a whole.

## **Modified Opinion - Form & Content of Auditor's Report**

### **Basis of Modification Para:**

- ❖ In addition to other elements as per SA 700.
- ❖ Amend Auditor's responsibility statement.
- ❖ Description of matter giving rise to modification.
- ❖ Placed immediately before Opinion Para.
- ❖ Use heading "*Basis for ..... Opinion*".

### **Opinion Para:**

- ❖ Use heading "Qualified Opinion", "Adverse Opinion", or "Disclaimer of Opinion", as appropriate.

**SA 705**

Material misstatement in FS relating to	Description in BMP in Audit Report
Specific amounts in FS (including quantitative disclosures)	Description & quantification of financial effects of misstatements unless impracticable.
	If impracticable, state so.
Narrative disclosures	Explanation of how disclosures are misstated.
Non-disclosure of info required to be disclosed	<ul style="list-style-type: none"> <li>• Discuss with TCWG .</li> <li>• Nature of omitted info.</li> <li>• Include omitted disclosures if: → <ul style="list-style-type: none"> <li>▪ Not prohibited by L&amp;R;</li> <li>▪ Is practicable to do so; and</li> <li>▪ SAAE has been obtained re omitted info.</li> </ul> </li> </ul>
Modification results from inability to obtain SAAE	Reasons for inability.
Adverse/ disclaimer opinion	Reasons for any other matters which auditor is aware that would have required modified opinion & its effects.

**SA 705**

- ❖ Disclosing the omitted information in the basis for modification paragraph would not be practicable if:
- The disclosures have not been prepared by management or the disclosures are otherwise not readily available to the auditor; or
  - In the auditor's judgment, the disclosures would be unduly voluminous in relation to the auditor's report.

### **Illustrative Wordings – Qualified Opinion**

***Except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph:***

- ❖ The FS present fairly, in all material respects (or give a true and fair view) in accordance with the applicable FRF when reporting in accordance with a fair presentation framework;

**OR**

- ❖ The FS have been prepared, in all material respects, in accordance with the applicable FRF when reporting in accordance with a compliance framework.

**SA 705**

- ❖ When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase “except for the possible effects of the matter(s)…” for the modified opinion.
- ❖ When the auditor expresses a qualified opinion, it would not be appropriate to use phrases such as “with the foregoing explanation” or “subject to” in the opinion paragraph as these are not sufficiently clear or forceful.

### **Illustrative Wordings – Adverse Opinion**

- ❖ In the auditor's opinion, because of the significance of the matter(s) described in the Basis of Adverse Opinion paragraph:
  - The FS do not present fairly (or give a true and fair view) in accordance with the applicable FRF when reporting in accordance with a fair presentation framework; or
  - The FS have not been prepared, in all material respects, in accordance with the applicable FRF when reporting in accordance with a compliance framework.

**SA 705**



### **Illustrative Wordings – Disclaimer of Opinion**

- ❖ Because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion; and,
- ❖ Accordingly, the auditor does not express an opinion on the financial statements.

SA 705

### **Description of Auditor's Responsibility**

- ❖ **Qualified/ Adverse Opinion:**
  - Amend description.
  - State that auditor believes that audit evidence obtained is sufficient & appropriate to provide basis for auditor's modified opinion.
- ❖ **Disclaimer of Opinion:**
  - Amend the introductory para/description of auditor's resp and scope of audit.
  - "Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with Standards on Auditing issued by the Institute of Chartered Accountants of India. Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion".

SA 705

## **Communication with TCWG**

If modified opinion is expected, communicate with TCWG:

- ❖ Circumstances that led to expected modification.
- ❖ Proposed wording of modification.

**SA 705**

- ❖ Communicating with TCWG enables:
  - Auditor to give notice to TCWG of the intended modification(s) and the reasons (or circumstances) for the modification(s);
  - Auditor to seek concurrence of TCWG re facts of the matter(s) giving rise to the expected modification(s), or to confirm matters of disagreement with mgt as such; and
  - TCWG to have an opportunity, where appropriate, to provide the auditor with further information and explanations in respect of the matter(s) giving rise to the expected modification(s).

## **Material Modification** **vis a vis ISA 705**

**Added:**

- ❖ In Paragraph A18- Effect of aggregate of quantifications of misstatement on FS.

**SA 705**

# SA 706

## Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

*Effective for Audits of financial statements for periods beginning on or after April 1, 2011*

### Overview of SA 706

- ❖ **Introduction**
  - Scope
  - Effective date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements & Application**
  - Emphasis of matter paragraphs
  - Other matter paragraphs
  - Communication with TCWG

SA 706

## **Scope & Auditor's Objectives**

- ❖ Additional communication in audit report (AR).
  - ❖ When auditor considers necessary.
  - ❖ To draw users' attention to:
    - Matter/s presented or disclosed in FS that are of such importance that they are fundamental to users' understanding of FS.
- OR**
- Matter/s other than those presented/ disclosed in FS that are relevant to users' understanding of audit/ auditor's responsibilities/AR.

**SA 706**

- ❖ Other SAs may contain specific requirements for the auditor to include Emphasis of Matter paragraphs or Other Matter paragraphs in the auditor's report. In those circumstances, the requirements in this SA regarding the form and placement of such paragraphs apply.

## **Definitions**

- ❖ **Emphasis of Matter Paragraph (EMP):**
  - Para included in AR.
  - Refers to a matter appropriately presented/ disclosed in FS that.
  - In the auditor's judgment is of such importance that.
  - It is fundamental to users' understanding of FS.
- ❖ **Other Matter Paragraph (OMP):**
  - Para included in AR.
  - Refers to matter other than those presented/ disclosed in FS.
  - In auditor's judgment.
  - Is relevant to users' understanding of audit, auditor's responsibilities or auditor's report.

**SA 706**

## **EMP in Audit Report**

- ❖ **Matters fundamental to understanding of FS:**
  - Auditor should have obtained SAAE that matter is not materially misstated in FS.
  - EMP to refer only to info presented/ disclosed in FS.
- ❖ **Widespread use of EMP reduces effectiveness of auditor's communication of such matters:**
  - More info in EMP than FS may imply matter not adequately presented or disclosed in FS.
  - Thus, EMP limited to matter presented/ disclosed in FS.

**SA 706**

- ❖ **Examples of EMP circumstances:**
  - An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
  - Early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.
  - A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

## **EMP not a substitute for**

- ❖ Need for expression of qualified opinion or an adverse opinion, or disclaiming an opinion, or
- ❖ Disclosures to be made by mgt in FS as required by applicable FRF.

**SA 706**

## **EMP – Some More Considerations**

- ❖ Placement - immediately after Opinion para.
- ❖ Use heading “EMP” or other appropriate heading.
- ❖ EMP to contain clear ref to:
  - Matter being emphasised.
  - Where relevant, disclosure that fully describe the matter can be found in FS.
- ❖ Indicate that audit opinion is not modified in respect of matter emphasised.

**SA 706**

## OMP in Audit Report

- ❖ Include if not prohibited by L&R.
- ❖ Use heading "Other Matter"/ other appropriate heading.
- ❖ Placement:
  - immediately after Opinion para & EMP; or
  - elsewhere if OMP is relevant to Other Reporting Responsibilities section.

### SA 706

- ❖ **Relevant to users' understanding of audit.**  
Explanation of why auditor is unable to resign even where he is unable to obtain SAAE due to limitations imposed by mgt.
- ❖ **Relevant to users' understanding of Auditor's Responsibility:**
  - Law, regulation or generally accepted practice may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of FS or of the auditor's report thereon. Where relevant, one or more sub-headings may be used that describe the content of the OMP.
  - An OMP does not deal with circumstances where the auditor has other reporting responsibilities that are in addition to the auditor's responsibility under the SAs to report on FS or where the auditor has been asked to perform and report on additional specified procedures, or to express an opinion on specific matters.
- ❖ **Reporting on more than one set of financial statements**  
An entity may prepare one set of FS in accordance with a general purpose framework (e.g., the national framework) and another set of financial statements in accordance with another general purpose framework (e.g., IFRS), and engage the auditor to report on both sets of FS. If the auditor has determined that the frameworks are acceptable in the respective circumstances, the auditor may include OMP in the auditor's report, referring to the fact that another set of FS has been prepared by the same entity in accordance with another general purpose framework and that the auditor has issued a report on those financial statements.
- ❖ **Restriction on distribution or use of the auditor's report**  
FS prepared for a specific purpose may be prepared in accordance with a general purpose framework because the intended users have determined that such general purpose FS meet their financial information needs. Since the auditor's report is intended for specific users, the auditor may consider it necessary in the circumstances to include OMP, stating that the auditor's report is intended solely for the intended users, and should not be distributed to or used by other parties.

## OMP – Other Considerations

- ❖ Clearly reflect that such other matter is not required to be presented and disclosed in FS.
- ❖ Not to include:
  - Info prohibited from inclusion by L&R, other standards, e.g., ethics relating to confidentiality of information.
  - Info required to be provided by mgt.
- ❖ Placement:
  - Depends upon nature of info to be communicated.

SA 706

- ❖ **Placement:**
  - OMP is included to ***draw users' attention to a matter relevant to their understanding of the audit of FS***, give immediately after the Opinion paragraph and any Emphasis of Matter paragraph.
  - OMP included to ***draw users' attention to a matter relating to Other Reporting Responsibilities addressed in the auditor's report***, give in the section sub-titled "Report on Other Legal and Regulatory Requirements."
  - Alternatively, when ***relevant to all the auditor's responsibilities or users' understanding of the auditor's report***, give OMP as a separate section following the Report on the Financial Statements and the Report on Other Legal and Regulatory Requirements.

## Communication with TCWG

### **Communicate:**

- ❖ Expectation to include EMP/ OMP.
- ❖ Proposed wordings of paras.

SA 706

### **Such communication:**

- ❖ Enables TCWG to be made aware of the nature of any specific matters that the auditor intends to highlight in AR,
  - ❖ Provides them with an opportunity to obtain further clarification from the auditor where necessary.
- Where the inclusion of an Other Matter paragraph on a particular matter in the auditor's report recurs on each successive engagement, the auditor may determine that it is unnecessary to repeat the communication on each engagement.



# SA 710

## Comparative Information – Corresponding Figures and Comparative Financial Statements

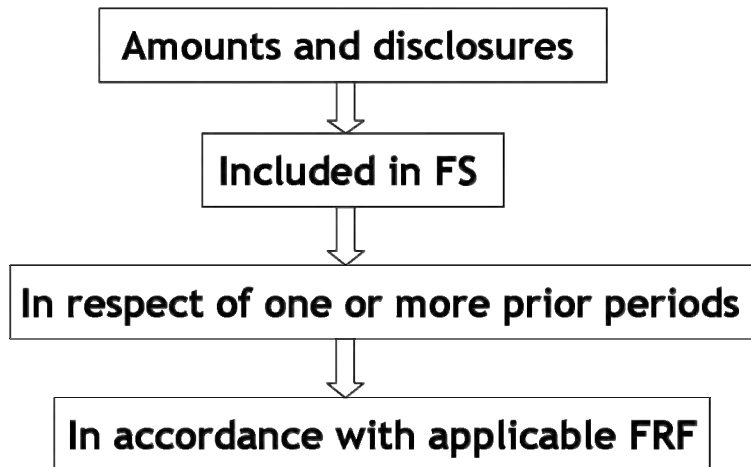
*Effective for Audits of financial statements for periods beginning on or after April 1, 2011*

### Overview of SA 710

- ❖ **Introduction**
  - Scope
  - Effective date
- ❖ **Objectives**
- ❖ **Definitions**
- ❖ **Requirements & Application**
  - Audit procedures
  - Audit reporting
- ❖ **Appendix: Illustrative Audit Reports**

SA 710

## Comparative Information



SA 710

## Scope

- ❖ Auditor's responsibilities relating to comparative info in audit of FS.
- ❖ When prior period FS are audited by another auditor/ unaudited:
  - Also apply SA 510 to audit of opening balances.
- ❖ Nature of Comparative Info:
  - Depends upon applicable FRF.
  - Two approaches:
    - Corresponding figures.
    - Comparative FS.
  - Approach often specified by L&R:
    - May also be specified by terms of engagement.

SA 710

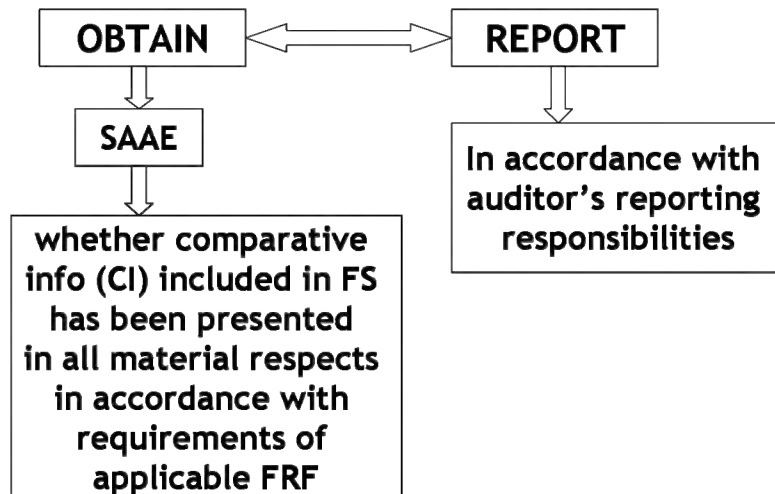
**Corresponding Figures vis a vis Comparative FS:**  
**Audit reporting differences**

Corresponding Figures	Comparative FS
Auditor's opinion on FS refers to current period only	Auditor's opinion refers to each period for which FS are presented

**SA 710** separately covers audit reporting for both types of approaches

SA 710

**Auditor's Objectives**



SA 710

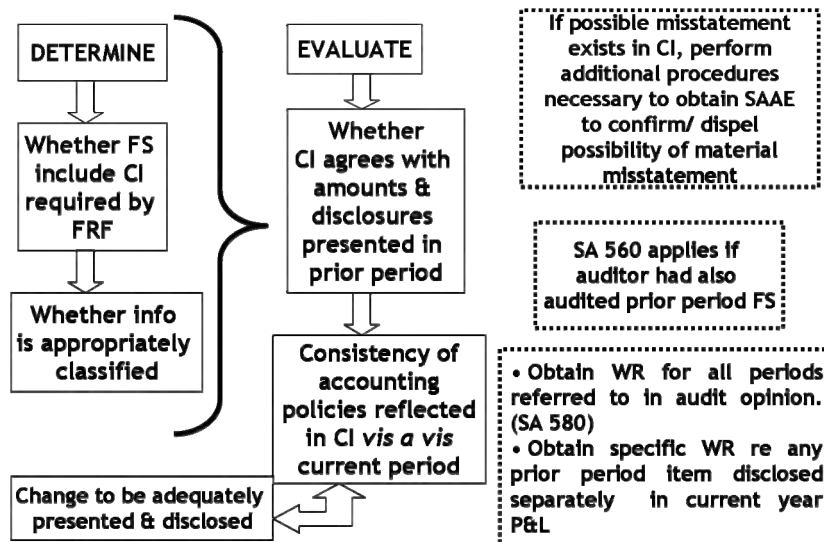
## Definitions

	Corresponding Figures	Comparative FS
Amounts & disclosures for prior periods	Integral part of current period FS	If audited, are referred to in audit opinion.
Intention/ objective	To be read only in relation to amounts & disclosures relating to current period	Included for comparison with current period FS.
Level of info/ detail	Dictated primarily by relevance to current period figures	Comparable with current period FS

SA 710

- ❖ **Prior Periods** – prior periods when the comparative information includes amounts and disclosures for more than one period.

## Audit Procedures



SA 710

### Written Representation:

- Management needs to re-affirm that the WR it previously made with respect to the prior period remain appropriate.
- For corresponding figures- current period only.

## **Audit Reporting – Corresponding Figures**

- ❖ Audit opinion not to refer to corresponding figures, EXCEPT:
  - Auditor's report in prior period FS was modified and the subject matter is still unresolved:
    - Modify current audit report also.
  - Auditor obtains audit evidence re existence of material misstatement in prior period FS on which unmodified opinion was issued:
    - Express qualified/ adverse opinion on current FS wrt Corresponding figures if misstatement has not been dealt as required by applicable FRF.

### **SA 710**

- ❖ In the Basis for Modification paragraph in the auditor's report, the auditor shall either:
  - Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
  - In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.
- ❖ When the prior period financial statements that are misstated have not been amended and an auditor's report thereon has not been issued in accordance with the requirements of SA 560, "Subsequent Events", but the corresponding figures have been properly dealt with as required under the applicable financial reporting framework and the appropriate disclosures have been made in the current period financial statements, the auditor's report may include an Emphasis of Matter paragraph describing the circumstances and referring to, where relevant, disclosures that fully describe the matter that can be found in the financial statements (see SA 706).

## **Prior Period FS Audited by Another Auditor**

- ❖ If L&R permits reference to predecessor auditor's report on corresponding figures, current audit report to include Other Matter para:
  - FS of prior period were audited by another auditor.
  - Type of opinion expressed by predecessor auditor (reasons for modification, if any).
  - Date of that report.

### **SA 710**

### **Prior Period FS are Unaudited**

- ❖ Include Other Matters para:
  - That corresponding figures are unaudited.
- ❖ BUT, this does not relieve the auditor from need to obtain SAAE that opening balances do not contain misstatements that can potentially affect current FS.

**SA 710**

- ❖ Where prior period financial statements were not audited, the auditor should request the management to disclose this fact on the face of the current period financial statements with respect to the corresponding figures.

### **Audit Reporting – Comparative FS**

- ❖ Audit opinion to refer to each period for which FS are presented and on which opinion is expressed.
- ❖ If opinion on prior period FS expressed in current period differs from opinion expressed in the relevant prior period, give substantive reason for difference in Other Matter para. (SA 706)

**SA 710**

- ❖ Because the auditor's report on comparative financial statements applies to the financial statements for each of the periods presented, the auditor may express a qualified opinion or an adverse opinion, disclaim an opinion, or include an Emphasis of Matter paragraph with respect to one or more periods, while expressing a different auditor's opinion on the financial statements of the other period.

## **Prior Period FS Audited by Another Auditor**

### **Audit report to also contain:**

- ❖ Other Matter para, stating that:
  - FS of prior period were audited by predecessor auditor.
  - Type of opinion expressed by him (reasons for modifications, if any).
  - Date of that report.
- ❖ If material misstatement exists in prior period FS (not reflected in previous audit report):
  - Communicate misstatement to mgt/ TCWG.
  - Request that predecessor auditor be informed.

**SA 710**

- ❖ If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period.
- ❖ The predecessor auditor may be unable or unwilling to revise the auditor's report on the prior period financial statements. An Other Matter paragraph of the auditor's report may indicate that the predecessor auditor reported on the financial statements of the prior period before amendment. In addition, if the auditor is engaged to audit and obtains sufficient appropriate audit evidence to be satisfied as to the appropriateness of the amendment, the auditor's report may also include the following paragraph:
  - "As part of our audit of the 20X2 financial statements, we also audited the adjustments described in Note X that were applied to amend the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 20X1 financial statements of the company other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X1 financial statements taken as a whole."

## **Prior Period FS are Unaudited**

- ❖ Include Other Matters para:
  - That corresponding FS are unaudited.
- ❖ BUT, this does not relieve the auditor from need to obtain SAAE that opening balances do not contain misstatements that can potentially affect current FS.

**SA 710**

### **Material Modifications vis a vis ISA 710**

- ❖ **Paragraphs 9 and 12** : the requirement of restatement of prior period items has been replaced with the requirement to disclose the prior period items in the current year's Statement of Profit & Loss.
- ❖ **Paragraph 17** : the nomenclature, "Reissue" has been replaced with the word, "Revised".

SA 710

## **SA 720**

### **The Auditor's Responsibilities in Relation to Other Information in Documents Containing Audited Financial Statements**

*Effective for Audits of financial statements for periods beginning on or after April 1, 2010*



## Overview of SA 720

- ❖ **Introduction**
  - Scope
  - Effective date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements**
  - Reading Other Information (OI)
  - Material Inconsistencies
  - Material Misstatement of Fact
- ❖ **Application & Other Explanatory Material on these aspects**



SA 720

## Scope

- ❖ Deals with auditor's responsibility wrt **other information (OI)** in documents containing:
  - audited financial statements; and auditor's opinion thereon.
- ❖ **Unless** any specific requirement in an engagement:
  - Auditor's opinion does not cover OI.
  - Auditor has no specific responsibility to determine whether OI is properly stated.
- ❖ **BUT, read the OI** since:
  - inconsistencies vis-a-vis audited FS undermines the credibility of the audited FS.

SA 720

## **Documents Containing Audited FS**

- ❖ Refers to :
  - Annual reports (or similar documents)  

  - Issued to owners (or similar stakeholders)  

  - Containing audited FS and Audit Report

**SA 720**

## **Auditor's Objective**

- ❖ Respond appropriately:
- ❖ where such other information could undermine credibility of audited FS and Audit Report.

**SA 720**

## **Definitions**

### **Other Information (OI)**

- ❖ Financial & non-financial information, Included by law/ regulation/custom, in documents containing audited FS and Audit Report. Examples:
  - Report by management / TCWG.
  - Financial summaries/ highlights.
  - Financial ratios.
  - Selected quarterly data.
- ❖ Does not include:
  - Press release/transmittal memorandum accompanying the documents containing audited FS.
  - Information contained in analyst briefings.
  - Information on entity's website.

**SA 720**

## **Inconsistency**

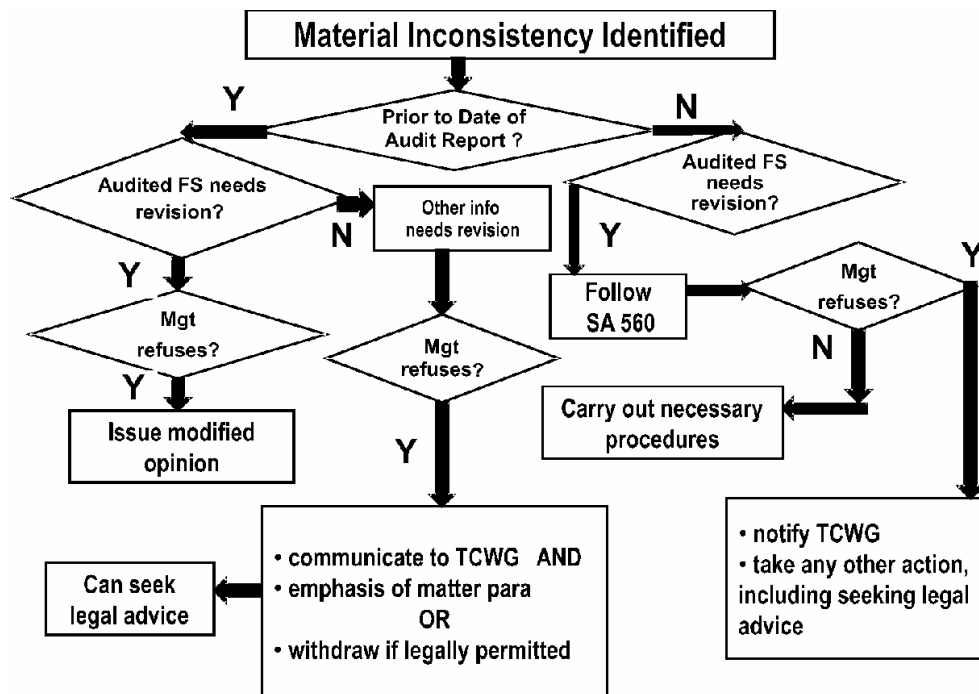
- ❖ OI that contradicts information contained in audited FS.
- ❖ May raise doubt about:
  - audit conclusions drawn from audit evidence obtained earlier.
  - Basis of audit opinion on FS.
- ❖ **Misstatement of Fact**
  - OI that is:
    - Unrelated to audited FS and
    - Incorrectly stated/ presented.
  - May undermine credibility of audited FS.

**SA 720**

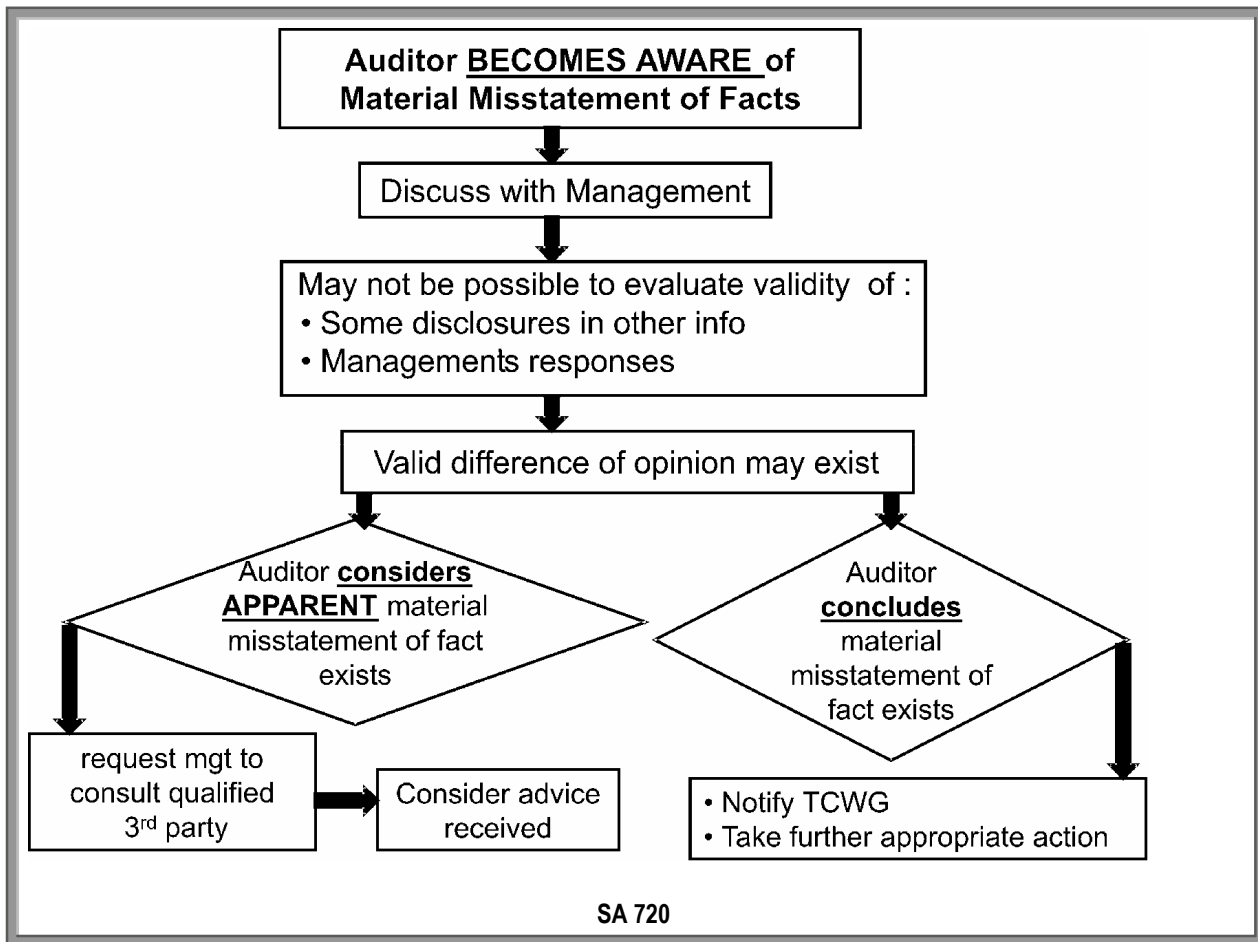
## Reading Other Information

- ❖ Read OI to identify material inconsistencies *vis-a-vis* audited FS.
- ❖ Make appropriate arrangements with mgt/TCWG to get OI **before** date of Audit Report:
  - Helps timely resolution of possible material inconsistency/ misstatement of facts.
  - Agreement with management as to time of availability of OI.
  - If not possible before, then get OI, as soon as practicable.

SA 720



SA 720



### 800-899 - Specialized Areas

- ❖ SA 800, "Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks" (April 1, 2011)
- ❖ SA 805, "Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement" (April 1, 2011)
- ❖ SA 810, "Engagements to Report on Summary Financial Statements" (April 1, 2011)

# SA 800

## Special Considerations: Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks

*Effective for Audits of financial statements for periods beginning on or after April 1, 2011*

### Overview of SA 800

- ❖ **Introduction**
  - Scope
  - Effective date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements & Application**
  - Considerations when accepting the engagement
  - Considerations when planning & performing the audit
  - Forming an opinion & reporting considerations

SA 800

### **Scope of SA 800**

- ❖ Deals with special considerations in the application of SAs to audit of FS prepared in accordance with a special purpose framework.
- ❖ Written in the context of complete set of FS prepared in accordance with a special purpose framework.
- ❖ Does not override the requirements of the other SAs.
- ❖ May not deal with all special considerations relevant in the circumstances of the engagement.

**SA 800**

### **Auditor's Objective**

**Address appropriately considerations relevant to:**

- ❖ Engagement acceptance.
- ❖ Engagement planning & performance.
- ❖ Forming opinion & reporting on FS.

**SA 800**

## **Definitions**

### **Special Purpose FS**

- ❖ FS prepared in accordance with special purpose framework:
  - It may be the only FS that entity prepares, FS may be used by users other than those designated under SPFRF.
  - Even then FS are considered to be prepared under SPFRF.

**SA 800**

## **Special Purpose Framework**

- ❖ FRF designed to meet financial info needs of specific users:
  - Compliance / Fair presentation.
  - SPFRF based on GPFRF but not complying with all its requirements cannot be described as GPFRF.
- ❖ Related notes ordinarily comprise a summary of significant accounting policies and other explanatory info:
  - Applicable FRF determines the form and content of FS, and what constitutes a complete set of FS.

**SA 800**

- ❖ Examples of special purpose frameworks are:
  - The cash receipts and disbursements basis of accounting for cash flow information that an entity may be requested to prepare for creditors;
  - The financial reporting provisions established by a regulator to meet the requirements of that regulator; or
  - The financial reporting provisions of a contract, such as a bond indenture, a loan agreement, or a project grant.



## **Engagement Acceptance - Considerations**

- ❖ Obtain understanding of:
  - Purpose for which FS are prepared.
  - Intended users.
  - Steps taken by mgt to determine that applicable FRF is acceptable.

### **SA 800**

- ❖ Financial information needs of the intended users are a key factor in determining the acceptability of the FRF applied in the preparation of the financial statements.
- ❖ Applicable FRF may encompass:
  - Financial reporting standards established by authorised or recognised organisation.
  - Some L & R may prescribe the FRF to be used by management. (See SA 210, para 18).
  - The financial reporting provisions of a contract, or sources. Acceptability of the financial reporting framework is determined by considering whether the framework exhibits attributes normally exhibited by acceptable financial reporting frameworks. (SA 210)

## **Planning & Performing an Audit – Considerations**

- ❖ Determine whether the application of SAs require special considerations in circumstances of the engagement.

### **SA 800**

- ❖ Refer SA 200 on applicability of SAs and absence of conditions requiring applicability of an SA.
- ❖ SA 320 re judgment re matters that are material to users of financial statements are based on consideration of common financial info needs of users as a group.
- ❖ SA 315 requires understanding of selection and application of accounting principles and policies. In case where accounts are prepared on the basis of provisions of a contract, auditor is required to obtain understanding of any significant interpretations of the contract.
- ❖ TCWG may not have a responsibility of overseeing the preparation of those financial statements in SFRF; for example, when the financial information is prepared solely for management's use. In such cases, the requirements of SA 260 may not be relevant to the audit of the SPFS, except when the auditor is also responsible for the audit of the entity's GPFS statements or, for example, has agreed with TCWG of the entity to communicate to them relevant matters identified during the audit of the SPFS.

## **Forming an Opinion & Reporting Considerations**

### **❖ Apply SA 700.**

Also:

- ❖ Describe the purpose for which FS are prepared & intended users.
- ❖ If mgt has a choice of FRFs in the preparation of FS:
  - Explanation of mgt's responsibility for the FS make reference to its responsibility for determining acceptability of applicable FRF.
- ❖ Evaluate whether FS adequately describe the FRF applied.
- ❖ Include Emphasis of Matter para to alert users re application of special purpose FRF:
  - FS may not be suitable for another purpose.

### **SA 800**

- ❖ SA 700 requires the auditor to evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.

### **Restriction on Distribution or Use**

- ❖ SPFS may be used for purposes other than those for which they were intended. Alert users by:
  - Considering it appropriate to indicate that the auditor's report is intended solely for the specific users.
  - Depending on the L & R, restrict the distribution or use of the auditor's report. Include these other matters, and the heading in AR.

# SA 805

## **Special Considerations: Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement**

*Effective for audits of single financial statements or of specific elements, accounts or items for periods beginning on or after April 1, 2011*

### **Overview of SA 805**

- ❖ **Introduction**
  - Scope
  - Effective date
- ❖ **Objective**
- ❖ **Definitions**
- ❖ **Requirements & Application**
  - Considerations when accepting the engagement
  - Considerations when planning & performing the audit
  - Forming an opinion and reporting considerations

SA 805

## **Scope**

- ❖ SAs 100 – 700 series apply to audit of FS:
  - To be adopted as necessary in audit of other historical financial info.
- ❖ SA 805 deals with special considerations in application of these SAs to:
  - Audit of single financial statements (SFS).
  - Specific element/account/ item of FS (EFS).
- ❖ DOES NOT:
  - Apply to report of component auditor.
  - Override requirements of other SAs.
  - Deal with special considerations that may be relevant in circumstances of the engagement.

### **SA 805**

- ❖ The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, SA 800 also applies to the audit.
- ❖ **“Historical financial information” (SA 200)**  
Information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.
- ❖ **“Financial statements” (SA 200)**  
A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a FRF. The term ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable FRF.
- ❖ Other historical financial information- a single financial statement or a specific element of a financial statement.
- ❖ A Reasonable assurance engagement other than an audit of historical financial information is performed in accordance with Proposed Standard on Assurance Engagements (SAE) 3000.

#### **Examples of Specific Elements, Accounts or Items of a Financial Statement:**

- ❖ Accounts receivable, allowance for doubtful accounts receivable, inventory, the liability for accrued benefits of a private pension plan, the recorded value of identified intangible assets, or the liability for “incurred but not reported” claims in an insurance portfolio, including related notes.
- ❖ A schedule of externally managed assets and income of a private pension plan, including related notes.
- ❖ A schedule of net tangible assets, including related notes.
- ❖ A schedule of disbursements in relation to a lease property, including explanatory notes.
- ❖ A schedule of profit participation or employee bonuses, including explanatory notes.

## Auditor's Objective

- ❖ Address appropriately special considerations that are relevant to:
  - Acceptance of the engagement.
  - Planning & performance of that engagement.
  - Forming an opinion & reporting on SFS & EFS.

SA 805

## Definitions

- ❖ **Element of a FS (EFS):**
  - Element/ account/ item of a FS.
- ❖ **Financial Reporting Standards.**
- ❖ **Single Financial Statements (SFS):**
  - Includes related notes.

SA 805

- ❖ **“Financial Reporting Standards”:**
  - Accounting Standards promulgated by the Accounting Standards Board (ASB) of ICAI,
  - Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006,
  - Accounting Standards for Local Bodies promulgated by the Committee on Accounting Standards for Local Bodies (CASLB) of ICAI,  
as may be applicable
- ❖ **A single financial statement** (for example, a cash flow statement) or to a specific element of a financial statement (for example, cash and bank balances) includes the related notes. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the financial statement or to the element.

## **Acceptability of FRF**

- ❖ SA 200 requires compliance with all SAs relevant to audit:
  - This applies to audit of SFS even if the auditor also audits the complete FS.
  - If auditor not also engaged to audit the complete FS, consider the practicability of audit of SFS in accordance with SAs.

### **SA 805**

- ❖ Includes need to comply with ethical standards including independence. (SA 200)
  - ❖ Why it is not practicable to audit SFS if you are not also engaged to audit complete FS:
    - The auditor often does not have the same understanding of the entity and its environment, including its internal control, as an auditor who also audits the entity's complete set of financial statements.
    - The auditor also does not have the audit evidence about the general quality of the accounting records or other accounting information that would be acquired in an audit of the entity's complete set of financial statements.
- Accordingly, the auditor may need further evidence to corroborate audit evidence acquired from the accounting records. In the case of an audit of a specific element of a financial statement, certain SAs require audit work that may be disproportionate to the element being audited.

## **Acceptability of FRF**

- ❖ Auditor to determine acceptability of FRF (SA 210):
  - Consider whether FRF includes all requirements relevant to preparation of SFS/EFS.
  - For audit of SFS, determine:
    - Whether application of FRF will result in presentation that provides adequate disclosures to enable intended users to understand info conveyed in SFS; and
    - Effect of material transactions and events on info conveyed in SFS.

### **SA 805**

## Form of Opinion

- ❖ Expected form of opinion depends upon applicable FRF & applicable L&R.
- ❖ Communicate expected form of report – SA 210:
  - Consider whether expected form of opinion is appropriate in the circumstances.

### SA 805

- ❖ Factors that may affect the auditor's consideration as to whether to use the phrases "presents fairly, in all material respects", or "gives a true and fair view" in the auditor's opinion include:
  - Whether the applicable FRF is explicitly or implicitly restricted to the preparation of a complete set of FS.
  - Whether the SFS or the EFS will:
    - Comply fully with each of those requirements of the framework relevant to the particular financial statement or the particular element, and the presentation of the FS or the element include the related notes.
    - If necessary to achieve fair presentation, provide disclosures beyond those specifically required by the framework or, in exceptional circumstances, depart from a requirement of the framework.
- ❖ The auditor's decision as to the expected form of opinion is a matter of professional judgment.

## **Planning & Performance Considerations**

- ❖ Adapt all SAs as necessary in the audit of SFS:
  - Careful consideration of relevance of each SA is necessary.
  - When auditing SFS in conjunction with full FS, audit evidence obtained as part of audit of full FS may be useful but auditor nevertheless needs to plan & perform audit of SFS to obtain SAAE.
  - Some items from complete FS may be interrelated with EFS:
    - Auditor would need to perform procedures on such interrelated items.
  - Materiality of SFS < materiality for full FS:
    - Affects Nature, Timing, Extent of audit procedures.

**SA 805**

## **Forming Opinion & Reporting - Considerations**

- ❖ Apply SA 700, as necessary.
- ❖ If also engaged to report on full FS, express separate opinion on each engagement.
- ❖ If audited SFS published with entity's audited full FS, presentation of SFS should be clearly differentiated from full FS.
- ❖ Do not issue audit report on SFS until satisfied with the differentiation.

**SA 805**



## **Modified Opinion/ EMP/OMP Para on Full FS**

- ❖ Determine effect on SFS:
  - If appropriate, modify opinion on SFS/ include EMP, OMP.
  - If necessary to issue adverse / disclaimer opinion on full FS, unmodified opinion on SFS cannot be expressed, except (*for a specific element*):
    - Not prohibited by L&R;
    - Audit report on SFS not published together with audit report on full FS; and
    - Specific element does not constitute a major portion of entity's full FS.

Exception does not apply to SFS

SA 805

# **SA 810**

## **Engagements to Report on Summary Financial Statements**

*Effective for engagements for periods beginning on or after April 1, 2011*

## **Overview of SA 810**

### **❖ Introduction**

- Scope
- Effective date

### **❖ Objectives**

### **❖ Definitions**

### **❖ Requirements & Application**

- Engagement acceptance
- Nature of procedures
- Form of opinion
- Timing of work and events subsequent to the date of auditor's report
- Audit report on summary financial statements
- Restriction on distribution or use
- Comparatives
- Unaudited supplementary information presented with summary financial statements
- Other information in documents containing summary financial statements
- Auditor association

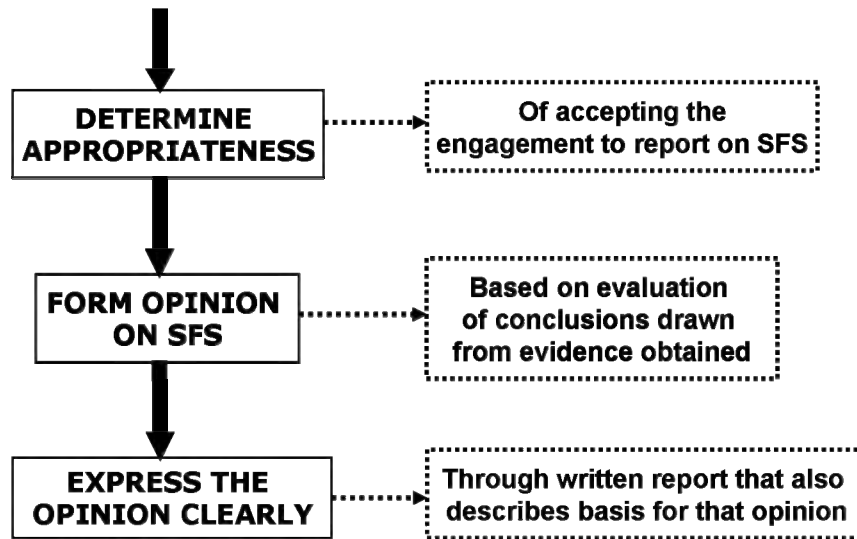
**SA 810**

## **Scope**

- ❖ Deals with auditor's responsibilities.
- ❖ When undertaking engagement to report.
- ❖ On summary financial statements (SFS).
- ❖ Derived from FS audited in accordance with SA.
- ❖ By that same auditor.

**SA 810**

## Objectives



SA 810

## Definitions

APPLIED CRITERIA	AUDITED FS	SUMMARY FS
Criteria applied by management in preparation of SFS	<ul style="list-style-type: none"> <li>FS audited by the auditor in accordance with SAs,</li> </ul> <p style="text-align: center;"><b>AND</b></p> <ul style="list-style-type: none"> <li>From which SFS are derived.</li> </ul>	Historical financial info that is: <ul style="list-style-type: none"> <li>Derived from FS</li> </ul> <p style="text-align: center;"><b>BUT</b></p> <ul style="list-style-type: none"> <li>Contains less detail than FS</li> </ul> <p style="text-align: center;"><b>WHILE STILL</b></p> <ul style="list-style-type: none"> <li>Providing a structured representation</li> </ul> <p style="text-align: center;"><b>CONSISTENT WITH</b></p> <ul style="list-style-type: none"> <li>That provided by entity's FS</li> </ul>

SA 810

- ❖ Summary FS provides info on entity's economic resources or obligations at a point in time or the changes therein for a period of time.

## **Engagement Acceptance**

- ❖ **Ordinarily,**
- ❖ Accept the engagement only when also engaged to audit in accordance with SAs those FS from which these SFS have been derived.

### **SA 810**

- ❖ **LOGIC** - The audit of the base FS provides the auditor with the necessary knowledge to discharge the auditor's responsibilities in relation to the SFS in accordance with this SA. Application of this SA will not provide sufficient appropriate evidence on which to base the opinion on the SFS if the auditor has not also audited the FS from which the SFS are derived.
- ❖ **EXCEPTION:** By way of footnote 5 – to cover situations of audit reports on financial information derived from FS of past 5 years in case of a prospectus.

## Before Accepting the Engagement

**DETERMINE  
whether  
applied criteria  
are acceptable**

**AGREE  
with mgt  
the form of opinion  
to be expressed on SFS**

**OBTAIN  
mgt agreement that it  
acknowledges & understands  
its responsibilities**

**Do not accept engagement if:  
• criteria are unacceptable OR  
• unable to obtain mgt agreement  
unless required by L&R**

SA 810

### Acceptability of Criteria

- ❖ SFS contain aggregated information and limited disclosure => increased risk that they may not contain the information necessary so as not to be misleading in the circumstances. This risk increases when established criteria for the preparation of summary financial statements do not exist.
- ❖ Factors affecting auditor's determination of the acceptability of the applied criteria include:
  - The nature of the entity;
  - The purpose of SFS;
  - The information needs of the intended users of SFS; and
  - Whether the applied criteria will result in SFS that are not misleading in the circumstances.
- ❖ Where established criteria do not exist but have been developed by management, their acceptability parameters would be whether they:
  - Adequately disclose their summarised nature and identify the audited FS;
  - Clearly describe from whom or where the audited FS are available or, if law or regulation provides that the audited FS need not be made available to the intended users of the SFS and establishes the criteria for the preparation of SFS, that law or regulation;
  - Adequately disclose the applied criteria;
  - Agree with or can be re-calculated from the related information in the audited FS; and
  - In view of the purpose of SFS, contain the information necessary, and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.

### Management acknowledgement

- For the preparation of SFS in accordance with the applied criteria;
- To make the audited FS available to the intended users of SFS without undue difficulty (or, if law or regulation provides that the audited FS need not be made available to the intended users of SFS and establishes the criteria for the preparation of SFS, to describe that law or regulation in SFS); and
- To include the auditor's report on SFS in any document that contains the SFS and that indicates that the auditor has reported on them.

### Not to accept engagement unless required by L&R

- An engagement conducted in accordance with such law or regulation does not comply with this SA.
- Accordingly, the auditor's report on SFS shall not indicate that the engagement was conducted in accordance with this SA.
- Include appropriate reference to this fact in the terms of the engagement.
- Determine the effect that this may have on the engagement to audit FS from which SFS are derived.

## **Nature of Procedures**

### **EVALUATE:**

- ❖ Whether SFS adequately:
  - Disclose their summarised nature; &
  - Identify the audited FS.
- ❖ If SFS are not accompanied by audited FS, whether they clearly describe:
  - From whom or where audited FS are available; OR
  - L&R that specifies that audited FS need not be made available to intended users of SFS & establishes criteria for preparation of SFS.
- ❖ Whether SFS adequately disclose the applied criteria.

**SA 810**

- ❖ Whether SFS are prepared in accordance with applied criteria.
- ❖ Whether SFS contain necessary info & are appropriately aggregated so as not to be misleading.
- ❖ Whether audited FS are available to intended users without undue difficulty.

### **COMPARE:**

- ❖ SFS with related info in audited FS to determine if SFS agree with or can be re-calculated from related info in audited FS.

**SA 810**

### **Undue difficulty is affected by factors such as whether:**

- ❖ The SFS describe clearly from whom or where the audited FS are available;
- ❖ The audited FS are on public record; or
- ❖ Management has established a process by which the intended users of the SFS can obtain ready access to the audited FS.

## **Form of Opinion**

- ❖ **Unmodified opinion on SFS, include in auditor's opinion:**
  - SFS are consistent, in all material respects, with audited FS, in accordance with (applied criteria)

**OR**

  - SFS are fair summary of audited FS in accordance with (applied criteria)
- ❖ **If L&R prescribe different wordings:**
  - Apply the procedures described in slides relating to nature of procedures and any further procedures necessary to be able to express the prescribed opinion; and
  - Evaluate whether users of SFS might misunderstand the auditor's opinion on SFS and, if so, whether additional explanation in the auditor's report on SFS can mitigate possible misunderstanding.

### **SA 810**

- ❖ If the auditor concludes that additional explanation in the auditor's report on SFS cannot mitigate possible misunderstanding, the auditor shall not accept the engagement, unless required by law or regulation to do so.
- ❖ An engagement conducted in accordance with such law or regulation does not comply with this SA.
- ❖ Accordingly, the auditor's report on the summary financial statements shall not indicate that the engagement was conducted in accordance with this SA.

## **Timing of Work & Subsequent Events**

- ❖ Report on SFS may be dated later than date of report on audited FS:
  - Audit report to state that SFS and audited FS do not reflect the effects of events after the date of audit report.
- ❖ Date the report on the SFS no earlier than:
  - Date on which the auditor has obtained sufficient appropriate evidence on which to base the opinion, including evidence:
    - SFS have been prepared; and
    - Recognised authority have asserted their responsibility for SFS.
  - Date of report on the audited FS.

### **SA 810**

- ❖ The auditor may become aware of facts that existed at the date of the auditor's report on the audited FS, but of which the auditor previously was unaware. In such cases, the auditor shall not issue the auditor's report on the SFS until the auditor's consideration of such facts in relation to the audited FS in accordance with SA 560 has been completed.
- ❖ When the auditor reports on the SFS after the completion of the audit of the FS, the auditor is not required to obtain additional audit evidence on the audited FS, or report on the effects of events that occurred subsequent to the date of the auditor's report on the audited FS since the SFS are derived from the audited FS and do not update them.

## Report on SFS - Elements

<b>Title</b>
<b>Addressee</b>
<b>Introductory para</b>
<b>Mgt responsibility para</b>
<b>Auditor responsibility statement</b>
<b>Auditor opinion on SFS</b>
<b>Auditor's signature</b>
<b>Date of Auditor's Report</b>
<b>Place of signature</b>

### SA 810

- ❖ **Title**- clearly indicating it as the report of an independent auditor. This distinguishes the report of the independent auditor from reports issued by others.
- ❖ **Addressee**- If addressee of SFS is not the same as the addressee of the auditor's report on audited FS, evaluate the appropriateness of using a different addressee.
  - Factors affecting auditor's evaluation of appropriateness of the addressee of SFS include:
    - Terms of the engagement
    - Nature of the entity
    - Purpose of SFS.
- ❖ **Introductory Paragraph**
  - Identifies SFS on which the auditor is reporting, including the title of each statement included in SFS;
  - Identifies the audited FS;
  - Refers to the auditor's report on the audited FS, the date of that report, and, subject to other requirements of this SA, the fact that an unmodified opinion is expressed on the audited FS;
  - If the date of the auditor's report on SFS is later than the date of the auditor's report on the audited FS, states that SFS and the audited FS do not reflect the effects of events that occurred subsequent to the date of the auditor's report on the audited FS; and
  - A statement indicating that SFS do not contain all the disclosures required by FRF applied in the preparation of audited FS, and that reading SFS is not a substitute for reading the audited FS.
- ❖ **Management's responsibility para** - explaining that management is responsible for the preparation of the summary financial statements in accordance with the applied criteria.
- ❖ **Auditor responsibility statement**- based on the procedures required by this SA.
- ❖ **Auditor's signature**- Along with the firm registration number, wherever applicable, and the membership number assigned by the Institute of Chartered Accountants of India (ICAI).



### **Qualified Opinion/ EoM/ OM Para in Report on Audited FS**

- ❖ If satisfied that SFS are consistent in all material respects or are a fair summary of audited FS in accordance with applied criteria, report on SFS to also:
  - State that audit report on FS contains qualified opinion/ EoM/OM para **AND**
  - Describe:
    - Basis for qualified opinion on audited FS, and that qualified opinion; or EoM/ OM para; and
    - Effect thereof on SFS, if any.

SA 810

### **Adverse/ Disclaimer of opinion in Audit Report**

**Additional matters to be given in audit report:**

- ❖ Statement that audit report contains adverse/ disclaimer of opinion;
  - ❖ Description of basis of such opinion;
- AND**
- ❖ Statement that as a result of adverse/ disclaimer of opinion it is inappropriate to express an opinion on SFS.

SA 810

## **Modified Opinion on SFS**

**Express adverse opinion if:**

- ❖ SFS are not consistent in all material respects with or are not a fair summary of audited FS in accordance with applied criteria.

**AND**

- ❖ Management does not agree to make the necessary changes.

**SA 810**

## **Restriction on Distribution/ Use**

- ❖ When distribution or use of the auditor's report on the audited FS is restricted, or the auditor's report on the audited FS alerts readers that the audited FS are prepared in accordance with a special purpose framework, the auditor shall include a similar restriction or alert in the auditor's report on SFS.

**SA 810**

## Comparatives

- ❖ If audited FS contain comparatives, but SFS do not, **determine** whether such omission is reasonable in the circumstances of the engagement.
- ❖ **Determine** the effect of an unreasonable omission on the auditor's report on SFS.
- ❖ If SFS contain **comparatives that were reported on by another auditor**:
  - Auditor's report on SFS shall also contain the matters that SA 710 requires the auditor to include in the auditor's report on the audited FS.

**SA 810**

- ❖ Circumstances that may affect the auditor's determination whether an omission of comparatives is reasonable include:
  - Nature and objective of SFS,
  - Applied criteria, and
  - Information needs of the intended users of the SFS.

## Unaudited Supplementary Info Presented with SFS

- ❖ Evaluate whether such info. is clearly differentiated from SFS.
- ❖ If entity's presentation of such info. is not clearly differentiated from SFS, the auditor shall ask management to change the presentation of such info.
- ❖ If management refuses to do so, the auditor to explain in auditor's report on SFS that such information is not covered by that report.

(see SA 700)

**SA 810**

## **Other Info. In Documents Containing SFS**

- ❖ **READ** other info to identify material inconsistencies *vis a vis* SFS.
- ❖ If material inconsistency identified:
  - Determine whether SFS or other info needs revision.
- ❖ If material misstatement of fact identified:
  - Discuss the matter with mgt.  
(see SA 720)

**SA 810**

### **Auditor Association**

- ❖ If auditor becomes aware that entity plans to state that auditor has reported on SFS in a document containing SFS, but does not plan to include the related auditor's report, the auditor shall request management to include the auditor's report in the document.
- ❖ If management does not do so, the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately associating the auditor with the SFS in that document.

#### **SA 810**

- ❖ The auditor may be engaged to report on the FS of an entity, while not engaged to report on the SFS. If, in this case, the auditor becomes aware that the entity plans to make a statement in a document that refers to the auditor and the fact that SFS are derived from the FS audited by the auditor, the auditor shall be satisfied that:
  - The reference to the auditor is made in the context of the auditor's report on the audited FS; and
  - The statement does not give the impression that the auditor has reported on the SFS.
 If the above conditions are not met, the auditor shall request management to change the statement to meet them, or not to refer to the auditor in the document. Alternatively, the entity may engage the auditor to report on SFS and include the related auditor's report in the document.
- ❖ If management does not change the statement, delete the reference to the auditor, or include an auditor's report on SFS in the document containing the SFS, the auditor shall advise management that the auditor disagrees with the reference to the auditor, and the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately referring to the auditor.
- ❖ Other appropriate actions may include informing the intended users and other known third-party users of the inappropriate reference to the auditor. The auditor's course of action depends on the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

### **Material Modifications *vis a vis* ISA 810**

- ❖ **Paragraph 5:** the word "ordinarily" has been added to cover situations of audit reports on financial information derived from FS of past 5 years in case of a prospectus and also footnote on this.
- ❖ **Paragraph 14:** requirement of mentioning the auditor's address has been replaced with the place of signature.
- ❖ **Paragraph 14:** mentioning of membership number assigned by the Institute of Chartered Accountants of India, & Firm's registration number, wherever applicable, has been added.

#### **SA 810**

# **Standards on Review Engagements (SREs)**

## **Standards on Review Engagements**

- ❖ SRE 2400, "Engagements to Review Financial Statements" (*April 1, 2010*)
- ❖ SRE 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" (*April 1, 2010*).

# **SRE 2400**

## **Engagements to Review Financial Statements**

*Effective for reviews of financial statements for periods beginning on or after April 1, 2010.*

## **Overview of SRE 2400**

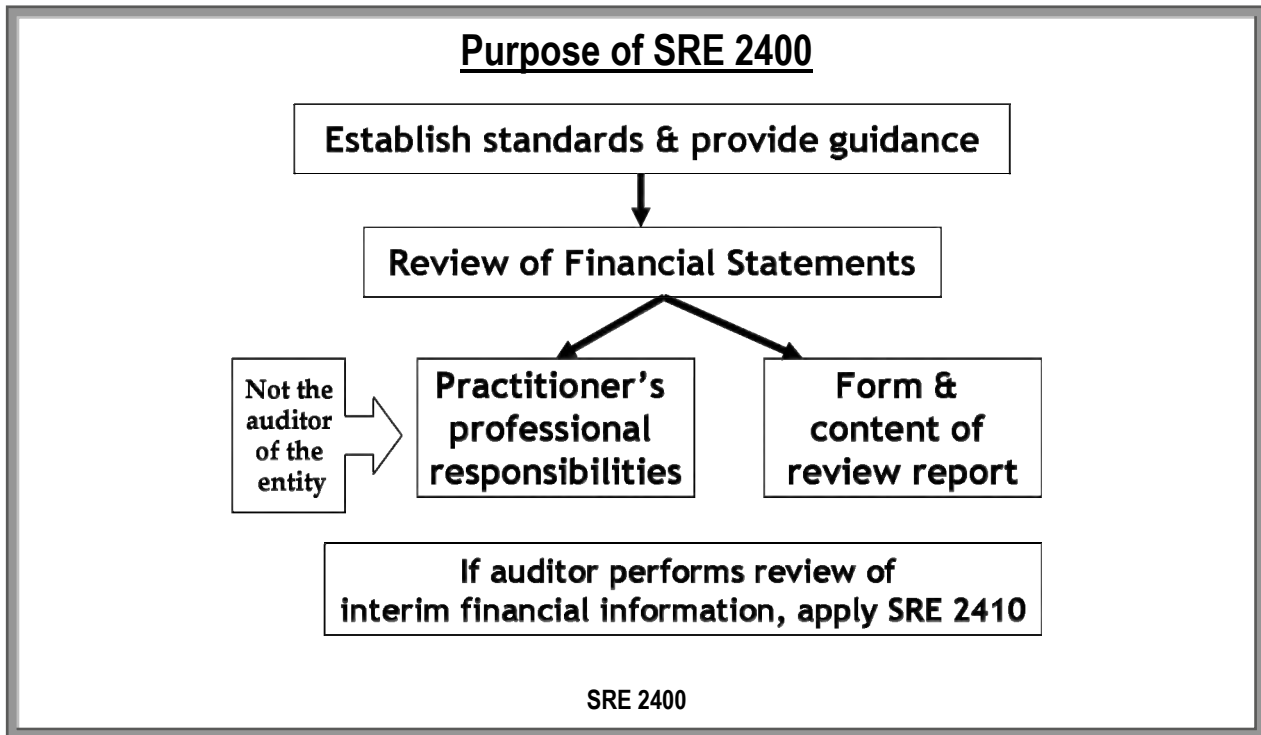
- ❖ Introduction.
- ❖ Objective of a Review Engagement.
- ❖ General Principles of a Review Engagement.
- ❖ Scope of a Review.
- ❖ Moderate Assurance.
- ❖ Terms of Engagement.
- ❖ Planning.
- ❖ Work Performed by Others.
- ❖ Documentation.
- ❖ Procedures and Evidence.
- ❖ Conclusions and Reporting.
- ❖ Effective Date.
- ❖ Appendices.

### **SRE 2400**

#### **APPENDICES :**

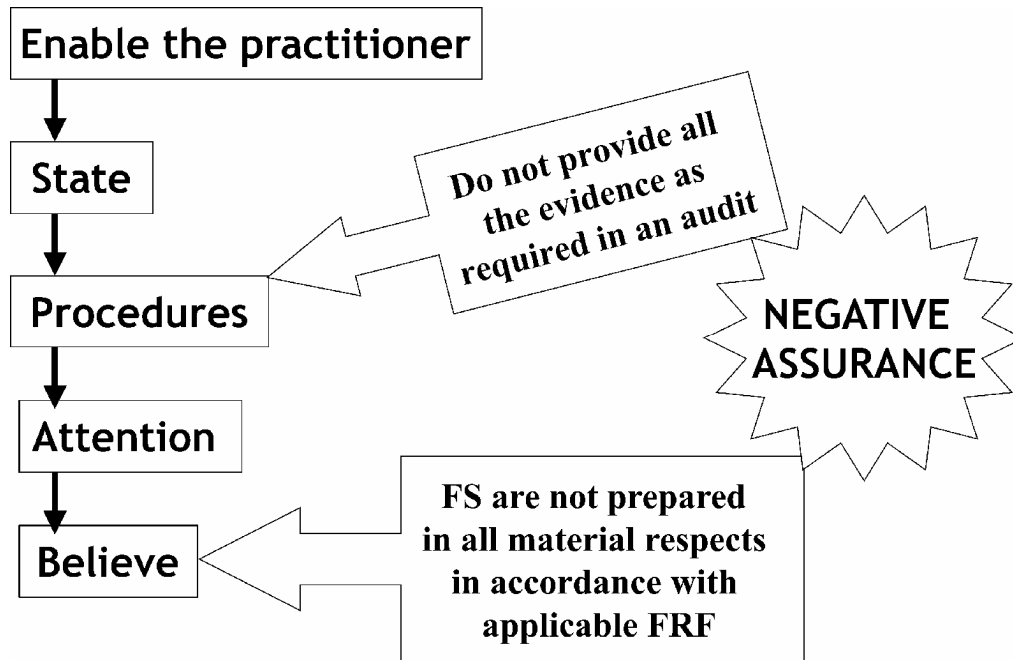
- ❖ Example of an Engagement Letter for a Review of Financial Statements
- ❖ Illustrative Detailed Procedures that may be Performed in an Engagement to Review Financial Statements
- ❖ Form of Unqualified Review Report
- ❖ Examples of Review Reports Other than Unqualified





- ❖ SRE 2400 can also be applied, adapted as necessary in circumstances, to engagements to review other historical financial information.
- ❖ Guidance in the Standards on Auditing (SAs) may be useful to the practitioner in applying this SRE.

## Objective of a Review Engagement



SRE 2400

- ❖ A review provides a **Moderate Level** of assurance. This assurance is expressed in the form of **Negative Assurance**.

## **General Principles**

- ❖ Comply with ICAI Code of Ethics.
- ❖ Conduct review in accordance with this SRE.
- ❖ Exercise professional skepticism while:
  - Planning review.
  - Performing review.
- ❖ Obtain sufficient appropriate evidence:
  - For expressing negative assurance.
  - Primarily through inquiry & analytical procedures.

### **SRE 2400**

- ❖ Principles enunciated in ICAI Code of Ethics which govern professional responsibilities of the practitioner:
  - Independence;
  - Integrity;
  - Objectivity;
  - Professional competence and due care;
  - Confidentiality;
  - Professional behaviour; and
  - Technical standards.
- ❖ Professional skepticism means recognising that circumstances may exist which cause the financial statements to be materially misstated.

## **Scope of Review**

- ❖ Refers to **review procedures deemed necessary** in circumstances to achieve objectives of review.
- ❖ Procedures should be determined having regard to requirements of:
  - This SRE.
  - Relevant professional bodies.
  - Legislation & regulation.
  - Terms of engagement.
  - Reporting requirements.

**SRE 2400**

## **Terms of Engagement**

- ❖ Agree ToE with the client:
  - Engagement letter.
  - Other suitable form of contract.
- ❖ Send to client an engagement letter documenting key terms of appointment:
  - Confirms practitioner's acceptance of appointment.
  - Avoids misunderstandings reg. objectives & scope.
  - Clarifies practitioner's responsibility.
  - Assists in planning the review.
  - Clarifies form of report to be issued.

**SRE 2400**

## Contents of Engagement Letter

- ❖ Objective of service.
- ❖ Mgt responsibility for FS.
- ❖ Scope of review.
  - Reference to SRE 2400.
- ❖ Unrestricted access to records/dox/information.
- ❖ Specimen report.
- ❖ Fact that engagement will not disclose errors/ illegal acts/ other irregularities.
- ❖ Audit not being performed so no audit opinion expressed.

### SRE 2400

- ❖ A statement that an audit is not being performed and that an audit opinion will not be expressed. To emphasise this point and to avoid confusion, practitioner may also consider pointing out that a review engagement will not satisfy any statutory or third party requirements for an audit.
- ❖ Specimen engagement letter is given in **Appendix 1** to this SRE.

## Planning

- ❖ Obtain/ update knowledge of business wrt:
  - Organisation.
  - Accounting systems.
  - Operating characteristics.
  - Nature of assets, liabilities, revenues & expenses.
- ❖ Need to have understanding of other matters relevant to FS.
- ❖ Knowledge needed to:
  - Make relevant inquiries.
  - Design appropriate procedures.
  - Assess the responses & other information obtained.

### SRE 2400

- ❖ Planning ensures that effective engagement will be performed.
- ❖ Other matters relevant to FS:
  - Entity's production and distribution methods.
  - Product lines.
  - Operating locations.
  - Related parties.

**Work Performed by Others:**

- ❖ Practitioner should be satisfied that such work is adequate for purposes of review.

**Documentation:**

- ❖ Document matters important in providing evidence:
  - To support the review report; AND
  - That review was carried out in accordance with this SRE.

**SRE 2400**

## Procedures & Evidence

- ❖ Apply judgment in determining specific nature, timing & extent of procedures.
- ❖ Apply same materiality considerations as in audit.
- ❖ Detailed procedures are given in para 20 of this SRE.
- ❖ Also inquire about events subsequent to date of FS that may require adjustment/ disclosure in FS.
- ❖ **Information materiality misstated:** If reason to believe that information subject to review may be materially misstated:
  - Carry out additional or more extensive procedures as necessary.
  - To be able to express negative assurance or to confirm that a modified report is required.

### SRE 2400

- ❖ **The practitioner should apply judgment in determining the specific nature, timing and extent of review procedures.** The practitioner will be guided by such matters as the following:
  - Any knowledge acquired by carrying out audits or reviews of the FS for prior periods.
  - Practitioner's knowledge of the business including knowledge of accounting principles and practices of industry in which entity operates.
  - Entity's accounting systems.
  - Extent to which a particular item is affected by management judgment.
  - Materiality of transactions and account balances.
- ❖ **The practitioner should apply the same materiality considerations as would be applied if an audit opinion on the financial statements were being given.** Although there is a greater risk that misstatements will not be detected in a review than in an audit, judgment as to what is material is made by reference to information on which the practitioner is reporting and the needs of those relying on that information, not to the level of assurance provided.
  - No responsibility for performing procedures to identify events occurring after the date of the review report.

## **Conclusion & Reporting - I**

- ❖ Report should contain a clear written expression of negative assurance.
- ❖ Assess whether any info obtained during review indicates:
  - FS do not give true and fair view in accordance with FRF.
- ❖ Elements of a review report are given in para 26 of this SRE.

### **SRE 2400**

- ❖ Illustrative formats of review reports are given in Appendix 3 and 4 to this SRE.
- ❖ **The report on a review of financial statements should contain the following basic elements, ordinarily in the following layout:**
  - Title;
  - Addressee;
  - Opening or introductory paragraph including:
    - Identification of the FS on which the review has been performed; and
    - A statement of responsibility of mgt and responsibility of practitioner;
  - Scope paragraph, describing the nature of a review, including:
    - A reference to this SRE applicable to review engagements, or to relevant national standards or practices;
    - A statement that a review is limited primarily to inquiries and analytical procedures; and
    - A statement that an audit has not been performed, that the procedures undertaken provide less assurance than an audit and that an audit opinion is not expressed;
  - Statement of negative assurance;
  - Date of report;
  - Place of Signature;
  - Practitioner's signature and membership number assigned by the ICAI; and
  - Firm's registration number allotted by ICAI.



## **Conclusion & Reporting - II**

### **If FS Give a True & Fair View**

- ❖ State that:
  - Nothing has come to practitioner's attention that causes practitioner to believe that the FS do not give a true and fair view in accordance with the applicable FRF.

### **If True and Fair View is Impaired**

- ❖ Describe the matters that impair true & fair view.
- ❖ Unless impracticable, quantify the possible effects on the FS and either:
  - Qualify the negative assurance, OR
  - Provide adverse statement (if circumstances so warrant).

**SRE 2400**

### **Adverse Statement**

- ❖ When effect of the matter is so material and pervasive to the FS that practitioner concludes that a qualification is not adequate to disclose misleading or incomplete nature of the FS:
  - Give an adverse statement that the FS do not give a true and fair view (or are not presented fairly, in all material respects) in accordance with the applicable FRF.

## **Conclusion & Reporting - III**

### **Material Scope Limitation**

- ❖ Describe the limitation and either:
  - Express a qualification of negative assurance provided regarding possible adjustments to FS that might have been deemed necessary had the limitation not existed; OR
  - When possible effect of limitation is so significant & pervasive that no level of assurance can be provided, do not provide any assurance.

### **Date of Report**

- ❖ Date as of the date the review is completed:
  - Includes, performing procedures relating to events upto date of report.
  - Should not be a date prior to date on which FS were approved by management.

**SRE 2400**

# **SRE 2410**

## **Review of Interim Financial Information** **Performed by the Independent Auditor of the Entity**

*Effective for reviews of interim financial information for periods beginning on or after April 1, 2010*

## **Overview of SRE 2410**

- ❖ Introduction.
- ❖ General Principles of a Review of IFI.
- ❖ Objective of an Engagement to Review IFI.
- ❖ Agreeing the Terms of the Engagement.
- ❖ Procedures for a Review of IFI.
- ❖ Evaluation of Misstatements.
- ❖ Management Representations.
- ❖ Auditor's Responsibility for Accompanying Information.
- ❖ Communication.
- ❖ Reporting the Nature, Extent & Results of Review of IFI.
- ❖ Documentation.
- ❖ Effective date.
- ❖ Appendices.

### **SRE 2410**

#### **APPENDICES**

- ❖ Example of an Engagement Letter for a Review of IFI.
- ❖ Analytical Procedures Auditor May Consider When Performing a Review of IFI.
- ❖ Example of a Management Representation Letter.
- ❖ Examples of Review Reports on IFI.
- ❖ Examples of Review Reports with a Qualified Conclusion for a Departure from the Applicable FRF.
- ❖ Examples of Review Reports with a Qualified Conclusion for a Limitation on Scope Not Imposed by Management.
- ❖ Examples of Review Reports with an Adverse Conclusion for a Departure from the Applicable FRF.

## **Interim Financial Information**

### **Financial information:**

- ❖ Prepared & presented in accordance with applicable financial reporting framework.
- ❖ Comprises either a complete or condensed set of financial statements.
- ❖ For a period that is shorter than entity's FY.

**SRE 2410**

- ❖ So even a complete set of FS that is prepared for a period shorter than client's FY will be reckoned as IFI.
- ❖ So the trigger point for distinguishing IFI from other FI is the period covered by that financial information.

## SRE Application Matrix

	Review of Financial Statements	Review of Interim Fin Info
<b>Independent auditor</b>	SRE 2400	SRE 2410
<b>Other practitioner</b>	SRE 2400	SRE 2400

### Why separate SRE 2410 for Independent Auditors?

- ❖ For audit engagements, independent auditor **would have obtained** understanding of entity and its environment including internal control.
- ❖ For reviewing IFI he **updates** this understanding through inquiry & analytical procedures.
- ❖ Other practitioner does not **ordinarily** have the same level of understanding.
- ❖ Need for different inquiries & procedures.

### SRE 2410

#### Which SRE to apply?

- ❖ Which SRE to apply depends upon the level of understanding of client and environment.
  - If understanding is similar as required in audit engagement, SRE 2410 applies.
  - So if the statutory auditor has been appointed for review of IFI but does not have adequate level of knowledge of client and environment, even he will have to apply SRE 2400 in that case and *vice versa*.
  - The moot point is that you need to achieve the objective of the review engagement.
- ❖ Through performing audit of the annual FS, auditor obtains an understanding of the entity and its environment, including its internal control. When the auditor is engaged to review the IFI, this understanding is updated through inquiries made in course of review, and assists auditor in focusing the inquiries to be made and analytical and other review procedures to be applied. A practitioner who is engaged to perform a review of interim financial information, and who is not the auditor of the entity, performs review in accordance with SRE 2400, "Engagements to Review Financial Statements". As the practitioner does not ordinarily have same understanding of entity and its environment, including its internal control, as the auditor of entity, practitioner needs to carry out different inquiries and procedures to meet objective of review.
- ❖ This SRE is directed towards a review of IFI by an entity's auditor. However, it is to be applied, adapted as necessary in circumstances, when an entity's auditor undertakes an engagement to review historical financial information other than IFI of an audit client.

## **General Principles of Review of IFI**

- ❖ Comply with ethical requirements applicable to audit of annual FS of entity.
- ❖ Implement quality control procedures applicable to individual engagement.
- ❖ Plan & perform engagement with attitude of professional skepticism.

### **SRE 2410**

- ❖ Ethical requirements govern following responsibilities of auditor:
  - Independence;
  - Integrity;
  - Objectivity;
  - Professional competence & due care;
  - Confidentiality;
  - Professional behaviour; and
  - Technical standards.
- ❖ Quality Control elements relevant to individual engagement:
  - Leadership responsibilities for quality on engagement;
  - Ethical requirements;
  - Acceptance and continuance of client relationships and specific engagements;
  - Assignment of engagement teams;
  - Engagement performance; and
  - Monitoring.
- ❖ Professional skepticism:
  - Planning & performance should recognise existence of circumstances that require a material adjustment in IFI so as to enable it to be prepared in all material respects in accordance with applicable FRF.

## **Objective of Engagement to Review IFI**

- ❖ Enable auditor to express a conclusion whether.
- ❖ On the basis of the review.
- ❖ Anything has come to auditor's attention.
- ❖ That causes auditor to believe.
- ❖ That IFI is not prepared in all material respects in accordance with applicable FRF.

### **SRE 2410**

- ❖ Objective of review of IFI is significantly different from Audit:
  - Review of IFI does not provide a basis for expressing an opinion whether the financial information gives a true and fair view, or is presented fairly, in all material respects, in accordance with applicable FRF.
  - Review not designed to obtain reasonable assurance that IFI is free from material misstatement.
  - Review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures.
  - Review may bring significant matters affecting IFI to the auditor's attention, but it does not provide all of the evidence that would be required in an audit.

## **Agreeing the Terms of Engagement**

- ❖ Auditor & client should agree on ToE.
- ❖ ToE ordinarily recorded in engagement letter.
- ❖ Helps avoids misunderstandings wrt:
  - Nature of engagement.
  - Objective and scope of review.
  - Management's responsibilities.
  - Auditor's responsibilities.
  - Assurance obtained.
  - Nature and form of report.

### **SRE 2410**

- ❖ Matters to be covered in Engagement Letter:
  - Objective of a review of IFI.
  - Scope of review.
  - Management's responsibility for:
    - The IFI.
    - Establishing and maintaining effective internal control relevant to preparation of IFI.
    - Making all financial records & related information available to auditor.
  - Management's agreement to provide written representations to auditor to confirm representations made orally during review, as well as representations implicit in entity's records.
  - Anticipated form and content of report to be issued, including identity of addressee of report.
  - Management's agreement that where any document containing IFI indicates that IFI has been reviewed by entity's auditor, review report will also be included in document.
- ❖ Illustrative engagement letter is given in Appendix 1 to this SRE.
- ❖ The terms of engagement to review IFI can also be combined with the terms of engagement to audit the annual FS.



## **Procedures for a Review of IFI**

### **(A) Understanding the entity & Its Environment, Including its Internal Control**

- ❖ Needed because it relates to preparation of annual FI as well as IFI.
- ❖ Should be sufficient to plan and conduct review to:
  - Identify types of potential material misstatements and consider likelihood of occurrence.
  - Select inquiries & analytical & other review procedures.
- ❖ Update understanding obtained during annual audits wrt preparation of annual FS.
- ❖ Obtain sufficient understanding of internal controls over preparation of IFI.

### **SRE 2410**

- ❖ Obtaining sufficient understanding of internal controls (IC) over preparation of IFI is necessary since these IC may differ from IC over annual financial information.

- ❖ Use the understanding to:
  - Determine inquiries to be made & analytical and other review procedures to be applied.
  - Identify particular events, transactions/ assertions to which inquiries/other procedures may be directed/applied.
- ❖ Determine nature of review procedures required for components. Factors to consider:
  - Component's materiality.
  - Risk of misstatement in component's IFI.
  - Extent of centralisation/ decentralisation of internal controls over preparation of component IFI.

**SRE 2410**

**The procedures performed by the auditor to update the understanding of the entity and its environment, including its internal control, ordinarily include the following:**

- ❖ Reading documentation, to the extent necessary, of the preceding year's audit and reviews of prior interim period(s) of the current year and corresponding interim period(s) of the prior year, to enable the auditor to identify matters that may affect the current-period IFI.
- ❖ Reading the most recent annual and comparable prior period IFI.
- ❖ Considering any significant risks, including the risk of management override of controls, that were identified in the audit of the prior year's FS.
- ❖ Considering materiality with reference to the applicable FRF as it relates to IFI to assist in determining nature and extent of procedures to be performed and evaluating effect of misstatements.
- ❖ Considering the nature of any corrected material misstatements and any identified uncorrected immaterial misstatements in the prior year's FS.
- ❖ Considering significant financial accounting and reporting matters that may be of continuing significance such as material weaknesses in internal control.
- ❖ Considering results of any audit procedures performed with respect to the current year's FS.
- ❖ Considering results of any internal audit performed and the subsequent actions taken by management.
- ❖ Inquiring of management about the results of management's assessment of the risk that the IFI may be materially misstated as a result of fraud.
- ❖ Inquiring of management about the effect of changes in the entity's business activities.
- ❖ Inquiring of management about any significant changes in internal control and the potential effect of any such changes on the preparation of IFI.
- ❖ Inquiring of management of the process by which the IFI has been prepared and the reliability of the underlying accounting records to which the IFI is agreed or reconciled.

**(B) Inquiries, Analytical and Other Review Procedures (AORP)**

- ❖ Auditor should make inquiries and Perform AORP.
- ❖ Nature & extent of Inquiries & AORP affected by:
  - Understanding of entity & its environment.
  - Results of risk assessment relating to preceding audit.
  - Materiality considerations.
- ❖ Ordinarily auditor not required to test accounting records through inspection/ observation/ confirmation.
- ❖ Some procedures can be before or simultaneous with preparation of IFI.
- ❖ Direct external confirmations ordinarily not necessary.

**SRE 2410**

- ❖ The auditor should make inquiries, primarily of persons responsible for financial and accounting matters, and perform analytical and other review procedures to enable auditor to conclude whether, on basis of procedures performed, anything has come to auditor's attention causing auditor to believe that IFI is not prepared, in all material respects, in accordance with applicable FRF.
- ❖ The auditor may perform many of the review procedures before or simultaneously with the entity's preparation of the IFI. For example, it may be practicable to update the understanding of the entity and its environment, including its internal control, and begin reading applicable minutes before the end of the interim period. Performing some of the review procedures earlier in the interim period also permits early identification and consideration of significant accounting matters affecting the IFI.

- ❖ Obtain evidence that IFI agrees/ reconciles with underlying accounting records.
- ❖ Inquire mgt:
  - If all events upto date of review report, that may require adjustment/ disclosure in IFI, have been identified.
  - Any changes in going concern assessment made by Mgt.

**SRE 2410**

**Evidence that IFI agrees or reconciles with underlying accounting records.**

- ❖ Trace the IFI to:
  - The accounting records, such as the general ledger, or a consolidating schedule that agrees or reconciles with the accounting records; and
  - Other supporting data in the entity's records as necessary.
- ❖ Not necessary for auditor to perform other procedures to identify events occurring after date of review report.
- ❖ When, as a result of inquiry/other review procedures, auditor becomes aware of events or conditions that may cast significant doubt on entity's ability to continue as a going concern, auditor should:
  - Inquire of management as to its plans for future actions based on its going concern assessment, the feasibility of these plans, and whether management believes that the outcome of these plans will improve the situation; and
  - Consider adequacy of disclosure about such matters in the IFI.
- ❖ When a matter comes to auditor's attention that leads auditor to question whether a material adjustment should be made for the IFI to be prepared, in all material respects, in accordance with the applicable FRF, auditor should make additional inquiries or perform other procedures to enable auditor to express a conclusion in review report.

## Evaluation of Misstatements

- ❖ Evaluate, individually & in aggregate, whether uncorrected misstatements that have **come to auditor's attention** are material to IFI.
- ❖ Not required to obtain reasonable assurance that IFI is free of material misstatements.
- ❖ Exercise professional judgment in evaluating materiality of misstatements.
- ❖ May designate amount below which aggregation not to be done if such aggregation would not have material impact on IFI.

**SRE 2410**

## Management Representations

### **Obtain written representations from mgt:**

- ❖ Responsibility for design and implementation of internal control to prevent and detect fraud and error.
- ❖ IFI is prepared and presented in accordance with applicable FRF.
- ❖ Uncorrected misstatements aggregated by auditor during review are immaterial, both individually and in the aggregate, to IFI.
- ❖ Has disclosed to the auditor:
  - All significant facts relating to any frauds or suspected frauds known to management that may have affected the entity.
  - Results of its assessment of the risks that the IFI may be materially misstated as a result of fraud.
  - All known actual or possible non-compliance with laws and regulations whose effects are to be considered when preparing the IFI.
  - All significant events that have occurred subsequent to the balance sheet date and through to the date of the review report that may require adjustment to or disclosure in IFI.

**SRE 2410**

### ❖ **Uncorrected misstatements**

A summary of such items is included in or attached to written representations.

- The auditor obtains additional representations as are appropriate related to matters specific to the entity's business or industry.
- An illustrative management representation letter is set out in Appendix 3 to this SRE.

## **Auditor's Responsibility for Accompanying Information**

- ❖ Read other accompanying info to consider:
  - Whether any such info materially inconsistent with IFI.
- ❖ If Other Info appears to contain a material misstatement of fact:
  - Discuss matter with mgt.

### **SRE 2410**

- ❖ **The auditor should read the other information that accompanies the interim financial information to consider whether any such information is materially inconsistent with the interim financial information.** If the auditor identifies a material inconsistency,
  - Consider whether the IFI or the other information needs to be amended.
  - If an amendment is necessary in the IFI and management refuses to make the amendment, the auditor considers the implications for the review report.
  - If an amendment is necessary in the other information and management refuses to make the amendment, the auditor considers including in the review report an additional paragraph describing the material inconsistency, or taking other actions, such as withholding the issuance of the review report or withdrawing from the engagement.
- ❖ **If a matter comes to the auditor's attention that causes the auditor to believe that the other information appears to include a material misstatement of fact, the auditor should discuss the matter with the entity's management.**
  - While reading the other information for the purpose of identifying material inconsistencies, an apparent material misstatement of fact may come to the auditor's attention (i.e., information, not related to matters appearing in the IFI, that is incorrectly stated or presented).
  - When discussing the matter with the entity's management, the auditor considers the validity of the other information and management's responses to the auditor's inquiries, whether valid differences of judgment or opinion exist and whether to request management to consult with a qualified third party to resolve the apparent misstatement of fact.
  - If an amendment is necessary to correct a material misstatement of fact and management refuses to make the amendment, the auditor considers taking further action as appropriate, such as notifying those charged with governance and obtaining legal advice.

## **Communication**

- ❖ If auditor believes that it is necessary to make a material adjustment to IFI:
  - Communicate this matter as soon as practicable to appropriate level of mgt.
- ❖ If mgt does not respond appropriately within reasonable time, inform to TCWG.
- ❖ If TCWG do not respond appropriately within reasonable time, consider:
  - Whether to modify the report; or
  - Possibility of withdrawing from engagement; and
  - Possibility of resigning from appointment to audit the annual FS.

**SRE 2410**

- ❖ If a matter comes to auditor's attention that causes auditor to believe in:
  - Existence of fraud or non-compliance by entity with L&R,
  - Communicate matter as soon as practicable to appropriate level of management.
- ❖ Communicate relevant matters of governance interest arising from review of IFI to TCWG.

**SRE 2410**

- ❖ The determination of which level of management is the appropriate one is affected by the likelihood of collusion or the involvement of a member of management. The auditor also considers the need to report such matters to TCWG and considers the implication for review.

## **Reporting the Nature, Extent and Results of the Review of IFI**

- ❖ Title.
- ❖ Addressee.
- ❖ Identification of IFI.
- ❖ Responsibility of mgt re preparation of IFI and related internal controls.
- ❖ Auditor's responsibility.
- ❖ Compliance with SRE 2410.
- ❖ Scope of review being lesser than audit.
- ❖ Conclusion of the auditor.
- ❖ Date of the report.
- ❖ Place of signature.
- ❖ Membership number.
- ❖ Firm registration number.

Some law or regulation may prescribe wording for the auditor's conclusion that is different from the wording described in paragraph 43(i) or (j). Although the auditor may be obliged to use the prescribed wording, the auditor's responsibilities as described in this SRE for coming to the conclusion remain the same.

**SRE 2410**

## **Departure from Applicable FRF**

- ❖ **Express qualified or adverse conclusion:**
  - When a matter has come to auditor's attention that causes auditor to believe that a material adjustment should be made to IFI for it to be prepared, in all material respects, in accordance with applicable FRF.

**SRE 2410**

- ❖ Illustrative review reports with a qualified conclusion are set out in Appendix 5 to this SRE.
- ❖ Illustrative review reports with adverse conclusion are set out in Appendix 7 to this SRE.



## Limitation on Scope

- ❖ If unable to complete review:
  - Communicate in writing to appropriate level of mgt and to TCWG the reason why review cannot be completed, and
  - Consider whether it is appropriate to issue a report.
- ❖ Do not accept review engagement:
  - If preliminary knowledge indicates inability to complete review due to limitation on scope by Mgt.
- ❖ If after accepting engagement, limitation imposed by mgt:
  - Request its removal.
  - If mgt refuses, communicate in writing to mgt & TCWG re why engagement cannot be completed.
  - Consider legal and regulatory responsibilities.

**SRE 2410**

## Going Concern and Significant Uncertainties

### **Going Concern:**

- ❖ Material uncertainty re entity's ability to continue as a going concern:
  - **If adequate disclosure made in IFI:**
    - Emphasis of matter para should be added.
  - **If adequate disclosure not made in IFI:**
    - Express a qualified or adverse conclusion, as appropriate.
    - Include specific reference to fact of such material uncertainty.

### **Significant Uncertainty**

- ❖ Consider modifying review report by adding a paragraph.
- ❖ To highlight a significant uncertainty coming to auditor's attention.
- ❖ Resolution of which is dependent upon future events and which may affect the IFI.

**SRE 2410**

## **Documentation**

- ❖ Documentation that is sufficient and appropriate to:
  - Provide a basis for the auditor's conclusion; and
  - Provide evidence that review was performed in accordance with,
    - This SRE; and
    - Applicable legal and regulatory requirements.

### **SRE 2410**

- ❖ The documentation enables an experienced auditor having no previous connection with the engagement to understand the nature, timing and extent of the inquiries made, and analytical and other review procedures applied, information obtained, and any significant matters considered during the performance of the review, including the disposition of such matters.

# **Standards on Assurance Engagements (SAEs)**

# **SAE 3400**

## **The Examination of Prospective Financial Information (PFI)**

*Effective in relation to reports on projections/forecasts issued on or after April 1, 2007*

## **Introduction - I**

- ❖ Establishes standards on engagements to examine and report on:
  - PFI.
  - Examination procedures for best estimate and hypothetical assumptions.
- ❖ PFI can be in the form of:
  - Forecast; or
  - Projection; or
  - Combination of both.
- ❖ Not applicable to examination of PFI expressed in general or narrative terms.

### **SAE 3400**

- ❖ Reference may be made to Clause 3 of Part I of the Second Schedule to the Chartered Accountants Act, 1949. The Clause states as follows:
  - A Chartered Accountant can participate and review the financial forecasts/projections, provided the report clearly mention:
    - Source of the information.
    - Basis of forecasts.
    - Major assumption made.
    - Does not vouch for accuracy.
  - A "*forecast*" means prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions).
  - A "*projection*" means prospective financial information prepared on the basis of:
    - Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, Such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or
    - A mixture of best-estimate and hypothetical assumptions.
  - PFI can include FS or one or more element of FS and may be prepared as:
    - Internal management tool.
    - Distribution and submission to third party.
    - Potential investors, shareholders, lenders.

## **Introduction - II**

- ❖ Obtain sufficient appropriate evidence on:
  - Reasonableness of management's best-estimate assumptions.
  - Hypothetical assumptions are consistent with the purposes of information.
  - PFI prepared properly on basis of assumptions.
  - Properly presented and adequate disclosure of all material assumptions.
  - Consistent with historical financial statements.

**SAE 3400**

## **Acceptance of Engagement**

- ❖ Before accepting engagement consider:
  - Intended use of the information.
  - Information - general or limited distribution.
  - Nature of the assumptions, i.e. best-estimates or hypothetical assumptions.
  - Elements to be included in information.
  - Period covered by information.
- ❖ Not accept or withdraw from engagement if:
  - Assumptions are clearly unrealistic.
  - Believes that PFI will be inappropriate for its intended use.

**SAE 3400**

- ❖ In accordance with SA 210 "Agreeing the Terms of Audit Engagements", it is necessary that auditor and client should agree on the terms of engagement.

## **Knowledge of Business**

- ❖ Obtain sufficient level of knowledge of business to evaluate all significant assumptions:
  - Internal controls over the system used to prepare PFI.
  - Documentation supporting management's assumptions.
  - Extent to which statistical, mathematical and computer-assisted techniques used.
  - Methods used to develop and apply assumptions.
  - Accuracy of PFI prepared in prior periods.
- ❖ Consider the extent to which reliance on the entity's historical financial information is justified.

**SAE 3400**

## **Period Covered**

- ❖ Consider the period of time covered by PFI:
  - More Length- Assumptions More Speculative.
  - Not extend beyond the time for which management has reasonable basis for assumptions.
- ❖ Relevant Factors:
  - Operating cycle.
  - Degree of reliability of assumptions.
  - Needs of users like, prepared in connection with application for loan or for issue of securities.

**SAE 3400**

## **Examination Procedures- I**

- ❖ Factors in determination of nature, timing, extent of examination procedures:
  - Knowledge obtained during previous engagements.
  - Management's competence.
  - Likelihood of material misstatement.
  - Extent to which PFI is affected by the management's judgment.
  - Sources of information.
  - Stability of entity's business.
  - Engagement team's experience.

**SAE 3400**

## **Examination Procedures- II**

- ❖ When hypothetical assumptions used:
  - All significant assumptions taken into consideration.
  - Consistent with purpose and realistic.
- ❖ Focus on areas sensitive to variation and material.
- ❖ If engagement for individual component, consider interrelationship of other components.
- ❖ Obtain written representations from Mgt. regarding:
  - Intended use of PFI.
  - Completeness of significant assumptions.
  - Mgt's acceptance of responsibility for PFI.

**SAE 3400**

- ❖ Examples of external sources are government publications, industry publications, economic forecast, existing or proposed legislation, and reports of changing technology.
- ❖ Examples of internal sources are budgets, the economic substance and viability of the entity and/or transaction or project of the entity, reputation of management responsible for assumptions underlying the prospective financial information, wage agreements, patents, royalty agreements and records, sales backlog records, debt agreements, and actions of the board of directors involving entity plans, etc.



## **Presentation and Disclosure**

- ❖ Consider requirements of statutes, regulations and professional pronouncements.
- ❖ Also consider whether:
  - Presentation is informative and not misleading.
  - Accounting policies and assumptions are clearly disclosed in notes to PFI.
  - Date of preparation is properly disclosed.
  - Basis of establishing points in a range is clearly indicated.
  - Adequacy of disclosure if any change in the accounting policy.

**SAE 3400**

## **Documentation**

- ❖ Document matters important in providing evidence:
  - To support his report on examination of PFI; and
  - That such examination was carried out in accordance with this SAE.

**SAE 3400**

### **Working papers includes:**

- ❖ Sources of information.
- ❖ Basis of forecasts and assumptions made in arriving forecasts.
- ❖ Hypothetical assumptions and supporting evidence.
- ❖ Management representations and acceptance of its responsibility.
- ❖ Audit plan and nature, timing and extent of examination procedures performed.
- ❖ In case auditor expresses a modified opinion or withdraws, reasons of such decision.

## **Reporting- I**

- ❖ The report of the Auditor should contain the following:
  - Title and Addressee.
  - Identification of the prospective financial information.
  - Reference to applicable Standards on Auditing.
  - Management responsibilities.
  - When applicable, a reference to purpose and/or restricted distribution.
  - Statement that examination procedures included examination, on a test basis.
  - Statement of negative assurance.
  - Opinion whether PFI properly prepared on basis of assumptions and presented in accordance with relevant financial reporting framework.
  - Appropriate caveats concerning achievability of results.
  - Date of report, Place of signature and Signature.

**SAE 3400**

## **Reporting- II**

- ❖ Qualified/Adverse opinion or withdraw from engagement, if auditor believes that:
  - Presentation and disclosure of the PFI is not adequate.
- ❖ Adverse opinion or withdraw from engagement, if auditor believes that:
  - One or more significant assumptions do not provide a reasonable basis for the PFI
- ❖ Disclaimer of opinion or withdraw from engagement, if:
  - Examination is affected by conditions that preclude application of procedure(s) considered necessary in circumstances.

**SAE 3400**

- ❖ Reference may be made to Appendix I of SAE 3400 for the illustrative format of an **Unmodified Report on a Projection**.
- ❖ Reference may be made to Appendix II of SAE 3400 for the illustrative format of an **Unmodified Report on a Forecast**.

# SAE 3402

## **Assurance Reports on Controls at A Service Organisation**

*Effective for service auditors' assurance reports  
covering periods beginning on or after 1st April, 2011*

It complements SA 402, "Audit Considerations Relating to an Entity Using a Service Organization" in that reports prepared in accordance with this SAE are capable of providing appropriate evidence under SA 402.

### **Overview of SAE 3402**

- Introduction
- Objectives
- Definitions
- Requirements
  - Framework For Assurance Engagements
  - Ethical Requirements
  - Management & TCWG
  - Acceptance & Continuance
  - Assessing suitability of criteria
  - Materiality
  - Obtaining understanding of SO's system

SAE 3402

- Obtaining evidence re description
- Obtaining evidence re design of controls
- Obtaining evidence re operating effectiveness of controls
- Work of internal audit function
- Written representations
- Other information
- Subsequent events
- Documentation
- Preparing SA's assurance report
- Other communication responsibilities
- Application guidance (on above aspects)
- Appendices

**SAE 3402**

## **Introduction**

- Report for use by User Entity (UE) and User Auditor (UA)
- On controls at Service Organisation (SO)
- That provides a service to UE
- That service is likely to be relevant to UE's Internal controls related to Financial Reporting (ICFR)
  - Matter of professional judgment

**SAE 3402**

- IC is a process designed to provide reasonable assurance regarding the achievement of objectives related to the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.
- Controls related to SO operations and compliance objectives may be relevant to a UE ICFR.
- Such controls may pertain to assertions about:
  - presentation and disclosure relating to account balances
  - classes of transactions or disclosures, or
  - evidence that the UA evaluates or uses in applying auditing procedures.
- For example, a payroll processing SO's controls related to the timely remittance of payroll deductions to government authorities may be relevant to UE as late remittances could incur interest and penalties that would result in a liability for the UE.
- Similarly, SO's controls over the acceptability of investment transactions from a regulatory perspective may be considered relevant to UE's presentation and disclosure of transactions and account balances in its financial statements.
- The determination of whether controls at a SO related to operations and compliance are likely to be relevant to UE's ICFR is a matter of professional judgment, having regard to the SO set by the SO and the suitability of the criteria.

### **SAE 3402 deals ONLY with....**

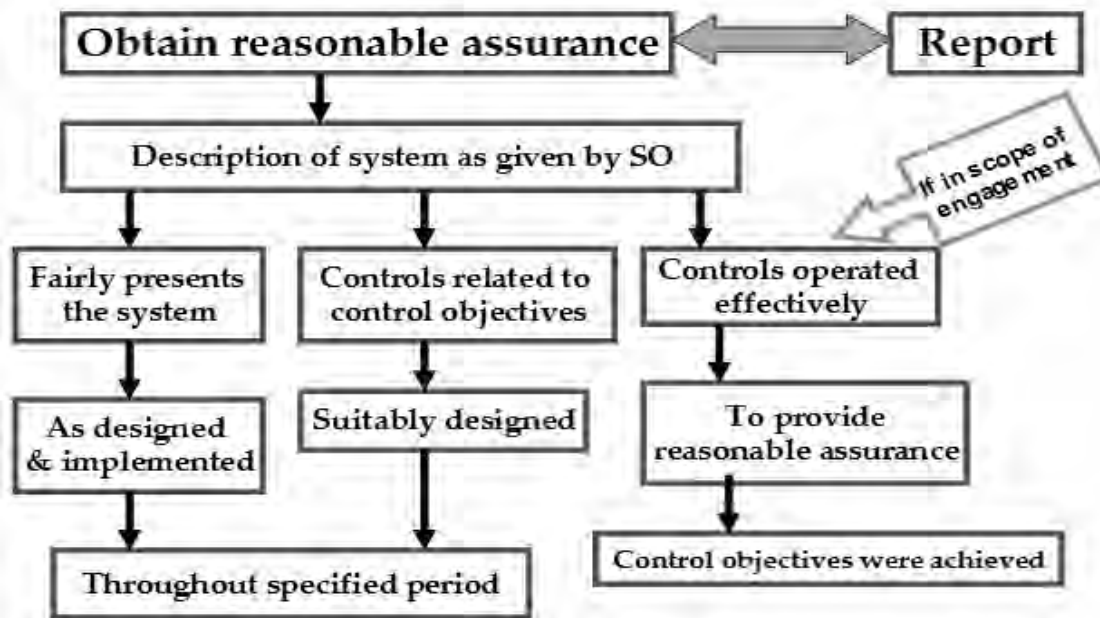
- Assertion-based engagements
- Reasonable assurance
- Assurance conclusion worded directly in terms of subject matter & criteria

SAE 3402

### **Applicability of SAE 3402**

- **Applies only if** in respect of **suitable design of controls**, SO is:
  - Responsible
  - Otherwise makes an assertion
- **Does not apply to:**
  - Reporting on whether controls at SO operated as described
  - Reporting only on controls at SO other than those related to a service related to UE's ICFR
  - Reporting on UE's transaction balances maintained by SO
  - AUP report on controls at SO

### SO Auditor's Objectives



SAE 3402

### Definitions

Carve out method	Inclusive method	SO's system
Complimentary UE Controls	Internal audit function	SO's assertion
Control objective	Internal auditors	Subservice organisation(SSO)
Controls at SO	Type 1 report	Test of controls
Controls at SSO	Type 2 report	User auditor(UA)
Criteria	Service auditor(SA)	User entity(UE)
	Service organisation(SO)	

SAE 3402

### Definitions - Carve Out Method

	Description of SO's systems	Scope of SA's engagement
<b>Nature of services provided by SSO</b>	√	---
<b>SSO's:</b> <ul style="list-style-type: none"> <li>• Relevant control objectives</li> <li>• Related controls</li> </ul>	X	X
<b>Controls at SO to monitor effectiveness of controls at SSO</b>	√	√

SAE 3402

- There are two methods of dealing with services provide by SSO:
  - Carve out method
  - Inclusive method
- Tick means included, cross means excluded.
- Monitoring of effectiveness of controls can be achieved by SO's review of assurance report on controls at SSO.

### Definitions - Inclusive Method

	Description of SO's systems	Scope of SA's engagement
Nature of services provided by SSO	√	---
SSO's: <ul style="list-style-type: none"> <li>• Relevant control objectives</li> <li>• Related controls</li> </ul>	√	√

**SAE 3402**

- When the inclusive method is used, the requirements in this SAE also apply to the services provided by the SSO
- Including obtaining agreement regarding the matters in paragraph 13(b)(i)-(v) as applied to the subservice organization rather than the service organization.
- Performing procedures at SSO entails coordination and communication between the service organization, the subservice organization, and the service auditor.
- The inclusive method generally is feasible only if:
  - SO and SSO are related, or
  - contract between SO and SSO provides for its use.



## Definitions -Complementary UE Controls

### **Design of SSO service**

#### **Controls**

**SO assumes will  
be implemented  
by UE**



**If necessary to achieve  
control objectives stated  
in SO's description of its  
system, are identified there**

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SAE 3402

## Definitions

### **Control Objective**

- Aim or purpose of particular aspect of control
- Relates to risks that controls seek to mitigate

### **Controls at SO**

- Controls over achievement of a control objective
- That is covered by SA's assurance report
- Includes aspect of:
  - UE's info system maintained by SO
  - One or more of the other components of IC at SO
- Excludes
  - SO controls not related to achievement of control objectives stated in description of SO's systems

SAE 3402

#### **Example of one or more components of IC at SO**

SO's control environment, monitoring, and control activities when they relate to the services provided.

#### **Example of exclusion**

Controls related to the preparation of SO's own financial statements.

## **Definitions**

### **Controls at SSO**

- Controls at SO
- To provide reasonable assurance
- About the achievement of a control objective

### **Criteria**

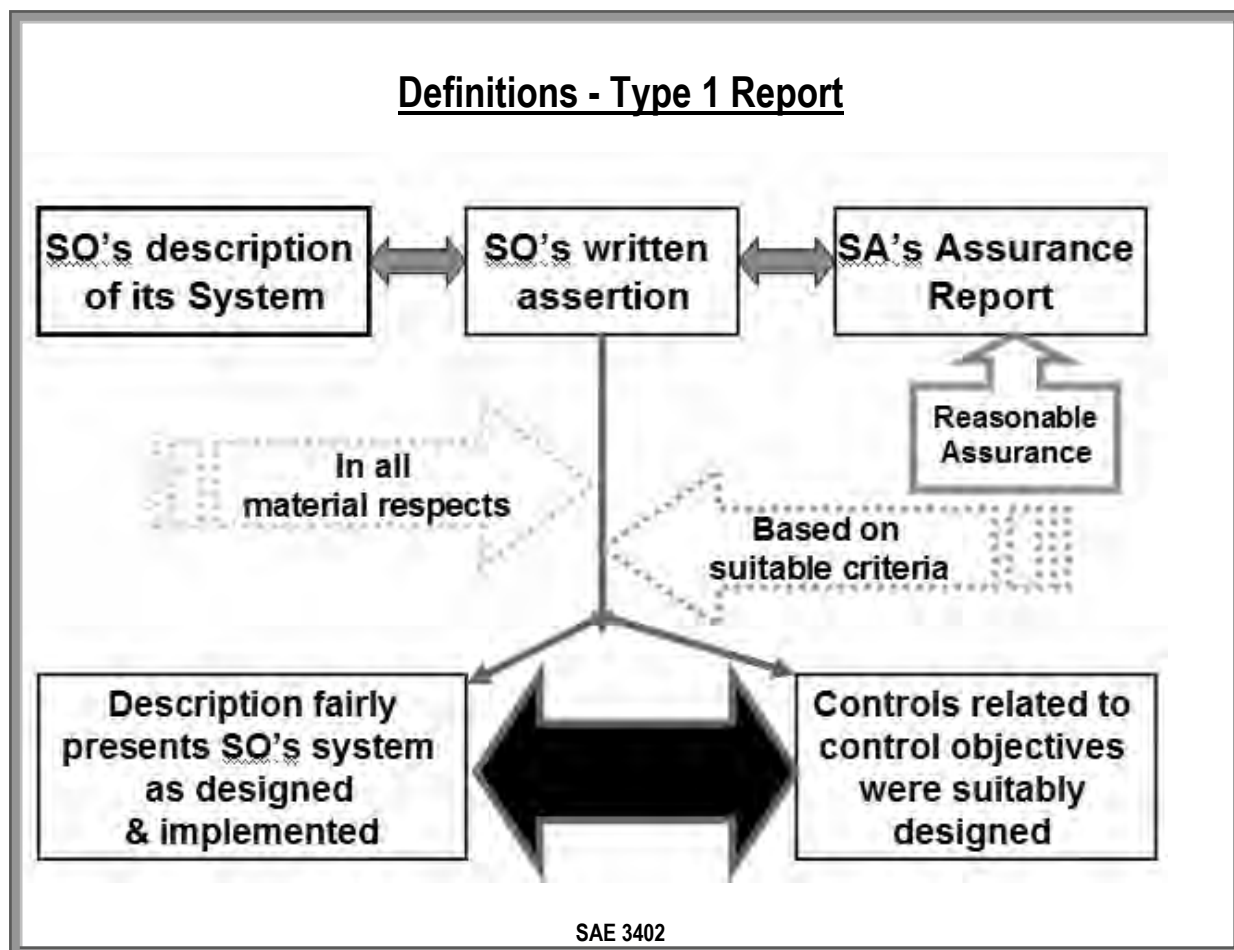
- Benchmarks
- Used to evaluate or measure
- A subject matter
  - Includes benchmarks for presentation & disclosure

SAE 3402

## **Definitions - Internal Audit Function**

- An appraisal activity
- Established or provided as service to SO
  - Includes inter alia examining, evaluating and monitoring the adequacy & effectiveness of internal controls

SAE 3402



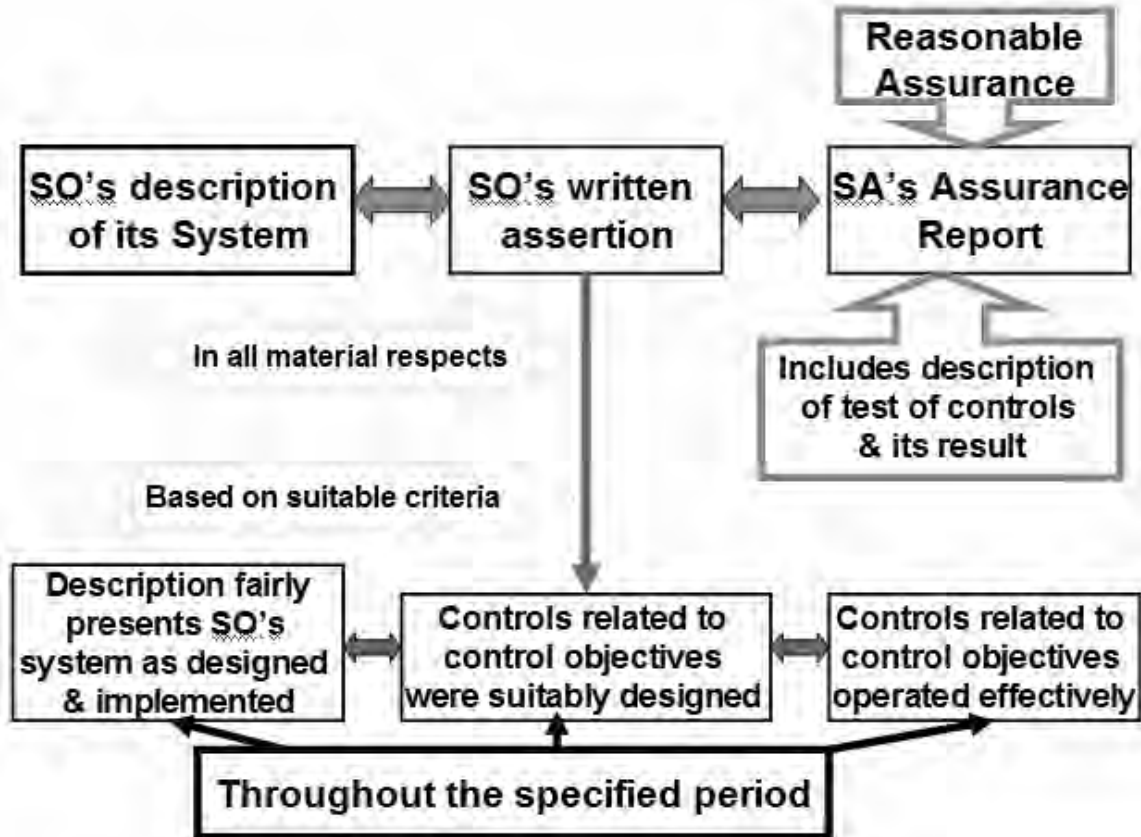
### **TYPE 1 REPORT**

#### **Report on the description and design of controls at a service organization**

A report that comprises:

- (i) The service organization's description of its system;
- (ii) A written assertion by the service organization that, in all material respects, and based on suitable criteria:
  - a. The description fairly presents the service organization's system as designed and implemented as at the specified date;
  - b. The controls related to the control objectives stated in the service organization's description of its system were suitably designed as at the specified date; and
- (iii) A service auditor's assurance report that conveys reasonable assurance about the matters in (ii)a.-b. above.

### Definitions - Type 2 Report



SAE 3402

### TYPE 2 REPORT

#### **Report on the description, design and operating effectiveness of controls at a service organization**

A report that comprises:

- (i) The service organization's description of its system;
- (ii) A written assertion by the service organization that, in all material respects, and based on suitable criteria:
  - a. The description fairly presents the service organization's system as designed and implemented throughout the specified period;
  - b. The controls related to the control objectives stated in the service organization's description of its system were suitably designed throughout the specified period; and
  - c. The controls related to the control objectives stated in the service organization's description of its system operated effectively throughout the specified period; and
- (iii) A service auditor's assurance report that:
  - a. Conveys reasonable assurance about the matters in (ii)a.-c. above; and
  - b. Includes a description of the tests of controls and the results thereof.

## **Definitions**

### **Service Auditor**

- Professional accountant in public practice
- At the request of SO
- Provides assurance report on controls at SO

### **Service Organisation**

- 3rd party organisation
  - Or its segment
- Provide services to UE
  - Likely to be relevant to UE's ICFR

**SAE 3402**

Definition does not state that he should necessarily be a "statutory auditor" of the SO.

So if the SO does not provide services that related to UE internal controls in so far as they relate to financial reporting, the service provider may not be reckoned as SO for the purposes of SA 402 or SAE 3402.

## **Definitions**

### **SO's System**

- Policies & procedures designed & implemented by SO
  - To provide UE with services covered by SA assurance report
- Description includes:
  - Services covered
  - Period/ Date
  - Control objectives
  - Related controls

### **Sub Service Organisation (SSO)**

- SO used by another SO
- To perform some of the services provided to UE
  - Likely to be relevant to UE's ICFR

### **Test of Controls**

- Procedure designed
- To evaluate operating effectiveness of controls
- In achieving control objectives
- Stated in SO's description of its system

**SAE 3402**

## Ethical Requirements

- SA to comply with:
  - Relevant ethical requirements
  - Includes independence requirements

**SA need not be independent from each UE if engagement performed in accordance with SAE 3402**

SAE 3402

Independence requirements are contained in:

- Chartered Accountants Act, 1949
- ICAI Code of Ethics
- Other relevant ICAI pronouncements

Collectively known as the CODE.

## Management & TCWG

**DETERMINE**

**CONSIDER**

Appropriate persons  
with SO's  
mgt/ TCWG with  
whom to interact

Use  
professional  
judgment

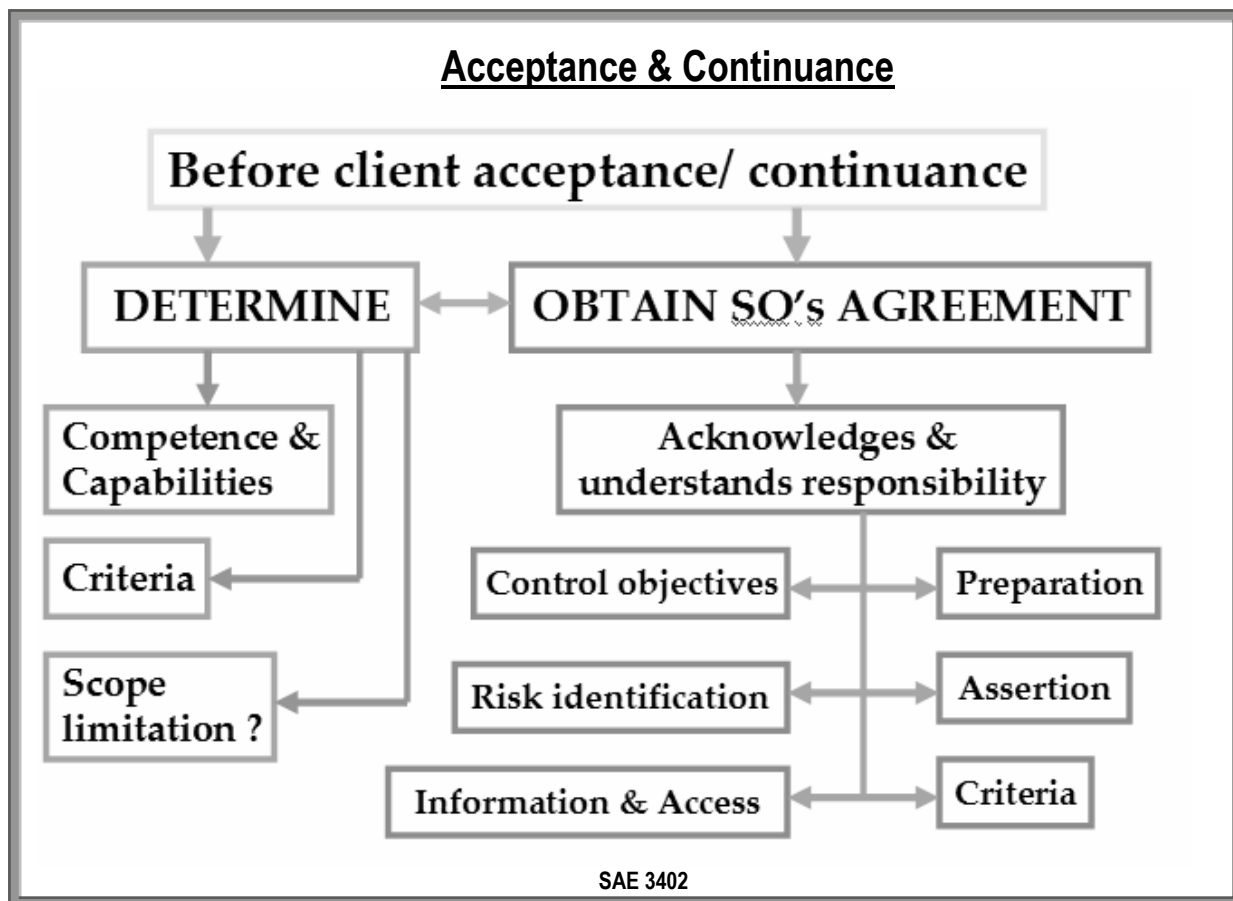
Which persons  
have appropriate  
responsibility &  
knowledge

**Inquiries**

**Representations**

**Communicating**

SAE 3402



**Competence & capabilities** – SA has the capabilities and competence to perform the engagement

Relevant capabilities and competence to perform the engagement include matters such as the following:

- \* Knowledge of the relevant industry;
- \* An understanding of information technology and systems;
- \* Experience in evaluating risks as they relate to the suitable design of controls; and
- \* Experience in the design and execution of tests of controls and the evaluation of the results.

**Criteria** - to be applied by SO to prepare the description of its system will be suitable and available to UE and UA; and

**Scope limitation** – scope of the engagement and SO's description of its system will not be so limited that they are unlikely to be useful to UE & UA.

## **Change in Terms of Engagement**

- Request from SO
- Before completion of the engagement
- Agree only if reasonable justification for change

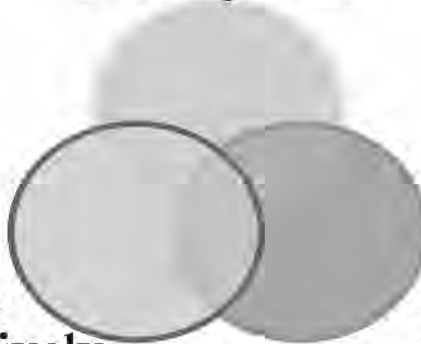
**SAE 3402**

- A request to change the scope of the engagement may not have a reasonable justification when, for example, the request is made to exclude certain control objectives from the scope of the engagement because of the likelihood that the service auditor's opinion would be modified; or the service organization will not provide the service auditor with a written assertion and the request is made to perform the engagement under Framework For Assurance Engagements.
- A request to change the scope of the engagement may have a reasonable justification when, for example, the request is made to exclude from the engagement a subservice organization when the service organization cannot arrange for access by the service auditor, and the method used for dealing with the services provided by that subservice organization is changed from the inclusive method to the carve-out method.

## **Assessing Suitability of Criteria**

### **Preparing description of its system**

**Whether  
controls are  
operating effectively  
(Type 2 Report)**



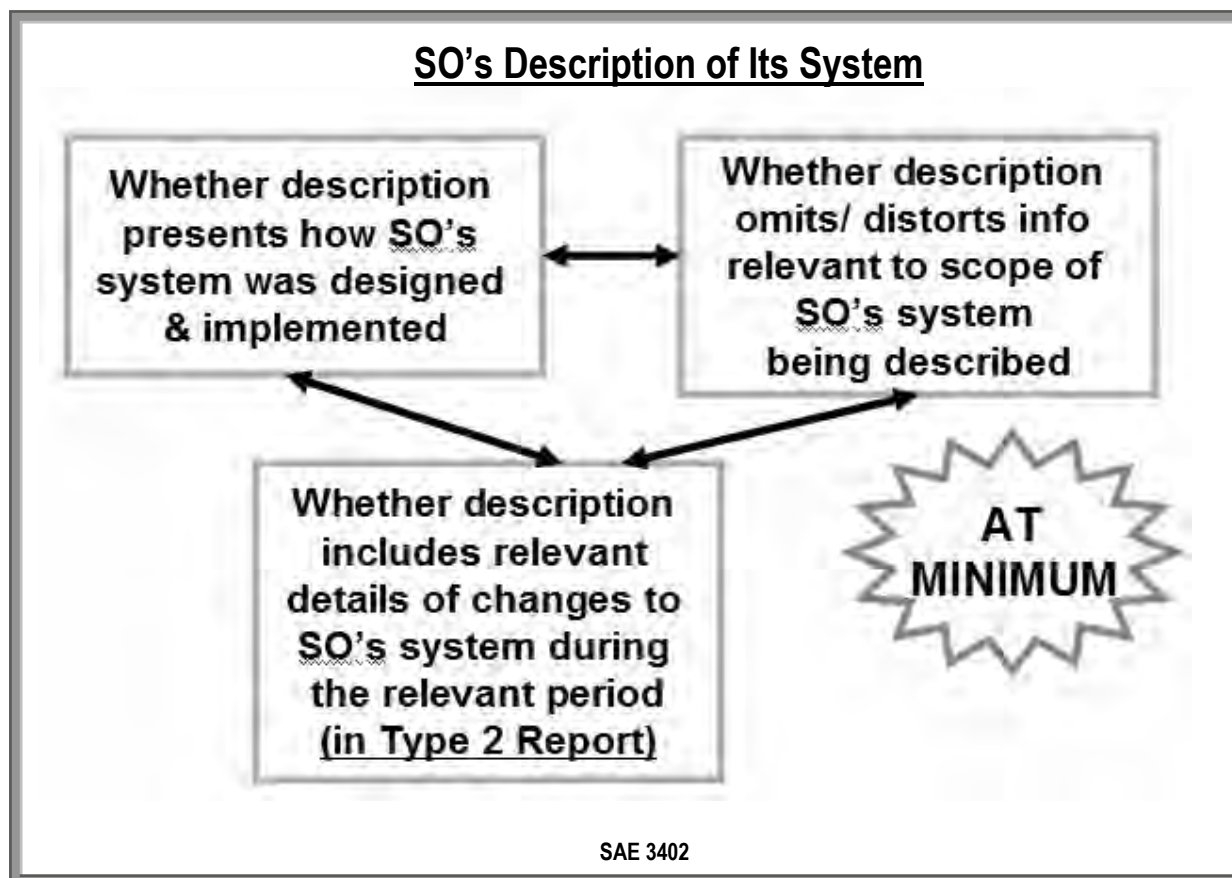
**Whether  
controls are  
suitably designed**

**SAE 3402**

SA needs to assess whether SO has used suitable criteria:

- in preparing the description of its system,
- in evaluating whether controls are suitably designed, and
- in the case of a type 2 report, in evaluating whether controls are operating effectively.





- **Whether the description presents how the service organization's system was designed and implemented, including, as appropriate:**
  - The types of services provided, including, as appropriate, classes of transactions processed;
  - The procedures, within both information technology and manual systems, by which services are provided, including, as appropriate, procedures by which transactions are initiated, recorded, processed, corrected as necessary, and transferred to the reports and other information prepared for user entities;
  - The related records and supporting information, including, as appropriate, accounting records, supporting information and specific accounts that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the reports and other information prepared for user entities;
  - How the service organization's system deals with significant events and conditions, other than transactions;
  - The process used to prepare reports and other information for user entities;
  - The specified control objectives and controls designed to achieve those objectives;
  - Complementary user entity controls contemplated in the design of the controls; and
  - Other aspects of the service organization's control environment, risk assessment process, information system (including the related business processes) and communication, control activities and monitoring controls that are relevant to the services provided.
- **In the case of a type 2 report, whether the description includes relevant details of changes to the service organization's system during the period covered by the description.**
- **Whether the description omits or distorts information relevant to the scope of the service organization's system being described**

while acknowledging that the description is prepared to meet the common needs of a broad range of UEs and their auditors and may not, therefore, include every aspect of the SO's system that each individual UE and its auditor may consider important in its particular environment.

### Whether Controls Are Suitably Designed

Whether SO has identified risks that threaten achievement of control objectives stated in description



Controls identified in the description would, if operated as described, provide reasonable assurance that those risks do not prevent the stated control objectives from being achieved



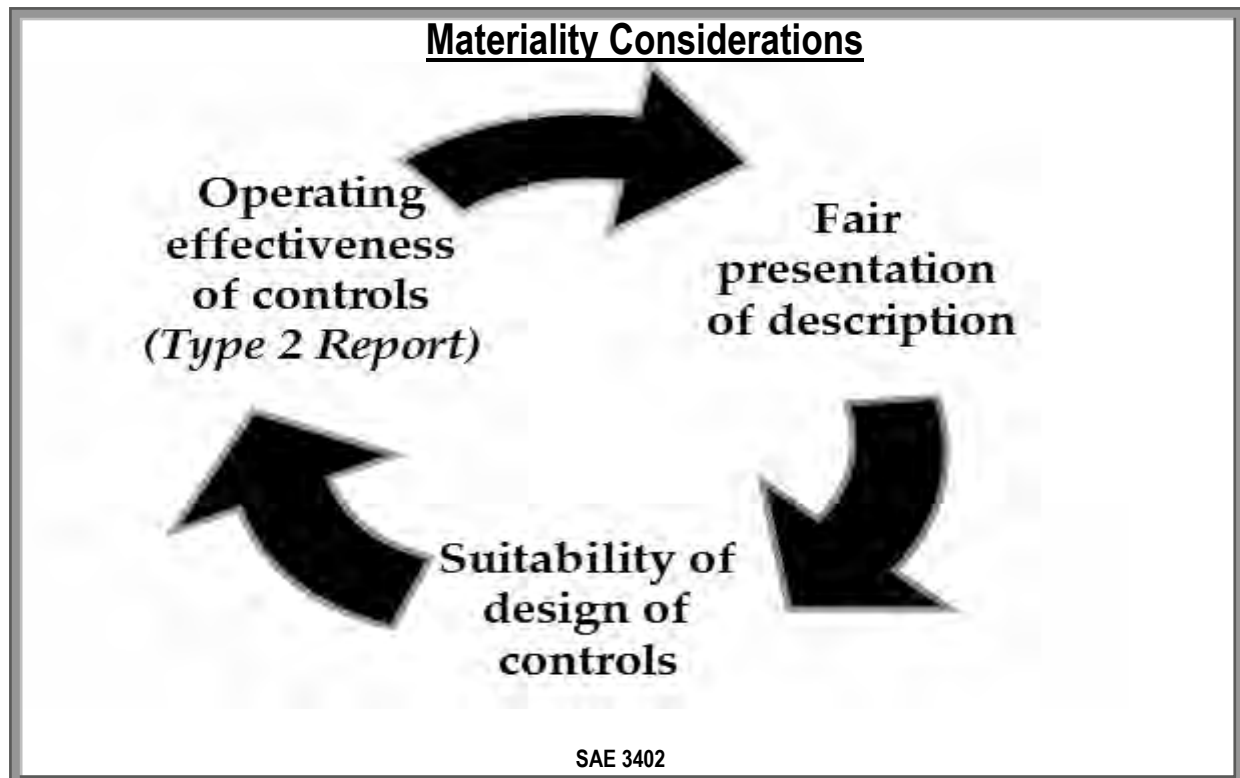
SAE 3402

### Operating Effectiveness of Controls

Whether controls were consistently applied as designed throughout the specified period

Whether manual controls were applied by persons who have appropriate competence & authority

SAE 3402



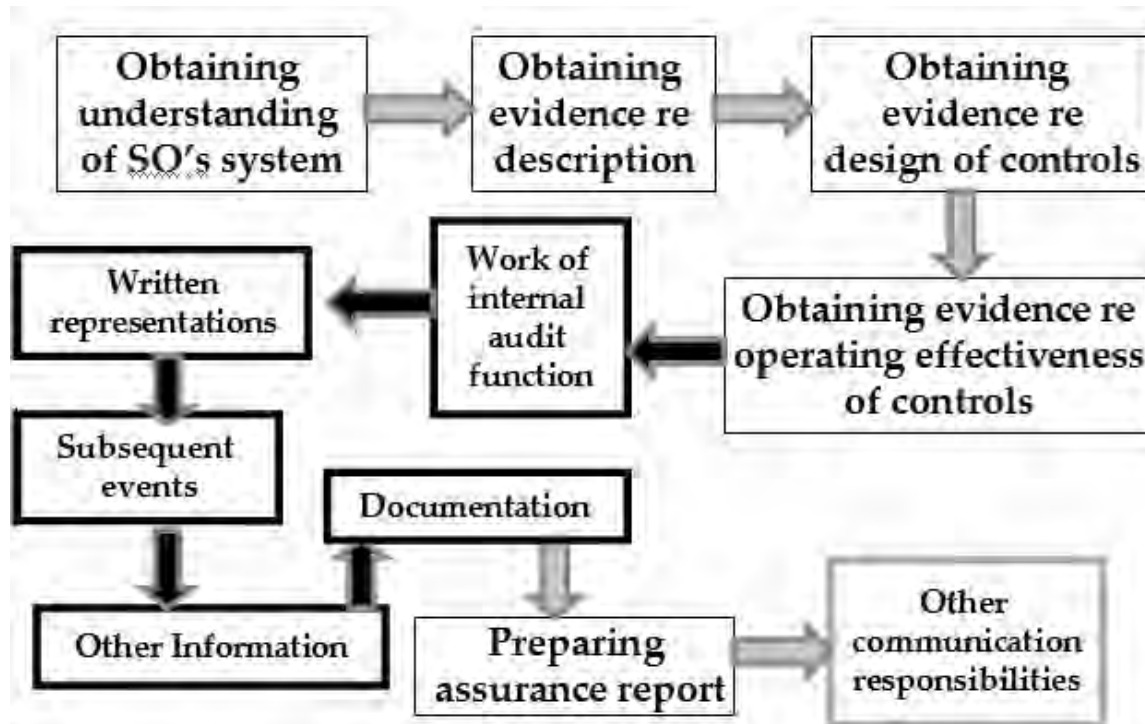
- In an engagement to report on controls at SO, the concept of materiality relates to the system being reported on, not the financial statements of UE.
- The concept of materiality takes into account that SA's assurance report provides information about SO's system to meet the common information needs of a broad range of UEs and their auditors who have an understanding of the manner in which that system has been used.
- Materiality considerations primarily include the consideration of qualitative factors, for example:
  - \* whether the description includes the significant aspects of processing significant transactions;
  - \* whether the description omits or distorts relevant information; and
  - \* ability of controls, as designed, to provide reasonable assurance that control objectives would be achieved.
- Materiality with respect to SA's opinion on the operating effectiveness of controls includes the consideration of both quantitative and qualitative factors, for example, the tolerable rate and observed rate of deviation (a quantitative matter), and the nature and cause of any observed deviation (a qualitative matter).

**Concept of materiality is not applied when disclosing, in the description of the tests of controls, the results of those tests where deviations have been identified.**

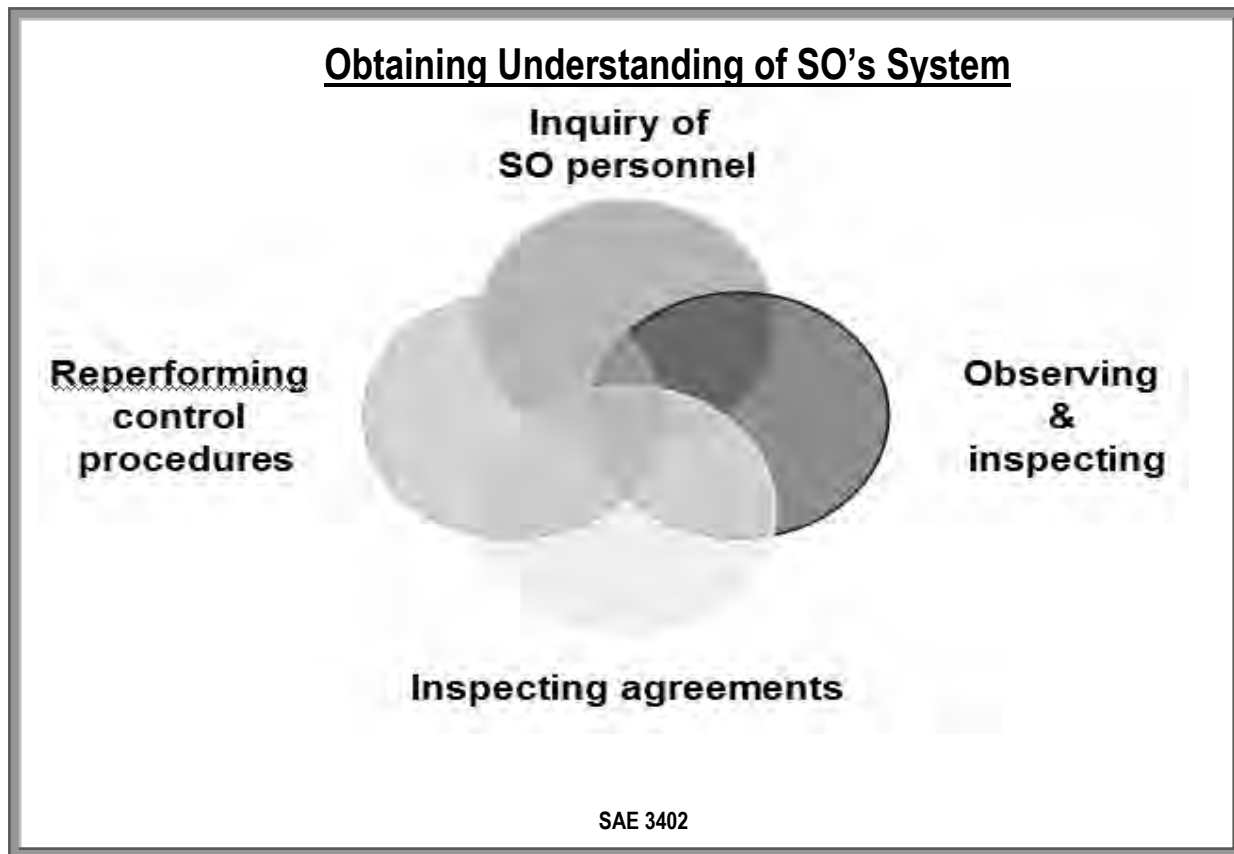
This is because, in the particular circumstances of a specific UE or UA, a deviation may have significance beyond whether or not, in the opinion of SA, it prevents a control from operating effectively.

For example, the control to which the deviation relates may be particularly significant in preventing a certain type of error that may be material in the particular circumstances of a user entity's financial statements.

### Flow of Assurance Engagement



SAE 3402



SA needs to obtain understanding of SO's system, including controls that are included in the scope of the engagement.

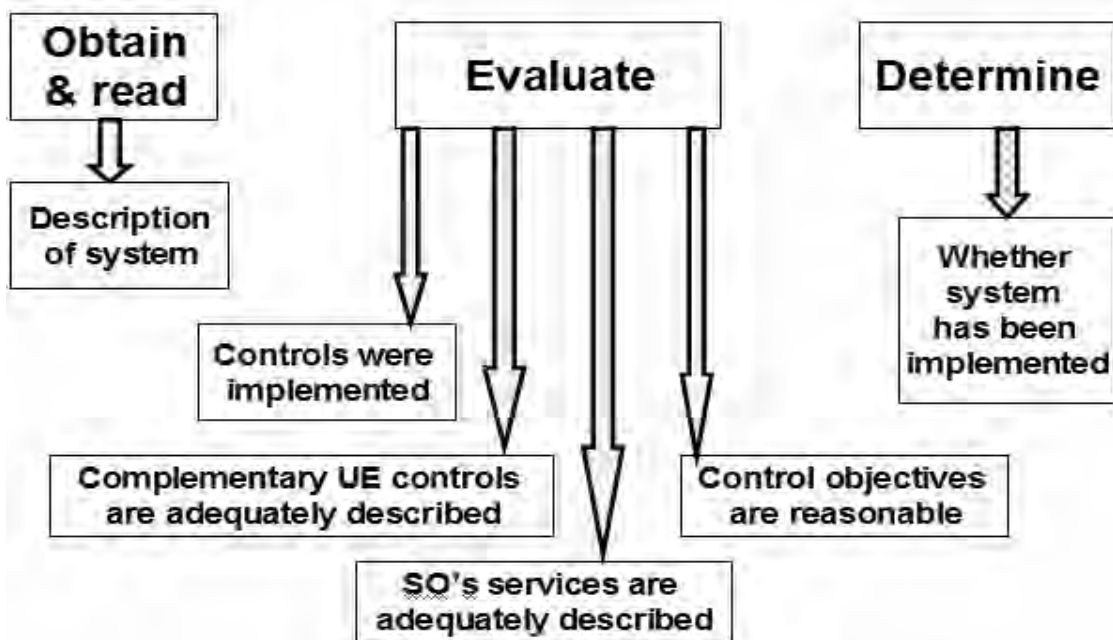
**Obtaining an understanding assists SA in:**

- Identifying the boundaries of that system, and how it interfaces with other systems.
- Assessing whether SO's description fairly presents the system that has been designed and implemented.
- Determining which controls are necessary to achieve the control objectives stated in SO's description of its system.
- Assessing whether controls were suitably designed.
- Assessing, in the case of a type 2 report, whether controls were operating effectively.

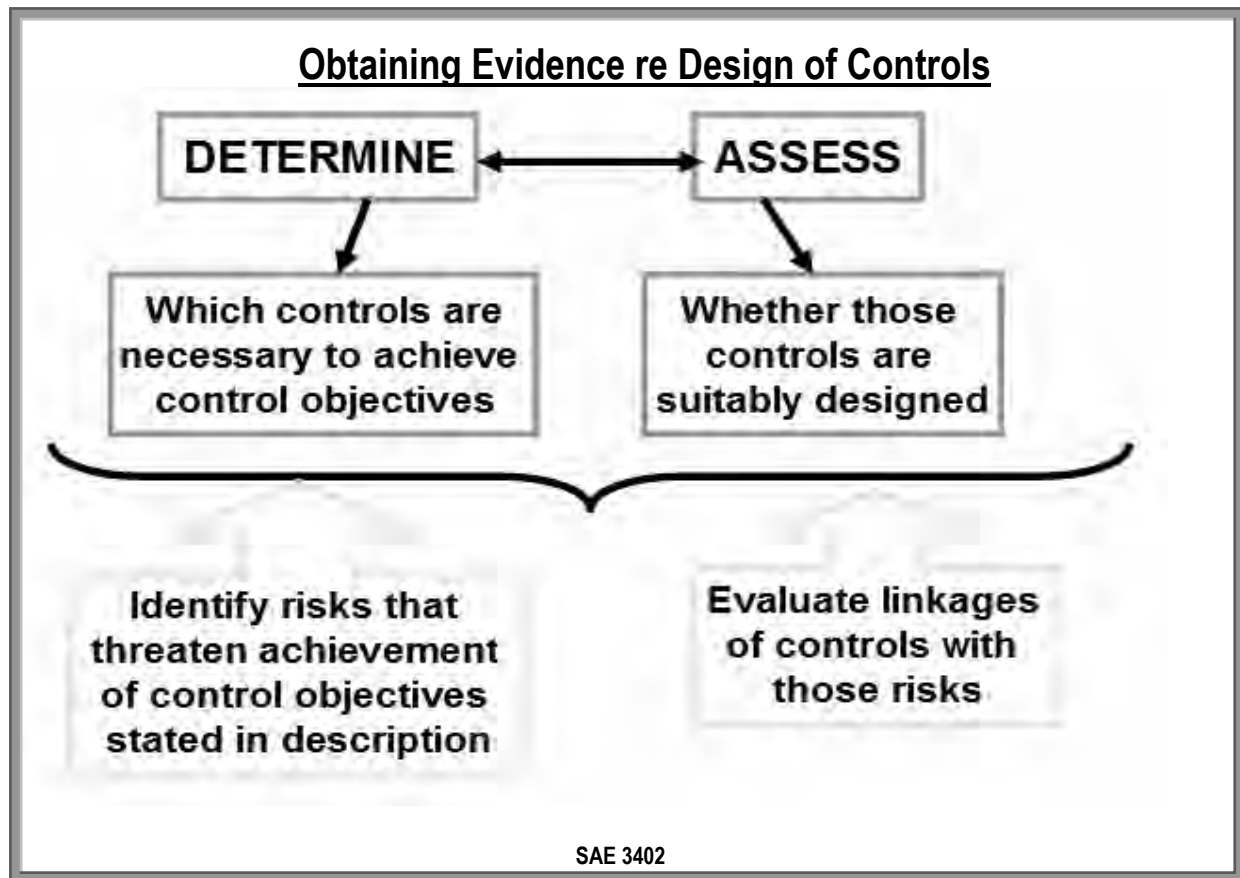
**Procedures to obtain this understanding:**

- Inquiring of those within SO who, in SA's judgment, may have relevant information.
- Observing operations and inspecting documents, reports, printed and electronic records of transaction processing.
- Inspecting a selection of agreements between SO and UEs to identify their common terms.
- Re-performing control procedures.

### Obtaining Evidence re Description



SAE 3402



- From the viewpoint of UE or UA, a control is suitably designed if, individually or in combination with other controls, it would, when complied with satisfactorily, provide reasonable assurance that material misstatements are prevented, or detected and corrected.
- SO or SA, however, is not aware of the circumstances at individual UEs that would determine whether or not a misstatement resulting from a control deviation is material to those UEs.
- Therefore, from the viewpoint of SA, a control is suitably designed if, individually or in combination with other controls, it would, when complied with satisfactorily, provide reasonable assurance that control objectives stated in SO's description of its system are achieved.
- A service auditor may consider using flowcharts, questionnaires, or decision tables to facilitate understanding the design of the controls.
- Controls may consist of a number of activities directed at the achievement of a control objective. Consequently, if the SA evaluates certain activities as being ineffective in achieving a particular control objective, the existence of other activities may allow SA to conclude that controls related to the control objective are suitably designed

## Obtaining Evidence re Operating Effectiveness

- Test the relevant controls
- Assess their operating effectiveness
- Understanding sufficient to opine on suitability of controls is **not** sufficient to opine on operating effectiveness - Unless controls are automated
- Cover at least **six** months
- Some controls may not leave trail – difficult to test
- Sufficient appropriate evidence re operation of controls in current period is **also** needed

**SAE 3402**

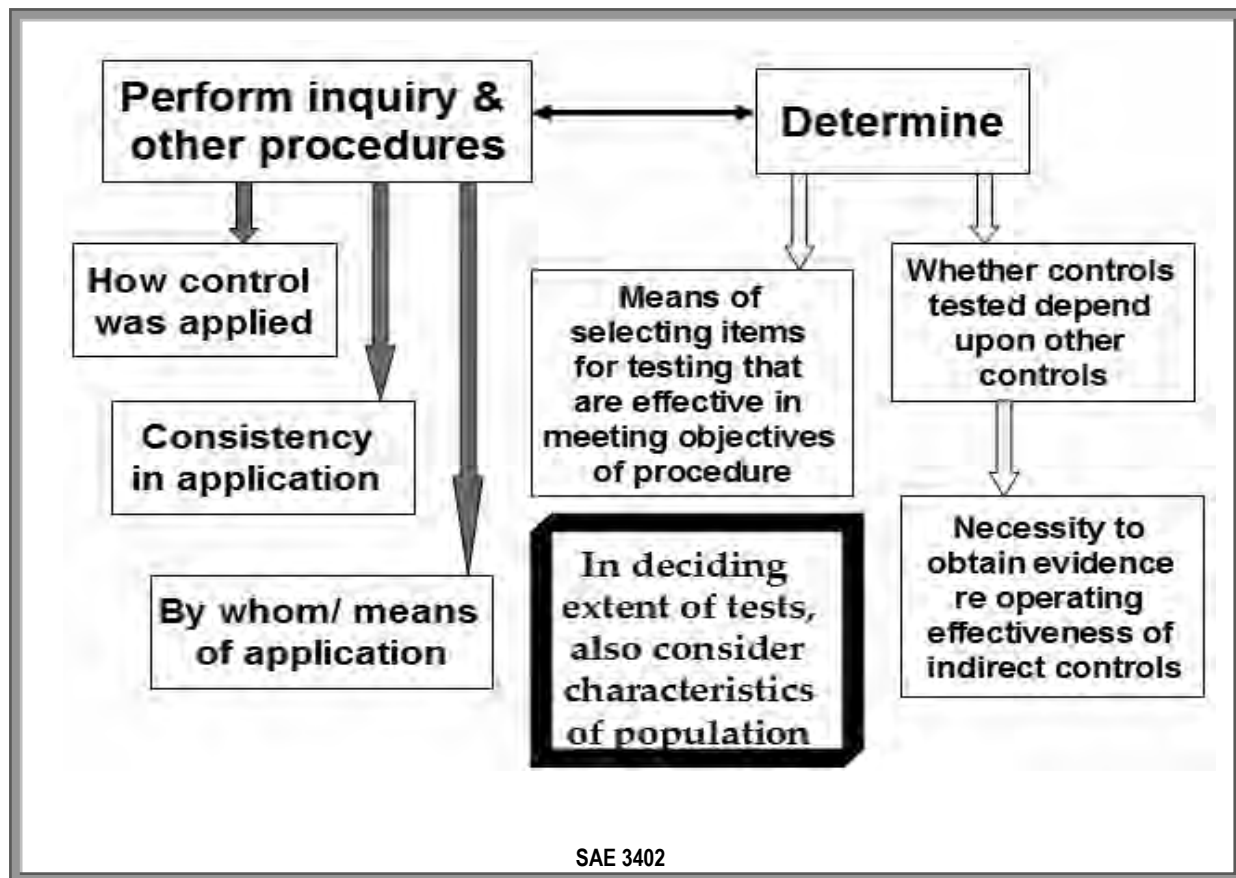
### **To be done for TYPE 2 Reports**

**Automation of controls** - For example, obtaining information about the implementation of a manual control at a point in time does not provide evidence about operation of the control at other times. However, because of the inherent consistency of IT processing, performing procedures to determine the design of an automated control, and whether it has been implemented, may serve as evidence of that control's operating effectiveness, depending on the service auditor's assessment and testing of other controls, such as those over program changes.

### **At least SIX months**

- If the period is less may consider it appropriate to describe the reasons in the assurance report.
- Circumstances that may result in a report covering a period of less than six months include:
  - the service auditor is engaged close to the date by which the report on controls is to be issued;
  - the service organization (or a particular system or application) has been in operation for less than six months; or
  - significant changes have been made to the controls and it is not practicable either to wait six months before issuing a report or to issue a report covering the system both before and after the changes.





#### Indirect controls – when testing operating effectiveness is necessary

- For example, when SA decides to test the effectiveness of a review of exception reports detailing sales in excess of authorized credit limits, the review and related follow up is the control that is directly of relevance to the service auditor.
- Controls over the accuracy of the information in the reports (for example, the general IT controls) are described as “indirect” controls. Because of the inherent consistency of IT processing, evidence about the implementation of an automated application control, when considered in combination with evidence about the operating effectiveness of SO’s general controls (in particular, change controls), may also provide substantial evidence about its operating effectiveness.

#### Means of selecting items for testing

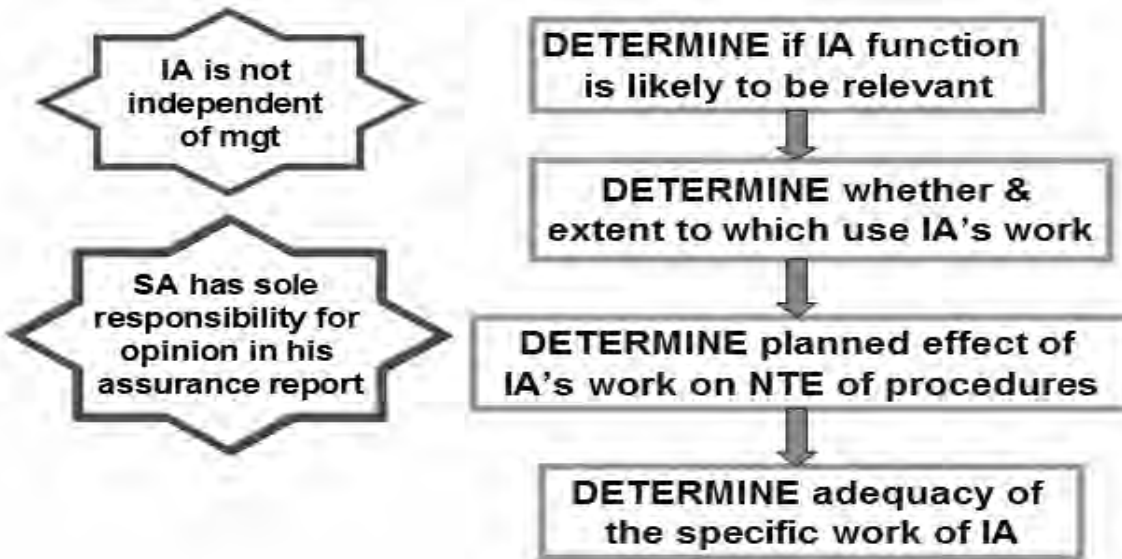
- **Selecting all items (100% examination).** This may be appropriate for testing controls that are applied infrequently, for example, quarterly, or when evidence regarding application of the control makes 100% examination efficient;
- **Selecting specific items.** This may be appropriate where 100% examination would not be efficient and sampling would not be effective, such as testing controls that are not applied sufficiently frequently to render a large population for sampling, for example, controls that are applied monthly or weekly; and
- **Sampling.** This may be appropriate for testing controls that are applied frequently in a uniform manner and which leave documentary evidence of their application.

While selective examination of specific items will often be an efficient means of obtaining evidence, it does not constitute sampling.

The results of procedures applied to items selected in this way cannot be projected to the entire population; accordingly, selective examination of specific items does not provide evidence concerning the remainder of the population.

Sampling, on the other hand, is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it.

## Work of Internal Audit Function - Considerations



SAE 3402

- IA may be responsible for providing analyses, evaluations, assurances, recommendations, and other information to management and those charged with governance. IA at SO may perform activities related to SO's own system of internal control, or activities related to the services and systems, including controls, that SO is providing to UE.

### For determining adequacy of IA's work, evaluate:

- The objectivity of the internal audit function;
- The technical competence of the internal auditors;
- Whether the work of the internal auditors is likely to be carried out with due professional care; and
- Whether there is likely to be effective communication between the internal auditors and the service auditor.

### In determining planned effect of the work IA on NTE of procedures, consider:

- The nature and scope of specific work performed, or to be performed, by the internal auditors;
- The significance of that work to the service auditor's conclusions; and
- The degree of subjectivity involved in the evaluation of the evidence gathered in support of those conclusions.

### Following factors may suggest the need for different or less extensive procedures :

- nature and scope of specific work performed, or to be performed, by IA is quite limited.
- work of IA relates to controls that are less significant to the SA's conclusions.
- work performed, or to be performed, by IA does not require subjective or complex judgments

### For evaluating adequacy of IA's work to use their specific work, evaluate whether:

- The work was performed by internal auditors having adequate technical training and proficiency;
- The work was properly supervised, reviewed and documented;
- Adequate evidence has been obtained to enable the internal auditors to draw reasonable conclusions;
- Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and
- Exceptions relevant to the engagement or unusual matters disclosed by the internal auditors are properly resolved.

### Effect on the Service Auditor's Assurance Report

- No reference to that work in the "opinion" section of SA's assurance report.
- For TYPE 2 report, if the work of IA has been used in performing tests of controls, that part of SA's assurance report that describes SA's tests of controls and the results thereof will include a description of IA's work and of SA's procedures wrt that work.

## **Written Representations**

- Reaffirm the assertion accompanying description of system
- Provide SA with all relevant information & access agreed to
- Disclosed to SA any of following, if aware of:
  - Non-compliance with L&R/ frauds/ uncorrected deviations
  - Design deficiencies in controls
  - Instances where controls have not operated as described
  - Any event in subsequent period that could significantly impact SA's report

**SAE 3402**

- WR have to be in the form of a representation letter addressed to SA.
- Date of WR should be as near as practicable to, but not after, the date of SA's assurance report.
- If, having discussed the matter with SA, SO does not provide one or more of WR requested as described in first 2 bullets of the slide, SA has to disclaim the opinion.
- If SO does not provide WR requested in accordance with last bullet of the slide, it may be appropriate to give modified opinion.

## **Other Information**

- Read other info to identify material inconsistencies *vis a vis* description of SO's system.
  - May become aware of apparent misstatement of facts
- Discuss inconsistency/ misstatement with SO.
  - If SO refuses, take further appropriate action

**SAE 3402**

If other information included in a document containing the service organization's description of its system and the service auditor's assurance report contains future-oriented information such as recovery or contingency plans, or plans for modifications to the system that will address deviations identified in the service auditor's assurance report, or claims of a promotional nature that cannot be reasonably substantiated, the service auditor may request that information be removed or restated.

If SO refuses to remove or restate the other information, further actions that may be appropriate include, for example:

- Requesting the service organization to consult with its legal counsel as to the appropriate course of action.
- Describing the material inconsistency or material misstatement of fact in the assurance report.
- Withholding the assurance report until the matter is resolved.
- Withdrawing from the engagement

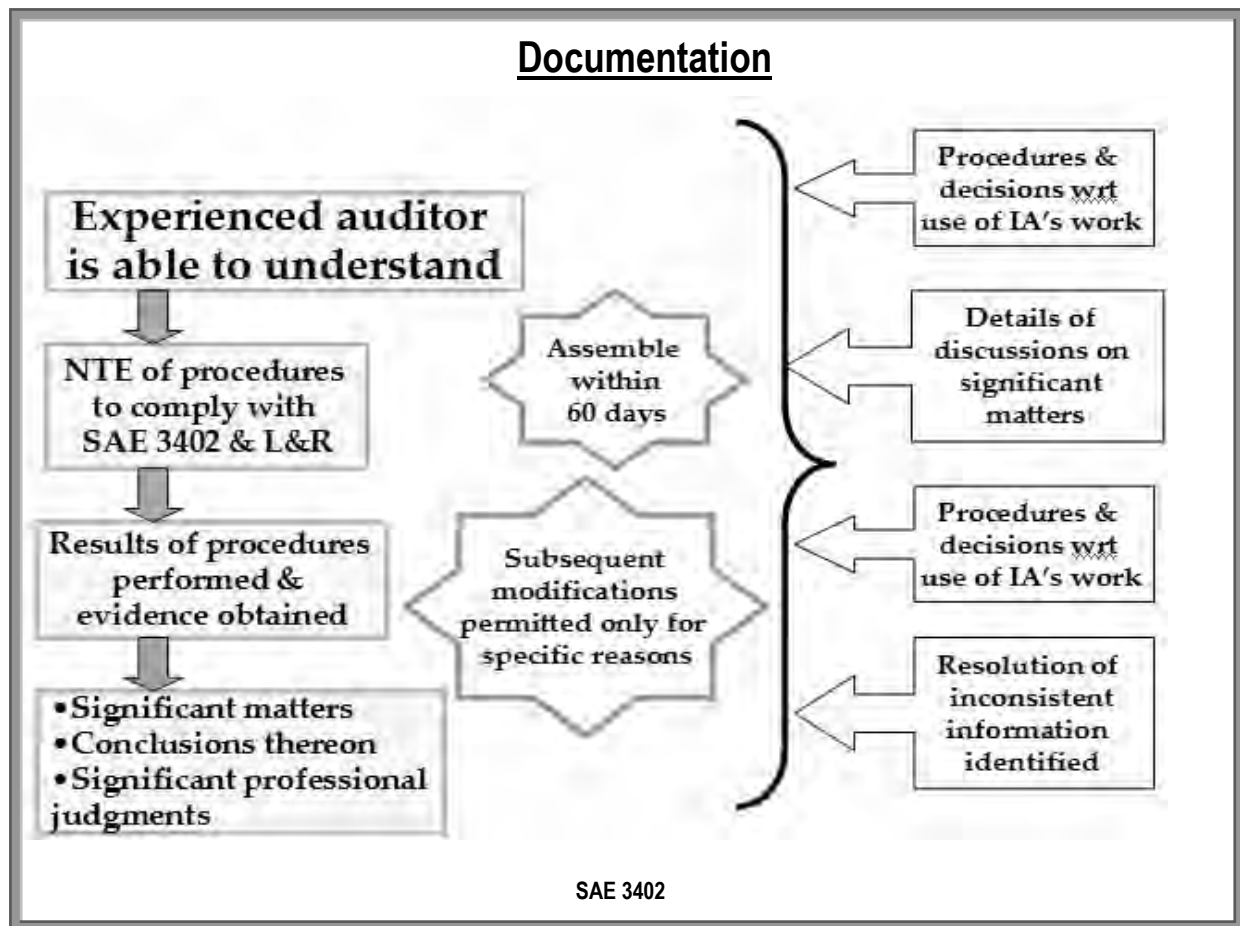
## **Subsequent Events**

- Inquire whether SO is aware of any such subsequent events which has significant effect on SO's assurance report.
- If SA aware of such events but info not disclosed by SO, make disclosure in assurance report.
- No obligation to perform any procedures after date of assurance report.

**SAE 3402**

### **No obligation wrt**

- description of the service organization's system, or
- suitability of design, or
- operating effectiveness of controls



**NTE of procedures performed:**

- The identifying characteristics of the specific items or matters being tested;
- Who performed the work and the date such work was completed; and
- Who reviewed the work performed and the date and extent of such review.

**IA's work used:**

- conclusions reached regarding the evaluation of the adequacy of IA's work, and
- the procedures performed by the service auditor on that work

**Discussions of significant matters**

- nature of the significant matters discussed and
- when and with whom the discussions took place.

**Information inconsistent** with the service auditor's final conclusion regarding a significant matter, document how the service auditor addressed the inconsistency.

**Assemble documentation in an engagement file**

- complete the administrative process of assembling the final engagement file on a timely basis
- after the date of the service auditor's assurance report

After assembly is complete, not permitted to delete or discard documentation before the end of its retention period.

**Modify or add new documentation after the assembly is completed**

- That documentation should not affect the service auditor's report, the service auditor shall
- Document:
  - The specific reasons for making them; and
  - When and by whom they were made and reviewed.

## Elements of Assurance Report

Title

Addressee

Identification &amp; description

Identification of criteria

Description of significant, inherent limitations

Restriction on use of assurance report

Identification of responsible party &amp; description of responsibilities

Compliance with SAEs

Summary of work performed

Practitioner's conclusion

Date of assurance report

Practitioner's signatures

Place of signature

SAE 3402

**Title** should clearly indicate that the report is an independent service auditor's assurance report.

**Identification of criteria** & the party specifying the control objectives.

**Compliance with SAEs** – implies compliance with ethical requirements and planning & performing procedures to obtain reasonable assurance.

**Date of assurance report** – should be no earlier than the date on which SA has obtained sufficient appropriate evidence on which to base the opinion.

**Place of signature** - The name of the service auditor, place of signature, membership number, firm registration number.

## **Assurance Report – Identification**

- SO's description of system & assertion
- Parts of description not covered by opinion
- Where applicable, statement that:
  - SA has not evaluated suitability of design/ operating effectiveness of complementary controls at UE
  - Control objectives can be achieved only if SO's controls and UE's complementary controls are suitably designed or operating effectively.
  - Where applicable, nature of activities provided by SSO
    - Method used – inclusive/ carve out

**SAE 3402**

### **Services performed by SSO**

Where the **carve-out method** has been used, a statement that SO's description of its system excludes the control objectives and related controls at relevant SSO, and that SA's procedures do not extend to controls at SSO.

Where the **inclusive method** has been used, a statement that SO's description of its system includes control objectives and related controls at the SSO, and that SA's procedures extended to controls at SSO.

## **Assurance Report – Restriction on Use**

- Statement that report is intended only for UE & UA
  - have sufficient understanding to consider it
  - Have access to other info including UE controls
- May include wording that specifically restricts:
  - distribution of report other than to intended users
  - Its use for other purposes

**SAE 3402**

## **Assurance Report – Identification of Responsible Party**

### **Statement on SO's responsibility:**

- Preparing description of its system & accompanying assertion
  - Completeness, accuracy & method of presentation
- Providing services covered by Description
- Stating the control objective
- Designing & implementing controls to achieve control objectives as stated in Description

SAE 3402

## **Statement on SA's responsibility**

Express opinion on:

- SO's Description
- Design of controls related to control objectives stated in Description
- Operating effectiveness of controls (in Type 2 Report)

Based on SA's procedures

SAE 3402

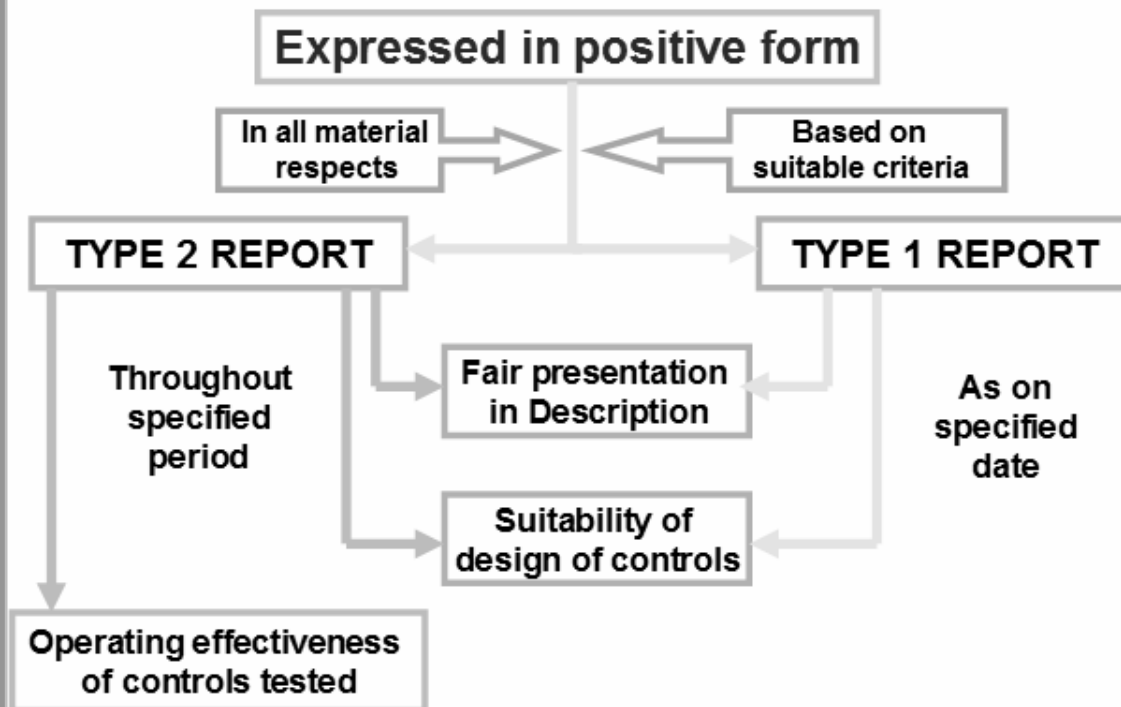


## Assurance Report – Summary of Work Performed

- SA's procedures to obtain reasonable assurance
- Statement that SA believes that evidence obtained is sufficient & appropriate basis for SA's opinion
- In Type 1 Report, a statement that SA has not tested operating effectiveness of controls
  - So no opinion on that aspect has been given
- Statement of:
  - Limitation of controls
  - Risk of projecting to future any evaluation of operating effectiveness of controls (in Type 2 Report)

SAE 3402

## Assurance Report – Opinion



SAE 3402

## **Additional Reporting Requirements for Type 2 Report**

- Description of:
  - Tests of control performed
    - Identify the controls tested
    - Whether tested items represent all or selection
    - Nature of tests to enable users to determine effect on their risk assessment
  - Results of those tests
    - Deviations identified & extent of testing done that led thereto
    - Number & nature of deviations noted
    - Report on deviations even if final conclusion is that related control objective was achieved

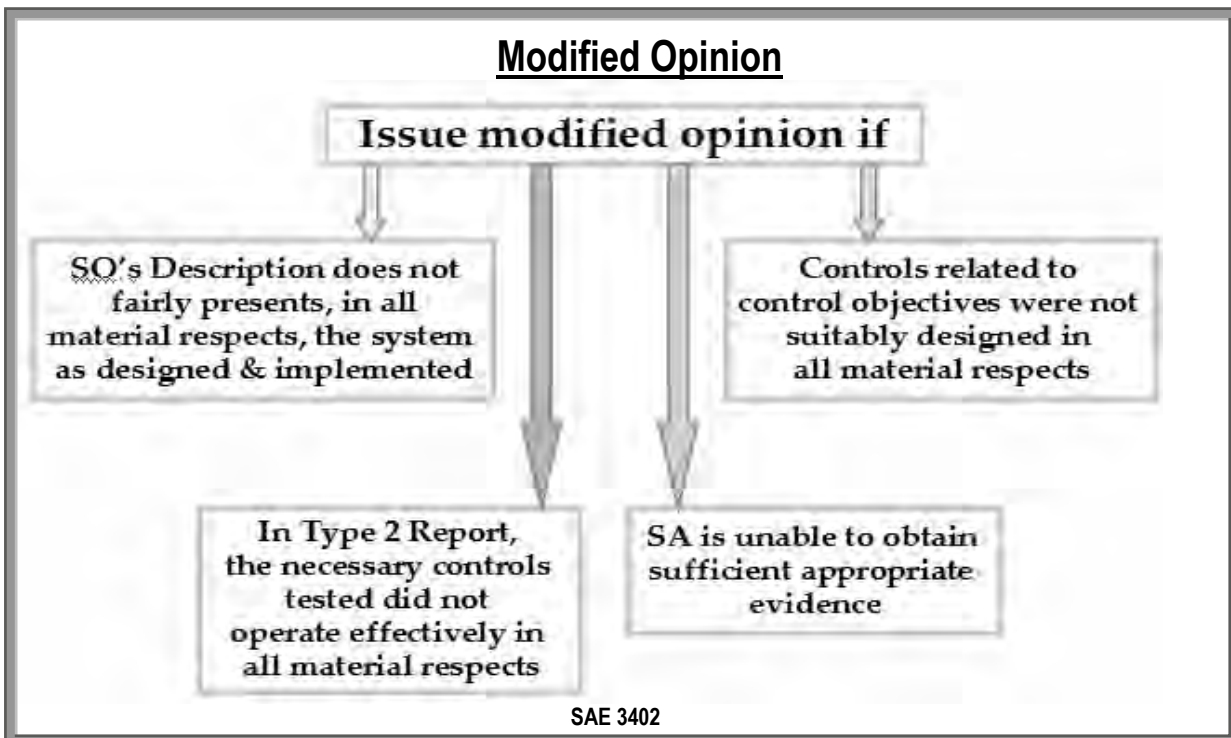
**Include as separate section after opinion or as attachment**

**SAE 3402**

In describing the nature of the tests of controls for a type 2 report, it assists readers of assurance report if SA includes:

- The results of all tests where deviations have been identified, even if other controls have been identified that allow the service auditor to conclude that the relevant control objective has been achieved or the control tested has subsequently been removed from the service organization's description of its system.
- Information about causative factors for identified deviations, to the extent the service auditor has identified such factors.

## **Modified Opinion**



- Any of the four situations calls for a modified opinion.
- Assurance report should contain a clear description of all the reasons for modification.

## **Other Communication Responsibilities**

- SA becomes aware:
  - Non-compliance/ fraud/ uncorrected errors
  - Not clearly trivial
  - May affect one or more UEs
- Determine if matter has been appropriately communicated to affected UEs
  - If not & SO is unwilling to do so, take appropriate action

**SAE 3402**

**Appropriate actions** may include:

- Obtaining legal advice about the consequences of different courses of action.
- Communicating with those charged with governance of the service organization.
- Communicating with third parties (for example, a regulator) when required to do so.
- Modifying the service auditor's opinion, or adding an Other Matter paragraph.
- Withdrawing from the engagement

# **Standards on Related Services (SRSs)**

## **Standards on Related Services (SRSs)**

- ❖ SRS 4400, "Engagements to Perform Agreed-upon Procedures regarding Financial Information" (April 1, 2004).
- ❖ SRS 4410, "Engagements to Compile Financial Information" (April 1, 2004).

# **SRS 4400**

## **Engagements to Perform Agreed- upon Procedures regarding Financial Information**

*Effective for all agreed upon procedures engagements beginning on or after April 1, 2004*

## **Introduction**

- ❖ Establishes standards on auditor's professional responsibilities with regard to:
  - Perform Agreed-upon Procedures (AUP) on Financial Information (FI).
  - Form & content of report of AUP engagements.
- ❖ Report of factual findings based on:
  - Specified procedures performed on specified subject matter of special elements, accounts or items of FS.

**SRS 4400**

- ❖ May provide guidance for engagements to perform AUP regarding non-financial information .

## **Objectives**

- ❖ To carry out procedures of audit nature to which the auditor, the entity and any appropriate third parties have agreed; **and**
- ❖ To report on factual findings.

**SRS 4400**

- ❖ No assurance is expressed in the report of the auditor and hence users assess for themselves the procedures and findings and draw their own conclusions from the work done by the auditor.
- ❖ The report is restricted to parties who have agreed to procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results. However, it is possible in certain circumstances that report of engagement may not be restricted only to parties who have agreed to the procedures to be performed, but made available to a wider range of entities or individuals, e.g., in case of government organisations.

## **General Principles**

- ❖ Comply with *Code of Ethics* issued by ICAI.
- ❖ Where the auditor is not independent:
  - A statement to that effect should be made in report of factual findings.
- ❖ Conduct AUP engagement in accordance with:
  - This SRS; and
  - Terms of engagement.

**SRS 4400**

- ❖ Ethical principles:
  - Integrity, Objectivity;
  - Professional competence and due care;
  - Confidentiality;
  - Professional conduct; and
  - Technical standards.

## **Defining Terms of Engagement-I**

- ❖ Ensure that there is clear understanding of agreed procedures, conditions of engagement with:
  - Representatives of entity.
  - Other specified parties who will receive copies of report.
- ❖ Matters agreed includes:
  - Nature of engagement.
  - Stated purpose for engagement.
  - Identification of FI to which AUP applied.
  - Nature, timing and extent of specific procedures to be applied.
  - Limitations on distribution of report.

**SRS 4400**

## **Defining Terms of Engagement-II**

- ❖ Send engagement letter:
  - Listing of procedures to be performed.
  - Restrictions on distribution of report.
- ❖ If procedures agreed between regulator/industry representatives then auditor may not be able to discuss procedures with all parties who will receive report.

**SRS 4400**

- ❖ Refer to Appendix I of SRS 4400 for an example of an engagement letter.

## **Planning and Documentation**

- ❖ Plan the work so that an effective engagement will be performed.
- ❖ Document matters which are important in providing evidence:
  - To support the report of factual findings.
  - That engagement was carried out in accordance with this SRS and terms of engagement.

**SRS 4400**



## **Procedures and Evidence**

- ❖ Perform AUP and use the evidence obtained as basis for report of factual findings.
- ❖ Procedures applied include:
  - Inquiry and analysis.
  - Recomputation, comparison and other clerical accuracy checks.
  - Observation.
  - Inspection.
  - Obtaining confirmations.

**SRS 4400**

- ❖ Refer to Appendix II of SRS 4400 for an illustrative list of procedures which may be used as one part of a typical AUP procedures engagement.

## **Reporting- I**

- ❖ Describe the purpose and agreed-upon procedures of engagement.
- ❖ Report of factual findings should contain:
  - Title and Addressee.
  - Identification of specific FI/ non-FI to which AUP have been applied.
  - Statement that procedures performed were those agreed upon with recipient.
  - Statement that engagement performed in accordance with Standards applicable to AUP engagements.

**SRS 4400**

- ❖ The report on an agreed-upon procedures needs to describe the purpose and agreed-upon procedures of engagement in sufficient detail to enable reader to understand nature and extent of work performed, and it should be clearly mentioned that no audit/review has been performed.

## **Reporting- II**

- ❖ Identification of the purpose of AUP.
- ❖ Listing of specific AUP performed.
- ❖ Description of factual findings including sufficient details of errors and exceptions found.
- ❖ Statement that procedures performed do not constitute either an audit or a review and as such, no assurance is expressed.
- ❖ Statement that had the auditor performed additional procedures, audit or review, other matters might have come to light.
- ❖ Statement that report is restricted to specified parties.
- ❖ Statement that report does not extend to entity's FS taken as a whole.
- ❖ Date of report.
- ❖ Place of signature.
- ❖ Auditor's signature

### **SRS 4400**

- ❖ Auditor's Signature:
  - The report should be signed by the accountant in his personal name.
  - Where firm is appointed, report should be signed in personal name of accountant and in name of firm.
  - Partner/proprietor signing report should also mention membership number assigned by the ICAI.
- ❖ Refer to Appendix II of SRS 4400 for an example of a report of actual findings issued in connection with an engagement to perform AUP regarding financial information.

## **SRS 4410**

### **Engagements To Compile Financial Information**

*Effective for all compilation engagements beginning on or after April 1, 2004*

## **Introduction**

- ❖ Establishes standards on:
  - Professional responsibilities of an accountant wrt engagement for compiling FS or other FI; and
  - The form and content of the Compilation Report.
- ❖ Applicable to the extent practicable, to engagements to compile non-financial information.

**SRS 4410**

## **Objective of Compilation Engagement**

- ❖ To use accounting expertise, as opposed to auditing expertise, to collect, classify and summarise FI.
- ❖ Procedures not designed to enable accountant to express any assurance on FI.

**SRS 4410**

- ❖ Ordinarily entails reducing detailed data to manageable and understandable form without requirement to test the assertions.
- ❖ Ordinarily include preparation of FS (which may or may not be a complete set of FS) but may also include collection, classification and summarisation of other FI.

## **General Principles**

- ❖ Comply with the Code of Ethics issued by ICAI.
- ❖ Where the accountant is not independent:
  - Include a statement to that effect in report.
- ❖ Accountant to issue a report in all circumstances, when accountant's name is associated with FI compilation.

### **SRS 4410**

- ❖ Ethical principles governing professional responsibilities for this type of engagement are:
  - Integrity; Objectivity;
  - Professional competence and due care;
  - Confidentiality; Professional conduct; and
  - Technical standards.

## **Responsibility of Management**

- ❖ Prevent and detect errors, frauds and other irregularities.
- ❖ Appropriate preparation and presentation of FS or other FI.
- ❖ A compilation engagement carried out by accountant does not relieve management of these responsibilities.

### **SRS 4410**

- ❖ Auditor to obtain an acknowledgement from the management of its responsibilities regarding:
  - Preparation and presentation of the FS.
  - Approval of information compiled.
  - Accuracy and completeness of accounting data.
  - Complete disclosure of material and relevant information.
- ❖ Management's responsibilities include:
  - Accuracy and completeness of information.
  - Preparation and presentation of the financial statements of the entity.
  - Safeguarding the assets of the entity.
  - Appropriate controls designed to prevent and detect fraud and other irregularities.
  - Ensuring that the activities of the entity are carried in accordance with the applicable laws and regulations.
  - Ensuring complete disclosure of all material information to the accountant.
- ❖ Appendix I to SRS 4410 gives an example of an engagement letter for a compilation engagement.

### **Defining Terms of Engagement**

- ❖ Confirms accountant's acceptance of engagement and ensures clear understanding of terms of engagement.
- ❖ Scope normally defined by client but in some cases form and content might be laid down under a statute.

**SRS 4410**

- ❖ Contents of engagement letter:
  - Nature of engagement including fact that neither audit nor review will be carried out.
  - Nature of information supplied by the client.
  - Management's responsibilities.
  - Use and distribution of information compiled.
  - Basis of accounting on which FI compiled.
  - Unrestricted access to records, documents.

### **Planning and Documentation**

- ❖ Plan the work so that an effective engagement will be performed.
- ❖ Document matters which are important in providing evidence that the engagement was carried out in accordance with:
  - This SRS; and
  - Terms of engagement.

**SRS 4410**

## **Procedures - I**

- ❖ Obtain General understanding of:
  - Business and operations of entity.
  - Accounting principles and practices of industry in which entity operates.
  - Form and content of FS/other FI.
- ❖ Request management representation.

### **SRS 4410**

- ❖ Normally reliance is placed on management for most of information needed to compile FS or other FI, including accounting estimates.
- ❖ Accountant is not, ordinarily, required to do:
  - Inquires of management to assess the reliability and completeness of information.
  - Assess internal controls.
  - Verification of any matters or explanations.

## **Procedures - II**

- ❖ Incorrect, incomplete, unsatisfactory information from management:
  - Consider performing additional procedures.
  - Request management to provide additional information.
- ❖ Management refusal to provide additional information:
  - Withdraw from engagement.
  - Inform entity of the reasons for withdrawal.
- ❖ Consider whether compiled information appears to be:
  - Appropriate in form; and
  - Free from obvious material misstatements.

### **SRS 4410**

- ❖ Material misstatements include:
  - Mistakes in application of identified financial reporting framework.
  - Non-disclosure of financial reporting framework and any known departures therefrom.
  - Non-disclosure of any other significant matters of which accountant has become aware.
- ❖ The identified financial reporting framework and any known departures therefrom should be disclosed within FI, though their effects need not be quantified.

## **Special Considerations - I** **Financial Reporting Framework (FRF)**

- ❖ Clients having identified FRF:
  - Ensure FS or other FI comply with requirements of FRF.
  - Disclosure of any material departure.
- ❖ Clients having no identified FRF:
  - Accounts assumed to be compliant with generally accepted accounting practices.
  - Different basis of compilation should be set out in Notes to accounts/other financial information and in accountant's report.

**SRS 4410**

## **Special Considerations - II** **Accounting Standards and Accounting Estimates**

- ❖ Material non-compliance with Accounting Standards:
  - Communicate to management.
  - If the same is not rectified, disclose in notes to accounts and accountant's report.
- ❖ If certain estimates are unreasonable:
  - Draw attention of management for re-consideration.
- ❖ Awareness of material misstatements:
  - Persuade management to carry out amendments.
  - If amendments not made and FS still misleading then withdraw from engagement.

**SRS 4410**



### **Special Consideration - III** **Others**

- ❖ Compiled information should be approved by client before compilation report is signed by accountant.
- ❖ Client should be asked to sign a statement on face of accounts retained by accountant.
- ❖ Ensure that users are aware of the extent of his involvement so that they do not derive unwarranted assurance.
- ❖ Words like audit, auditor's fees should not be used in correspondence, documents.
- ❖ Letterhead of accountant not to be used as it is liable to be misinterpreted.

**SRS 4410**

### **Reporting - I**

- ❖ Accountant should clearly bring out nature of association with FS and nature of work performed:
- ❖ Report should contain:
  - Title.
  - Addressee.
  - Identification of FI.
  - When relevant, statement that accountant is not independent of the entity.
  - Statement that engagement was performed in accordance with this SRS.
  - Statement that review/audit has not been done.

**SRS 4410**

- ❖ The title of the Accountant's Report should be "Accountant's Report on Compilation of Un-audited Financial Statements".
- ❖ The Addressee should, normally, be appointing authority.
- ❖ Identification of FI and also noting that it is based on information provided by management.
- ❖ Appendix II to this Standard contains examples of compilation reports.

## **Reporting - II**

- If necessary, disclosure of material departures from identified financial reporting framework.
- Statement of management responsibility.
- Date of report.
- Place of signature.
- Accountant's Signature & membership number.
- ❖ **Each page of FI or front of complete set of FS** should contain a reference:
  - "Un-audited", "Compiled without audit or review" and also "Refer to Compilation Report".

**SRS 4410**

# **PART – II**

## **Documentation Requirements in the Standards on Auditing**

# Documentation Requirements in the Standards on Auditing

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## Audit Documentation

***“The skills of an accountant can always be ascertained by an inspection of his working papers”.***

– Robert H Montgomery, *Montgomery’s Auditing*, 1912

What the noted authority on auditing said about the relationship between an accountant (read “auditor”) and his working papers almost 85 years back is true even today and then no wonder that “audit documentation” is the buzz word among the professional accountants today. The fact that “audit documentation” has remained as one of the top priorities in the professional circles, importantly, the standard setters, and that messing with the same has cost one of the oldest accounting firms its very existence drives home the point how important is documentation for the auditors. Audit documentation normally includes, in sufficient details, record of the following aspects of an audit:

- audit programme and other planning documents, including documents relating to assessment of the acceptance or continuance of the client.
- copies of significant client documents.
- checklists and questionnaires.
- notes of discussions with the client and/ or within the audit team on various aspects of the audit.
- management representation letters, third party confirmations and other important communications.
- details of tests performed, documents examined, analyses undertaken and results thereof. Though it is neither necessary nor practicable to document all the aspects of an audit, it needs to be adequate and appropriate enough to provide evidence that:
  - ⇒ the auditor’s basis for a conclusion about the achievement of the overall objective of the auditor; and
  - ⇒ the audit was planned and performed in accordance with Standards on Auditing and the applicable legal and regulatory requirements.

In addition, audit documentation serves a number of other purposes including:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 220.
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.

## **Background Material for Audit Training Workshops and Seminars**

- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Thus, the objectives to be met by the auditor when preparing audit documentation are:

- A sufficient and appropriate record of the basis for the auditor's report; and
- Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Strong audit documentation, therefore, also comes handy in cases of professional negligence against the auditor. Appropriate and adequate audit documentation, containing proper linkages, is virtually infallible evidence to the fact that the auditor has performed his work in accordance with the requirements of the professional Standards. One of the leading contemporary authorities working for an international auditing standards setter recently noted at a workshop organized by the Institute that the normal human psychology is that one documents/ records what one does. And going by that, the third parties, especially, the regulators and the law enforcers, normally, whatever be the facts, *prima facie* drew an analogy that what has not been documented has not been done. He also noted that there was a general perception among the professionals that bigger/ leading auditing firms were normally able to smooth sail such cases whereas the smaller audit firms/ practitioners found their defense difficult even though they had committed no such negligence. The main reason for this, he felt, was probably the fact that the larger auditing firms normally had stronger and well organized audit documentation which helped them in providing evidence of the work performed by them, whereas their smaller counterparts, were normally found to be lacking on the audit documentation aspects and therefore, unable to provide sufficient appropriate evidence of the work done by them. Therefore, notwithstanding the depth of knowledge that a practitioner has about his client, it is essential that the same is appropriately documented.

Further, the Standard on Quality Control (SQC) 1, issued by the Institute, which lays down the fundamental principles for maintenance of quality by the firms/ practitioners in the assurance engagements provided by them, draws its strength from the documentation skills and techniques of the practitioners. The Standard envisages that the audit documentation would be adequate enough to enable an "experienced auditor" (term which has been defined in the Standard) to follow the audit progress, basis of the decisions taken by the audit team, etc.

Audit documentation has also gained ground due to the process of peer review initiated by the Institute. The peer reviewer examines adequacy and appropriateness of the audit documentation of the reviewer. At its initial stages, peer review has been propagated as a learning exercise for the practice units rather than being a fault finding one.

Above all, strong documentation repository in an audit firm, comprising information about the clients is vital for building up the knowledge bank for the future use of the firm/ practitioner – a legacy of the firm/ practitioner. Working papers containing the history of the client over the years would help the audit staff to enrich their knowledge of not only what the client has been but also what they can expect the client to be. The knowledge bank would also come handy in helping the audit staff to understand the audit methodology, charting the reasons necessitating changes thereto as also understanding how the firm/ practitioner deal with various types of situations using the knowledge bank as the precedence.

To help the auditors in preparing sufficient appropriate audit documentation, the Institute had issued the Standard on Auditing (SA) 230, *Documentation*, in 1985. The Institute, in 2008, issued the Revised Standard on Auditing (SA) 230, *Audit Documentation*, providing detailed guidelines on important issues

such as timely preparation of audit documentation, documentation of audit procedures performed and audit evidence obtained, assembly of the final audit file, ownership of audit documentation, etc.

**DISCLAIMER** : These documentation requirements have been extracted from the requirements given in the individual Standards on Auditing under the specific head of documentation and are illustrative only. These documentation requirements may have been abridged or reworded. Accordingly, the readers are cautioned to refer to the text of the SAs for complete documentation requirements. Further, a mere compliance with these documentation requirements in this document does not imply compliance with the respective Standard on Auditing (SA). The members and other interested readers are also requested to peruse the respective SA to identify the various documentation requirements arising therein. Further, this document does not include all the SAs since some of the SAs are purely conceptual and per se contain no documentation requirements.

SA	SA Title
220	Quality Control for an Audit of Financial Statements
240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
250	Consideration of Laws and Regulations in an Audit of Financial Statements
260	Communication with Those Charged with Governance
300	Planning an Audit of Financial Statements
315	Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment
320	Materiality in Planning and Performing an Audit
330	The Auditor's Responses to Assessed Risks
450	Evaluation of Misstatements Identified during the Audit
540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
550	Related Parties
600	Using the Work of Another Auditor
610	Using the Work of Internal Auditors

**SA 220: Quality Control for an Audit of Financial Statements**

<b>Para Ref.</b>	<b>Issue</b>	<b>Documentation Needed</b>
24.	<ul style="list-style-type: none"> <li>• Compliance with the Relevant Ethical and independence Requirements.</li> <li>• Acceptance and Continuance of client relationship and audit engagements.</li> <li>• Consultations</li> </ul>	<ul style="list-style-type: none"> <li>• Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.</li> <li>• Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.</li> <li>• Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.</li> <li>• The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement.</li> </ul>
25	Engagement Quality Control Review- Timing and Procedures.	<p>The engagement quality control reviewer document:</p> <ul style="list-style-type: none"> <li>• The procedures required by the firm's policies on engagement quality control review have been performed;</li> <li>• The engagement quality control review has been completed on or before the date of the auditor's report; and</li> <li>• The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.</li> </ul>
A35	Documentation of Consultations.	<p>Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of:</p> <ul style="list-style-type: none"> <li>• The issue on which consultation was sought; and</li> <li>• The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.</li> </ul>

**SA 240: The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements**

<b><i>Para Ref.</i></b>	<b><i>Issue</i></b>	<b><i>Documentation Needed</i></b>
44	<ul style="list-style-type: none"> <li>Understanding the entity &amp; its environment.</li> <li>Assessment of risks of material misstatements.</li> </ul>	<ul style="list-style-type: none"> <li>The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and</li> <li>The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.</li> </ul>
45	Responses to assessed risks	<ul style="list-style-type: none"> <li>The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and</li> <li>The results of the audit procedures, including those designed to address the risk of management override of controls.</li> </ul>
46	Communications	Communications about fraud made to management, those charged with governance, regulators and others.
47	Fraud in revenue recognition	Reasons for concluding the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement,

**SA 250: Consideration of Laws and Regulations in an Audit of Financial Statements**

<b><i>Para Ref</i></b>	<b><i>Issue</i></b>	<b><i>Documentation Needed</i></b>
29	<ul style="list-style-type: none"> <li>Non - compliance</li> <li>Discussions</li> </ul>	<ul style="list-style-type: none"> <li>Identified or suspected non-compliance with laws and regulations.</li> <li>Results of discussions with : <ul style="list-style-type: none"> <li>Management;</li> <li>those charged with governance (where applicable); and</li> <li>other parties outside the entity.</li> </ul> </li> </ul>



## Background Material for Audit Training Workshops and Seminars

A21	Non compliance	<ul style="list-style-type: none"> <li>Documentation may include: <ul style="list-style-type: none"> <li>Copies of records or documents.</li> <li>Minutes of discussions held with management, those charged with governance or parties outside the entity.</li> </ul> </li> </ul>
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### SA 260: Communication with Those Charged with Governance

<i>Para Ref</i>	<i>Issue</i>	<i>Documentation Needed</i>
19	Oral & written communications to those charged with governance	<ul style="list-style-type: none"> <li>Matters required by SA 260R to be communicated are communicated orally, document: <ul style="list-style-type: none"> <li>The matter;</li> <li>When communication was made; and</li> <li>To whom communication was made.</li> </ul> </li> <li>Matters required by SA 260R to be communicated are communicated in writing, retain a copy.</li> </ul>
A49	Oral communication	May include a copy of minutes prepared by client retained as part of audit documentation where those minutes are an appropriate record of the communication.

### SA 300: Planning an Audit of Financial Statements

<i>Para Ref</i>	<i>Issue</i>	<i>Documentation Needed</i>
11	Planning	<ul style="list-style-type: none"> <li>The overall audit strategy;</li> <li>The audit plan; and</li> <li>Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.</li> </ul>
A17-A20	<ul style="list-style-type: none"> <li>Overall audit strategy.</li> <li>Audit plan.</li> </ul>	<ul style="list-style-type: none"> <li>In respect of overall audit strategy, document: <ul style="list-style-type: none"> <li>the key decisions considered necessary to properly plan the audit – scope, timing, conduct of audit; and</li> </ul> </li> </ul>

	<ul style="list-style-type: none"> <li>• Significant changes in the above two.</li> </ul>	<ul style="list-style-type: none"> <li>▪ communicate significant matters communicated to the engagement team.</li> <li>• May summarize the overall audit strategy in the form of a memorandum.</li> <li>• Documentation of the audit plan is record of planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks.</li> <li>• May use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.</li> <li>• A record of the significant changes to the overall audit strategy and the audit plan should document: <ul style="list-style-type: none"> <li>▪ resulting changes to the planned nature, timing and extent of audit procedures.</li> <li>▪ reasons for significant changes were made.</li> <li>▪ overall strategy and audit plan finally adopted for the audit.</li> <li>▪ Response to the significant changes occurring during the audit.</li> </ul> </li> <li>• In smaller entities a suitable, brief memorandum may serve as the documented strategy for the audit of a smaller entity.</li> </ul>
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**SA 315: Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment**

<b><i>Para Ref</i></b>	<b><i>Issue</i></b>	<b><i>Documentation Needed</i></b>
32(a)	Discussion	<ul style="list-style-type: none"> <li>• The discussion among the engagement team where required by paragraph 10 of SA 315, and the significant decisions reached: <ul style="list-style-type: none"> <li>▪ the susceptibility of the entity's financial statements to material misstatement; and</li> <li>▪ the application of the applicable financial</li> </ul> </li> </ul>

		reporting framework to the entity's facts and circumstances.
32(b)	Understanding of each of the aspects of the entity and its environment specified in paragraph 11	<ul style="list-style-type: none"> <li>• Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.</li> <li>• The nature of the entity, including: <ul style="list-style-type: none"> <li>▪ its operations;</li> <li>▪ its ownership and governance structures;</li> <li>▪ the types of investments that the entity is making and plans to make, including investments in special purpose entities; and</li> <li>▪ the way that the entity is structured and how it is financed.</li> </ul> </li> <li>• Accounting policies selection and application of accounting policies, including the reasons for changes thereto.</li> <li>• Auditor's evaluation of whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.</li> <li>• The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.</li> <li>• The measurement and review of the entity's financial performance.</li> </ul>
32(b)	Understanding of each of the internal control components specified in paragraphs 14-24	<ul style="list-style-type: none"> <li>• Control environment – Auditor's evaluation of whether: <ul style="list-style-type: none"> <li>▪ Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior.</li> <li>▪ The strengths in the control environment elements collectively provide an appropriate foundation for the other components of</li> </ul> </li> </ul>

		<p>internal control; and</p> <ul style="list-style-type: none"> <li>▪ Whether those other components are not undermined by deficiencies in the control environment.</li> </ul> <ul style="list-style-type: none"> <li>• Entity's risk assessment process for : <ul style="list-style-type: none"> <li>▪ Identifying business risks relevant to financial reporting objectives;</li> <li>▪ Estimating the significance of the risks;</li> <li>▪ Assessing the likelihood of their occurrence; and</li> <li>▪ Deciding about actions to address those risks.</li> </ul> </li> <li>• Management's failure to identify a risk otherwise expected to have been identified: <ul style="list-style-type: none"> <li>▪ Why that process failed to identify it; and</li> <li>▪ Evaluation of whether the process is appropriate to its circumstances or determine whether it represent a significant deficiency in internal control with regard to the entity's risk assessment process.</li> </ul> </li> <li>• If the entity has not established such a process or has an <i>ad hoc</i> process: <ul style="list-style-type: none"> <li>▪ Discussion with management regarding whether business risks relevant to financial reporting objectives have been identified and how they have been addressed.</li> </ul> </li> <li>• The information system, including the related business processes, relevant to financial reporting, and communication. <ul style="list-style-type: none"> <li>▪ Information system, including the related business processes, relevant to financial reporting, including the following areas: <ul style="list-style-type: none"> <li>➤ The classes of transactions in the entity's operations that are significant to the financial</li> </ul> </li> </ul> </li> </ul>
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		<p>statements;</p> <ul style="list-style-type: none"> <li>➤ The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;</li> <li>➤ The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;</li> <li>➤ How the information system captures events and conditions, other than transactions, that are significant to the financial statements;</li> <li>➤ The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and</li> <li>➤ Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.</li> </ul> <ul style="list-style-type: none"> <li>• Entity's communication of financial reporting roles and responsibilities and significant matters relating to financial reporting, including: <ul style="list-style-type: none"> <li>▪ Communications between management and those charged with governance; and</li> <li>▪ External communications, such as those with regulatory authorities.</li> </ul> </li> <li>• Control activities relevant to the audit: <ul style="list-style-type: none"> <li>▪ Understanding of control activities relevant to the audit; and</li> </ul> </li> </ul>
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		<ul style="list-style-type: none"> <li>▪ Entity's response IT risks.</li> <li>• Monitoring of controls: <ul style="list-style-type: none"> <li>▪ Entity's major activities to monitor internal control over financial reporting; and</li> <li>▪ How the entity initiates remedial actions to deficiencies in its controls.</li> </ul> </li> <li>• Understanding of the relevance of the Internal Audit Function: <ul style="list-style-type: none"> <li>▪ The nature of the internal audit function's responsibilities and how the internal audit function fits in the entity's organisational structure; and</li> <li>▪ The activities performed, or to be performed, by the internal audit function.</li> </ul> </li> <li>• Entities having uncomplicated businesses and processes relevant to financial reporting, documentation: <ul style="list-style-type: none"> <li>▪ Simple and brief.</li> <li>▪ Not necessary to document the entirety of the auditor's understanding of the entity and matters related to it.</li> <li>▪ Document only key elements of understanding.</li> <li>▪ Extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team.</li> <li>▪ For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.</li> </ul> </li> </ul>
32(b)	Sources of information from which the understanding was obtained	<ul style="list-style-type: none"> <li>• Sources of the information used in the entity's monitoring activities.</li> <li>• Basis upon which management considers the information to be sufficiently reliable for the</li> </ul>

## Background Material for Audit Training Workshops and Seminars

		purpose.
32(b)	Risk assessment procedures performed	
32(c)	Risks (in terms of para 25 of the standard)	<ul style="list-style-type: none"> <li>• Risks of material misstatement identified and assessed: <ul style="list-style-type: none"> <li>▪ at the financial statement level; and</li> <li>▪ at the assertion level.</li> </ul> </li> </ul>
32(d)	Risks requiring special audit considerations	The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27-30 of the Standard.

### SA 320: Materiality in Planning and Performing an Audit

<b>Para Ref.</b>	<b>Issue</b>	<b>Documentation Needed</b>
14.(a) & (b)	Materiality for the financial statements as a whole or materiality level(s) for particular classes of transactions, account balances or disclosures.	<ul style="list-style-type: none"> <li>• Materiality for the financial statements as a whole: <ul style="list-style-type: none"> <li>▪ For establishing the overall audit strategy</li> </ul> </li> <li>• Materiality level(s) for particular classes of transactions, account balances or disclosures: <ul style="list-style-type: none"> <li>▪ Determine materiality level(s) to be applied to particular classes of transactions, account balances or disclosures, which could be expected to influence the economic decisions of the users.</li> </ul> </li> </ul>
14 (c)	Performance materiality	<ul style="list-style-type: none"> <li>• Determine performance materiality: <ul style="list-style-type: none"> <li>• For assessing the risks of material misstatement; and</li> <li>• Determining the nature, timing and extent of further audit procedures.</li> </ul> </li> </ul>
14 (d)	Revisions as the Audit Progresses.	<ul style="list-style-type: none"> <li>• Revise materiality for the financial statements as a whole or materiality level(s) for particular classes of transactions, account balances or disclosures: <ul style="list-style-type: none"> <li>▪ Aware of information during the audit that would have caused the auditor to have</li> </ul> </li> </ul>

		<p>determined a different amount (or amounts) initially.</p> <ul style="list-style-type: none"> <li>• If the auditor concludes that a lower materiality than that initially determined is appropriate: <ul style="list-style-type: none"> <li>▪ Determine whether it is necessary to revise performance materiality, and</li> <li>▪ Whether the nature, timing and extent of the further audit procedures remain appropriate.</li> </ul> </li> </ul>
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**SA 330: The Auditor's Responses to Assessed Risks**

<b>Para Ref</b>	<b>Issue</b>	<b>Documentation Needed</b>
28(a)	Overall responses	Overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed.
28(b)	Linkages	Linkage of those procedures with the assessed risks at the assertion level.
28(c) & A63	Results	<ul style="list-style-type: none"> <li>• The results of the audit procedures, including the conclusions where these are not otherwise clear. <ul style="list-style-type: none"> <li>▪ The form and extent of audit documentation is a matter of professional judgment, and is influenced by: <ul style="list-style-type: none"> <li>▪ nature, size and complexity of the entity and its internal control,</li> <li>▪ availability of information, and</li> <li>▪ audit methodology and technology used in the audit.</li> </ul> </li> </ul> </li> </ul>
29	Operating effectiveness of controls obtained in previous audits	<ul style="list-style-type: none"> <li>• Document the conclusions reached about relying on such controls that were tested in a previous audit.</li> </ul>
30		<ul style="list-style-type: none"> <li>• The auditors' documentation shall demonstrate that the financial statements agree or reconcile with the underlying accounting records.</li> </ul>



**SA 450: Evaluation of Misstatements Identified during the Audit**

<b><i>Para Ref.</i></b>	<b><i>Issue</i></b>	<b><i>Documentation Needed</i></b>
15 & A25.	Uncorrected Misstatements	<ul style="list-style-type: none"> <li>▪ The amount below which misstatements would be regarded as clearly trivial.</li> <li>▪ All misstatements accumulated during the audit and whether they have been corrected: <ul style="list-style-type: none"> <li>○ Communication with management to correct the misstatement.</li> <li>○ Communication with those charged with governance: <ul style="list-style-type: none"> <li>▪ Uncorrected misstatements and</li> <li>▪ Effect that they, individually or in aggregate, may have on the opinion in the auditor's report.</li> </ul> </li> </ul> </li> <li>▪ The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion. Auditor should consider: <ul style="list-style-type: none"> <li>○ The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and</li> <li>○ The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.</li> </ul> </li> <li>▪ The auditor's documentation of uncorrected misstatements may take into account: <ul style="list-style-type: none"> <li>○ The consideration of the aggregate effect of uncorrected misstatements;</li> <li>○ The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and</li> <li>○ The evaluation of the effect of uncorrected</li> </ul> </li> </ul>

## **Documentation Requirements in the Standards on Auditing**

		misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).
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### **SA 540: Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures**

<b><i>Para Ref</i></b>	<b><i>Issue</i></b>	<b><i>Documentation Needed</i></b>
23(a)	Auditor's conclusion	<ul style="list-style-type: none"> <li>The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks.</li> </ul>
23(b) and A128	Management bias	<ul style="list-style-type: none"> <li>Indicators of possible management bias, if any. <ul style="list-style-type: none"> <li>Assists the auditor in concluding whether the auditor's risk assessment and related responses remain appropriate, and</li> <li>Evaluating whether the financial statements as a whole are free from material misstatement.</li> </ul> </li> </ul>

### **SA 550: Related Parties**

<b><i>Para Ref</i></b>	<b><i>Issue</i></b>	<b><i>Documentation Needed</i></b>
28	Related parties	<ul style="list-style-type: none"> <li>Names of the identified related parties.</li> <li>Nature of the related party relationships.</li> </ul>

### **SA 600: Using the Work of Another Auditor**

<b><i>Para Ref</i></b>	<b><i>Issue</i></b>	<b><i>Documentation Needed</i></b>
18	Components and component auditors	<ul style="list-style-type: none"> <li>Components whose financial information was audited by other auditors.</li> <li>Such components' significance to the financial information of the entity as a whole.</li> <li>Names of the other auditors.</li> </ul>

**Background Material for Audit Training Workshops and Seminars**

		<ul style="list-style-type: none"><li>• Any conclusions reached that individual components are not material.</li><li>• Procedures performed and the conclusions reached.</li><li>• Where component auditor's report is other than unmodified, document how principal auditor has dealt with the qualifications or adverse remarks contained in the other auditor's report in framing his own report.</li></ul>
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**SA610: Using the Work of Internal Auditors**

<b><i>Para Ref.</i></b>	<b><i>Issue</i></b>	<b><i>Documentation Needed</i></b>
13.	Using the specific work of the internal auditors	<ul style="list-style-type: none"><li>▪ Conclusions regarding the evaluation of the adequacy of the work of the internal auditors.</li><li>▪ Audit procedures performed by the external auditor on that work to determine its adequacy.</li></ul>

# **PART - III**

## **Case Studies and Technical Posers**

This part is a collection of scenarios in practical implementation of Standards on Auditing. The objective of the case studies is to initiate the reader's mind to find solutions to the problems presented in the case studies relating to implementation of the requirements enunciated in the applicable Standard(s) on Auditing and to, accordingly, encourage brainstorming among the participants at the training session.

## CASE STUDY – 1

### M/s. JKN & Co.

#### Client Acceptance Considerations\*

Mr. John is a partner with M/s. JKN & Co., a firm of Chartered Accountants, which has been invited by the Board of Directors of Trinca Ltd. to accept appointment as external auditors. Trinca Ltd. operates a number of car dealerships and has grown rapidly over the past three years through an aggressive take-over strategy. Mr. John is aware that the company's existing auditors, a much smaller firm, qualified their last auditor's report. During discussions, the CFO of Trinca Ltd. mentioned that their existing auditors could not cope with audit of a company of their size and, in particular, were not equipped to audit the recently installed sophisticated accounting software. He communicated that their company needed a firm of reputation and caliber like M/s. JKN & Co., in order to reassure the market as they intend to seek a public listing within two years.

A background check on the prospective client by M/s. JKN & Co revealed as follows:

- Management gives insufficient consideration to developing an accounting system adequate and appropriate to the expanding business. In particular, there is a lack of concern as to control. A number of petty employee frauds as a result of control weaknesses have been reported. However, no action is taken against the employees identified as engaged in fraud. The management attitude seems to be to encourage risk taking employees, who, in turn, make money on the side, whilst securing good deals for the company.
- The newly installed accounting software is unreasonably complicated though Trinca Ltd. claims this is necessary because of the need to maintain records to justify the company's claims for volume rebates, and bonuses under the complex incentive schemes by which car manufacturers reward dealers.

On an enquiry from the existing auditors, the former have advised M/s. JKN & Co. against accepting the engagement on grounds, including, that though they have no evidence of deliberate misrepresentation by the directors of Trinca Ltd. but the audit staff was hindered in their audit work by a less than helpful attitude by senior management who adopted an aggressive stance whenever a query was raised. The CFO of Trinca Ltd. was constantly on the phone to the partner claiming the audit staff was incompetent and accusing them of wasting his time asking unnecessary questions.

#### Queries to the Readers

- i) What factors should partners of M/s. JKN & Co. should considered for and against accepting the appointment?
- ii) In the case of acceptance of appointment, what matters should be taken into consideration in obtaining the required knowledge of the business and in developing the audit plan?

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\* Adapted from a Case Study published in Modern Auditing, Grahan W. Cosserat (Second Edition), John Wiley & Sons pg. 206.

## CASE STUDY – 2

### Mr. Vallabh

#### Audit of Inventories<sup>#</sup>

Mr. Vallabh is a senior auditor assigned to the Seasons Electronics audit. This is the first year his firm is conducting the audit for this particular client. In fact, although Seasons Electronics has previously engaged audit firms to perform limited-review services for the purpose of obtaining bank loans, this is the first year Seasons Electronics has contracted for a full-scale audit of its financial statements. The company is planning an initial public offering (IPO) of its stock in the next two or three years and has hired Mr. Vallabh's firm to conduct its first financial statement audit in preparation for the upcoming IPO.

Seasons Electronics is a medium sized company that buys copper rod and plastics materials used to make insulated copper wirings. Seasons Electronics operates from a single location totaling 600,000 square feet, which includes office space (4%), production area (56%), shipping and receiving (18%), and finished goods and raw materials inventory warehousing (22%). Seasons Electronics supplies insulated copper wiring in the southern parts of the country. The company has a good reputation for quality products and has had a good working relationship with its past audit firms over the past years. Mr. Vallabh has been assigned responsibility for auditing Seasons Electronics' inventories. He is in the planning stages of the audit and he is preparing to conduct some analytical procedures to help identify risk areas that may require further attention.

Mr. Vallabh's staff assistant assembled information relating inventories and other items, including a brief description of Seasons Electronics production and inventory areas. The information provided by the assistant is listed below :

(Amount in Rs.)

Particulars	2005	2004
Sales	94,50,000	91,50,000
Cost of Sales	72,62,500	69,60,000
Finished Goods Inventory	27,58,500	21,72,500
Copper Rod Inventory	36,25,000	27,50,000
Plastics Inventory	5,50,000	5,25,000
Days purchase in Account Payables	45.8 Days	47 Days
Days sales in Account Receivables	57.6 days	48.9 days
Market Price of Insulated Wire (per foot)	Rs. 0.008	Rs. 0.009
Market Price of Copper Rod (Per Kg.)	Rs. 0.510	Rs. 0.510
Market Price of Plastics (Per Kg.)	Rs. 0.125	Rs. 0.185

<sup>#</sup> Adapted from a Case Study published in Auditing Cases Buckless, Beasley, Glower, Prawitt (2000 edition), Prentice Hall, pg. 130.

Seasons Electronics makes several different gauges and types of insulates copper wire for use in applications ranging from residential telephones and electrical wiring to industrial grade, high-voltage power cables. The production area is divided into three areas, with each area specialising in a particular product group, including residential products, industrial products, and special-order products. Production is done in batches according to orders placed with the firm. For each batch, machinery is adjusted and calibrated according to the type and size of products to be manufactured, and the size of the batch depends on the amount of product needed. Average machine setup time from start to finish is approximately six hours, which is slightly below the industry average.

The different types of products Seasons Electronics manufacturers all use similar raw material, so raw material inventory is stored in a single location, divided only into copper and plastics materials. Finished insulated copper wire is stored on large, stackable spools of various sizes, with approximately 500,000 feet of wire spool. Copper rod inventory is stored on pallets, which are not stackable. Each pallet measures 6 feet by 6 feet, stands 5 feet tall, and holds 1,500 tons of copper rod. Plastics inventory is stored in 4-foot-diameter stackable barrels, with approximately 350 kg of plastic per barrel. The raw material inventory storage area is located near the shipping and receiving area for convenience. Inbound and outbound shipments of inventory are trucked to the nearest rail yard, from which they are distributed around the southern region of the country. A single 18-wheeler can carry up to 15 pallets of copper rod, 40 barrels of plastics, or 24 spools of finished wire.

Seasons Electronics production process is semi-automated, but it still requires a relatively large amount of labour. Thus, conversion costs are fairly evenly divided between direct labour and factory overhead. Overhead consists primarily of the costs of production facilities and depreciation and maintenance on the machinery. Seasons Electronics uses a hybrid product costing system (i.e., a system that combines characteristics of both job-order and process-costing systems) to accommodate both the continuous and homogenous nature of the manufacturing process and the fact that production runs are performed in separately identifiable batches. In accordance with the relatively homogenous nature of Season's products, overhead is allocated from a single cost pool bases on a combination of machine and direct labour hours.

As wire product is completed, it is rolled onto large spools of various sizes, usually in lengths of about 500,000 linear feet. These spools of finished inventory are stored next to the raw materials inventory near the facility's eight loading and unloading docks. In many cases the inventory is produced in response to specific customer orders received, in which case the spools are tagged for shipment to customers according to date requested. Inventory that has been produced without a customer order to provide a "cushion" for rush orders is stored toward the far end of the finished goods storage area, away from the shipping area.

The inventory and production areas are well organised and seem to flow smoothly. Machines appear to be well maintained. A cursory visual examination of inventories reveal no problems. Two spools in the finished goods area were tagged as being of the type of residential wiring recently banned by government safety guidelines. These spools are clearly marked, and the inventories supervisor indicated that they are to be destroyed within the next week. Procedures and records for tracking materials upon arrival, through the production process, and into finished goods and shipping, appear to be well designed.

### **Queries to the Readers**

What analytical procedures should Mr. Vallabh perform to help him identify risks or issues that indicate the need for further attention, if any, in case of the following management assertions:

- i) existence of occurrence.
- ii) completeness.
- iii) valuation of allocation.
- iv) rights and obligations.
- v) presentation and disclosure.



## CASE STUDY – 3

### M/s. S.K. Lal & Co.

#### Auditing in a CIS Environment<sup>β</sup>

Millennium Stores, is a first-year audit client of M/s. S.K. Lal & Co. The audit partner, Mr. Raj obtained background information about the sales system after recently meeting with client personnel at the corporate office. The company's sales system is computer-based & with computerised cash registers on the floors of all of its stores. At the point of sale, the company's sales personnel enter product number, quantity per product, and indication of whether it is a cash sale or credit sale. Additionally for credit sales, the sales personnel must enter customer credit card agency approving the credit sale. Millennium Stores only accepts Master or Citibank cards and a copy of the credit charge slip is maintained in the cash drawer. The computerised cash register performs the following tasks:

- Identifies correct price based on product number.
- Notifies clerk if product number is invalid.
- Calculates total price of purchase (price\* quantity).
- Extends totals, calculates sales taxes, and determines final transaction amount.
- Generates a customer receipt and a duplicate record of the transaction on a cash register tape that is locked inside the register. Cash register tapes indicate all inputted information. Only accounting department personnel have access to the tapes.

Stores clerks are allowed to operate any machine on the floor. If a cash register is not currently being used, all the clerk has to do is turn the machine on, and once the system is booted, the clerk begins by entering the product number. Generally, operation of the each register is self-explanatory although some problems have occurred previously. Millennium Stores has no formal training for cash register operation because management believes "on the job experience" is more effective.

At the end of each day, sales personnel count the cash in the drawer and list the total cash count on the Daily Deposit Sheet (a pre-printed blank form). In addition, the sales personnel summarize total credit sales on the Daily Deposit Sheet by listing total amounts from the credit sales slips in the register. The sales personnel takes the cash drawer, which includes credit slips, to the store cashier. The cashier verifies the Daily Deposit Sheet and initials the total cash and credit sales columns listed on the Daily Deposit Sheet. The cashier leaves Rs. 20,000 in each cash drawer to begin the following days. Cash drawers are stored overnight in the store's vault. The store cashier takes the cash plus credit charge slips to the bank at the end of each day. The bank immediately credits the store's cash account for all cash and credit and receipts presented. An independent person in accounting verifies that the sum of the cash and credit card slip totals on all Daily Deposit Sheets for the prior day reconcile to the validated deposit slip. After performing the reconciliation, the accounting clerk attaches the Daily Deposit Sheets to the validated deposit slip and files them together by date.

Accounting personnel close out the machines each night. As a part of this procedure, the machine prints subtotals of cash and credit sales for the day at the end of the cash register tape. Accounting personnel remove the cash register tapes from the machines each night, and the tapes are stored in the accounting department.

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<sup>β</sup> Adapted from a Case Study published in Auditing Cases: Buckless, Beasley, Glover, Prawitt (2000 edition), Prentice Hall, pg. 134.

Overnight, the computer system processes all transactions for each cash register and summarizes this information on a Daily Sales Report. The Daily Sales Report is generated for each store nightly. It summarizes total stores sales, as well as subtotals of cash and credit sales, by store cash register. These reports are filed by date at each store. In addition, the computer updates perpetual inventory records daily, which are stored on magnetic disk. No reports of this interface are generated daily by the computer.

At month's end, the computer generates a detailed Inventory Listing, which provides quantity information by product number. Also, the computer generates a Monthly Sales Report for each store. This report shows daily sales totals for the store for each day of the month. The computer also prepares and prints a consolidated General Ledger, which summarizes the postings of monthly sales totals from each store to the consolidated sales account.

### **Queries to the Readers**

- i) Describe the audit trail from the point of the sale to the general ledger posting of the consolidated sales and cash accounts and also emphasise whether the audit trail is in paper or electronics form.
- ii) Develop a proposed strategy for auditing the existence of sales. Is there a sufficient appropriate audit trail to be able to audit that assertion without relying on IT specialists?
- iii) What source should be used to select a sample of sales transactions to test the existence of sales at one store? Why this source is better than the other available sources?
- iv) Develop a proposed strategy for auditing the valuation of the sales account. Is there a sufficient paper trail to be able to audit that assertion without relying on IT audit specialists?
- v) What portion, if any, of the sales system will likely require the assistance of an IT systems auditor, who evaluates evidence existing only in electronic form?
- vi) What control weaknesses are there in the existing sales system?

## CASE STUDY – 4

### M/s. Krishnan Menon & Co.

#### Audit Quality Control<sup>λ</sup>

The senior partner of Krishnan Menon & Co., L. Krishnan, glanced at the newspaper in disbelief. "This can't be true," he muttered. "How did we ever manage to remain unaware of this?" he asked R.K. Menon. With him was a small news item adorning the front page of a leading financial newspaper. It concerned their new client an upcoming textile manufacturer, the Rs. 220 crore Nataraj Ltd. The announcement stated in bold letters that Nataraj had violated provisions of the Foreign Exchange Management Act (FEMA), and had been booked by the Reserve Bank of India. It went on to say that of the Rs. 70 crore worth of yarn imported during the year, the company was found to have over-invoiced imports by Rs. 33 crore.

Menon, who was also a founder partner, looked equally nonplussed. "Let us call a meeting day after tomorrow," he suggested. "The other partners can also fly down." That evening, Krishnan settled in his plush room and let his thoughts go back some 35 years...

Krishnan Menon & Co., chartered accountants, was established in 1970 in Coimbatore. During the initial years, the audit work was closely monitored and supervised by its two partners. The list of clients included small scale industrialist and partnership firms of professional and traders. Most of these clients shared as associated with the city that went back several generations. They were men of repute well-known for their integrity, and their business dealings were straightforward. As a matter of fact, the perceived audit risk factor was quite low. Even then, each time before finalising an audit report, Krishnan & Menon would sit down and discuss the issues raised during the audit. This was regardless of who acted as the principal auditor. They kept up a lively interest in professional issues and kept track of all new developments.

This was not all. Once every week, Krishnan would hold a meeting in the office. The discussions would centre around the day-to-day queries and issues specific to each audit client. In addition, there were exchanges on the current developments affecting the accounting profession. Articles appearing in professional journals were dissected and debated. Taxation and corporate law issues, in particular, were subjects of some extremely painstaking analysis.

With the passage of time, the firm witnessed steady growth and the annual gross billings swelled. The client portfolio too registered an impressive horizontal and vertical expansion. Their operations now ranged across industries and, of course, their numbers also puffed up. By 1990, the firm had three partners and eight qualified employees, and a branch at Trichur. During all these years of practice, all the partners were well-acquainted with each other, and the staff kept track of all clients. In the next decade, the growth of practice was exponential. The firm's gross billings increased by more than five times. Two more branches (at Visakhapatnam and Bangalore) were opened. By 2001, with nine partners and all of 36 qualified chartered accountants, Krishnan and Menon had a formidable reputation to live up to.

The sound of the phone ringing shook Krishnan out of his reverie. It was his secretary with the message that all the partners had confirmed they would attend the meeting. Krishnan now braced himself for the meeting on Wednesday. The meeting was attended by all the partners. They shared Krishnan's concern and were unanimous on initiating an action plan. One of the significant conclusions that emerged was that the firm had no formal policies and procedures for assigning personnel to undertake audit assignments, or for hiring staff members. The situation called for a thorough investigation. Accordingly, Menon was assigned the task of identifying instances. If any, that could be

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<sup>λ</sup> Adapted from Case Study contributed by Mr. Vijay Kapur published in *The Chartered Accountant*, April 1997, pg. 82-83.

potentially embarrassing to the firm. A schedule was drawn up for his visit to all the branch offices, and they all agreed to meet again in a fortnight.

The report that was submitted two weeks later was a revelation. It was a replete with interesting findings. (See Menon's Report : Executive Summary) The founder partners were appalled. All this time, their constant effort had been to instill a work culture that would encourage professionalism and continuous learning. This was, after all, a prerequisite for the growth of the firm. Obviously, the cracks were now beginning to show. What exactly were the implications of all this? We must do something fast, they concurred but what?

#### **MENON'S REPORT: EXECUTIVE SUMMARY**

- The Swamy Group of Industries accounts for about 28 per cent of gross audit billings for the year 1995-96.
- In 1995, three traders paid audit fees less than Rs. 5,000.
- The EDP in-charge of a branch was suspended for fraudulent transfer of funds to his saving accounts. The partner in-charge of the concurrent audit of the branch has admitted to lack of EDP knowledge.
- An audit manager accepted an expensive gift from an officer in the client company.
- Documentation was found to be woefully inadequate in the case of certain audits.
- One of the partners purchased a car, the finance for which was arranged by a finance company which is audited by the firm. Terms of credit extended are normal.
- A partner was assigned an engagement where a close relative was an officer in the company concerned.
- During the last two to three years, only 10 staff members attended seminars and workshops organized by professional accounting bodies.

#### **Queries to the Readers**

Views of the readers are invited on the shortcomings in the audit quality control system in Krishnan Menon & Co., and remedial measures.

## CASE STUDY – 5

### M/s. Verifiers & Co.

#### Audit Documentation\*

Vikram Seth, audit manager of M/s Verifiers & Co., chartered accountants, was all set for a week-long vacation in Bangalore the following morning when the telephone rang. It was Vishnu Gopal, senior partner in his firm, on the line. The tone itself conveyed the message. Seth was to change the venue of his visit. Instead of Bangalore, he would have to report to office the following morning. It was an emergency.

Seth reached office around 9.30 a.m. the next morning his disgust at the turn of events having abated considerably and headed straight for Gopal's cabin. Sonali, a senior articled trainee, was already closeted with him. It began with apologies. Gopal was sorry that Seth had to cancel his visit but the matter was urgent it was to do with the issue of audit report of Krashers Ltd. (Krashers). The previous evening, before leaving office, Seth had informed Gopal that he had reviewed the audit working papers of Krashers thoroughly and that there was nothing wrong in them. Seth had said a clean report could be issued to Krashers.

But Gopal had spent a couple of late hours in the office examining the audit working papers and had come round to the opinion that certain auditing procedures had not been followed, or even if they had been followed, the fact was not reflected in the documentation. Moreover, there was no evidence that Seth had really reviewed the working papers since he had not initialed at many places.

Gopal suggested that Seth must have forgotten to put his initials since he would have been pre-occupied with the Bangalore trip. But such slips could get the firm into trouble, he reminded the audit manager. And, more importantly, Gopal said, the working papers for quite a few significant transactions were not available in the file. The lapses were as follows:

- Bank reconciliations for two months had not been prepared and cash balances shown in the ledgers did not tally with confirmation received from the bank.
- No evidence was available to prove the authenticity of a transaction involving the sale of certain raw materials at a throwaway price to a sister concern of which the managing director of Krashers was a board member.
- A branch office of Krashers had been closed and let out to another company on lease for five years, and the property had been classified as investment property.
- Krashers had purchased explosives for which the company could have no conceivable use.

Further, it was not clear whether the internal control system, particularly for inventories and debtors, had been reviewed since there was no documentation for such review. Moreover, in the case of investments, there were no records of third party confirmations, and apparently, no follow-up had been carried out on non-responses to confirmations regarding inventories held by third parties and debtors.

"Look Vikram," Gopal said, "I have always relied on your opinion on various audit assignments. But I do not understand how this time the documentation fails to reflect the work you have performed. You should have taken particular care in this case since you knew fully well that Krashers is a new client." Seth's reply was firm. He emphasized that a fairly good job had been done and all standard audit procedures of the firm had been followed meticulously. There was no compromise on this aspect, he re-iterated. The extent of documentation required was a

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\* Adapted from Case Study contributed by Mr. Vijay Kapur published in The Chartered Accountant, June 1997.

matter of professional judgement, Seth said, adding that it was neither necessary nor practical to have every observation, consideration, or conclusion documented by the auditor in his working papers. However it was quite possible that the working papers were not adequate, he said, and explained that he had relied on verbal assurances offered by the management of Krashers.

Seth said that Chakresh, the managing director of Krashers, had assured him on more than one occasion that there was no problem in this regard and that all relevant papers would be handed over to the audit firm. Seth said even Sonali would confirm that two such meetings had taken place with the chief accounts officer of krashers.

"You would also recall that Chakresh has been pestering us to submit an early audit report since the date of the annual general meeting has been fixed and Krashers is planning for its first public issue," Seth explained to Gopal.

Seth went on to say that the audit had been planned properly so that sufficient appropriate audit evidence could be obtained. The internal control was also reviewed and tested properly using a standard questionnaire. Further, lot of extra book-keeping work was done since the records of Krashers were not exactly up-to-date. As far as the issue of cash not being reconciled was concerned, Seth said that would not pose much of a problem since he did not suspect any fraud. "In any case, just because some prospective investors rely on financial statements audited by us, we need not be overly concerned. And we can always prove that the audit was conducted exercising reasonable care and skill, and following the standards of auditing procedures," Seth asserted. He added that he had spent a good number of days on the job, and nothing had come to his attention to arouse the suspicion that the accounts did not provide a true and fair view. "Your point that I had not reviewed the working papers is not correct," Seth told Gopal. Sonali agreed with Seth but felt that before issuing the audit report, it would be better to spend some more time on the assignment.

Meanwhile, the telephone rang. It was Gopal's secretary. He was holding a call from Chakresh. Chakresh reminded Gopal that the audit report, though promised, has not been delivered yet. He said the Board was meeting that evening and he needed the report by that time.

Gopal politely informed Chakresh of the problem with the report. But Chakresh insisted on getting the report and assured Gopal that in case there was any inadequacy in the working papers, Krashers would take care of it. Gopal was in dilemma and stared at Seth and Sonali. He asked his secretary to connect him to his legal adviser.

### **Queries to the Readers**

What should Gopal do?

## CASE STUDY – 6

### M/s. Sparkle Limited

#### Going Concern\*

Mr. Chris Xavier's entire schedule had suddenly gone awry. The Managing Director of Sparkle Limited, a Rs. 143 crore company engaged in the business of mining and processing of precious and semi-precious stones, was in the middle of a grueling series of meetings to finalise the bid documents for a new mining venture. Absorbed in putting the final touches to his presentation to the state government, He had not glanced at the lengthy fax message that he had received in the morning from Mr. R. Krishnan, audit manager, M/s. Tickers & Co., statutory auditors of the company. Finally able to grab a few minutes between meetings, Xavier retrieved the fax from under a pile of slides. The Initial cursory scan, however, was soon transformed to an intent scrutiny as Xavier read the fax with mounting alarm. At stake was the future of a company he had devoted over 30 years to.

Noted the fax, "During the course of audit of your company, it was observed that the company had acquired a tract of land in Zozila (Madhya Pradesh) and invested about Rs. 25 crore (representing about 30 per cent of total assets). Further, another Rs. 50 lakh was spent by the company in acquiring the mining licence and other sundry work preparatory to the mining of the mineral zelota form which the rare metal zinesium can be extracted. The viability of the investment is solely dependent on quantity and quality of ore. The audit staff observed that the investment was made on the basis of report submitted by Mr. M. Venkatesh, a fairly senior employee of your company known for his expertise in evaluation of precious and semi-precious metals/stones, and a subsequent report obtained from the General Manager (Analysis) of reputed mining consultancy firm. As was apparent from the internal audit report, the management itself is not very comfortable with the report of Mr. Venkatesh probably because of his lack of adequate experience in the field of geological surveys. On the recommendation of MR. K. Kumar, Chief Internal Auditor, the matter was referred to the General Manager (Analysis). The sample obtained by Mr. Venkatesh from the site was also sent for analysis.

We have been given to understand that the final report submitted by the General Manager (Analysis) indicates a high proportion of the metal zinesium in the sample. However, the complete report detailing the methodology followed, the data relating to geographical features, the estimated quantity of ore, etc., and other assumptions have not been made available to us. Under the circumstances, we have no option but to issue an audit report indicating doubt about the going concern status of the company, since we are of the opinion that such a substantial investment made by the company is nothing but a pure gamble. However, we would like to verify the detailed report including credentials of the General Manager (Analysis) for the purchase of land in Zozila before we issue our audit report."

Xavier immediately buzzed his secretary and ordered her to cancel all remaining appointments. He then summoned Mr. S. Singh, Director (Finance) and Mr. K. Kumar Sparkle Ltd.'s Chief Internal Auditor for an emergency meeting. In the stormy session that ensued, a clearly worried Xavier demanded an explanation. Kumar clarified that though Venkatesh had a wealth of practical experience, he did not possess a professional qualification. So, at the insistence of the internal audit department, the General Manager (Analysis) were called in to evaluate technical feasibility of the project.

Mr. Singh pointed out that though there was no harm in submitting the complete report to statutory auditors, there were unfortunately certain remarks appearing on the report which could prove to be damaging. For instance, the report expressed doubts about the safety of the mine after five years. Nor did it clearly spell out the cost of operations. When presented with this explanation, Xavier's initial reaction was to send the complete report (including supporting documents) for examination by the auditors. But both Singh and Kumar expressed their reservations

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\* Adapted from Case Study contributed by Mr. Vijay Kapur, published in The Chartered Accountant, February, 1997.

about submitting the complete report. It would unnecessarily reopen the entire issue and could even raise fresh questions about viability of the project. Moreover, not only had the auditors grossly exaggerated the situation, they had overstepped their bounds in demanding the full report.

Xavier was in a dilemma. If he provided the full report to the auditors, it could still create a controversy that could adversely affect Sparkle Ltd.'s negotiations with the State Government for a mining lease, which were at a particularly delicate state. On the other hand, not submitting the detailed report could have serious consequences. After all, casting doubt on the going concern status of the company is the single most serious objection an audit report can raise. Just what are the rights of the auditor in such a situation, wondered Xavier.

#### **Queries to the Readers**

Readers are invited to offer their comments on the situation.



## CASE STUDY – 7

### M/s. Steel Krafts Private Limited

#### Illegal Acts of Clients<sup>Ω</sup>

Mr. Arshad, a chartered accountant and senior employee of the auditing firm M/s. SAS & Associates, was in the process of finalising the audit report for Steel Krafts Private Limited for the year ended March, 31, 2006. Steel Krafts was in the business of manufacturing precision steel instruments since 1996, when it started off as a partnership firm. In the first year of its operations, the firm picked up a small turnover of Rs. 25 lakh. In 2002, it converted itself into a private limited company. The Steel Krafts had always focused on developing a captive market for its products, and supplied to various ancillary units both in the public and private sectors. In the financial year 2005-06, Steel Krafts' turnover jumped to Rs. 10 crore. About 30 per cent of this figure was accounted for by exports to Russia, Belgium, and Yugoslavia. Steel Krafts appointed M/s. SAS & Associates as statutory auditors for the first time in the financial year 2005-06.

While going through the working papers, Arshad felt that an unqualified opinion could be issued to Steel Krafts for the year ended March 31, 2006. But as he prepared himself for the meeting back in his own office with Mr. K. Kumar, partner in-charge of the audit, he noticed a flurry of activity in the cabin of Steel Kraft's managing director (MD). A few minutes later, he saw two police officials coming out of the cabin. Arshad felt curious. He enquired Girish, a senior audit assistant, about the commotion. Girish informed that in February (2006), the MD's driver had run over a person and the visit of the police officials, in all probability, had something to do with that accident. But then, Girish added, the matter had already been settled out of court and the company had cleared all legal claims.

Arshad was not fully satisfied with Girish's explanation and went on to check the date of the accident and the relevant accounting records. While scrutinizing the entertainment expenses, Arshad stumbled upon some figures booked around the date of the accident. He called for Mukesh, the accounts manager of Steel Krafts. Arshad had seen from the accounting records that Kumar had started off with a monthly salary of Rs. 15,000 but was now drawing a gross salary of Rs. 350,000 a month (inclusive of car allowance.) During the last one year, there had been a noticeable change in Mukesh's lifestyle.

On persistent queries by Arshad about the car accident, Mukesh revealed that around Rs. 25,000 had been paid to the relevant authorities to hush up the case. The amount was camouflaged as an entertainment expense. "However, the two police officials visiting the Steel Krafts MD that day had nothing to do with the case", Mukesh said. "In fact, they were not from the police but from the Customs department. And, this time, it is a stickier case than the previous one", the accounts manager confided.

Arshad's curiosity had been raised again, and he would not let go without an explanation. After some persuasion, Mukesh gave in. He said the two customs officials had come in demanding a hefty sum since the boxes being air-freighted to Belgium actually contained rags instead of export material. "These things had to be done if one were to stay in business", he explained to Arshad. "In fact, no business could be run without greasing the palms of the officials", Mukesh said, adding that such payoffs, to a large extent, were responsible for Steel Krafts' rise in fortunes.

Seeing Arshad's bewilderment, Mukesh said that too much importance should not be attached to the payments since they were routine and the amounts involved were not material. He confided that, initially, even he was not comfortable dealing with such situations, but now he was reconciled to reality. He said the MD's family which held about 70 per cent equity in Steel Krafts considered him as one of the most trusted employees and, in fact almost all

<sup>Ω</sup> Adapted from Case Study contributed by Mr. Vijay Kapur published in The Chartered Accountant, April, 1997.

deals were routed through him. "Normally, these transactions were disguised as publicity or advertising expenditure", Mukesh said. He was also quick to remind Arshad that as a professional accountant he should not share the information given to him with anyone else.

Arshad was confounded at the revelations. After much thought, he called up Kumar requesting him to postpone the meeting by at least two days in view of the new developments. The next day, he began a thorough scrutiny of the expenditure under various heads. He was astonished to note that Steel Kraits had paid for the air tickets of certain government officials and their families who visited two international trade fairs in which Steel Kraits had participated. The more Arshad thought of the information he had stumbled upon, the more his dilemma grew. He kept wondering as to how he should go about the entire matter. Equally disturbing for him were the instances in which Steel Kraits had violated the various provisions of the law. "These could well have an impact on the financial statements and above all, the going concern of the company", he thought. Unable to decide the course of action that he should take, Arshad decided to place all the facts before Kumar and seek his advice. But Kumar, after going through the entire matter, was equally perplexed.

### **Queries to the Readers**

Readers are invited to offer their views on the scenario.

## CASE STUDY – 8

### M/s. Great Champs

#### Using Analytical Procedures as Substantive Tests<sup>Ψ</sup>

Great Champs, an independent, minor football team, competes in the Southern zone. The team finished in second place in 2006 with a good record. The Great Champs cumulative season attendance of 5,45,459 spectators set a new record high for the team, up from 4,90,000 in 2005. Bank-loan agreements require the Great Champs to submit audited financial statements annually to the bank. M/s. ABC & Co. has been the Great Champs' auditors for the past five years.

One of the major audit areas involved audit of ticket revenues. Those revenues reached nearly Rs. 10,88,0000 in 2005. In the prior years, the audit plan called for detailed testing of revenue accounts to gain assurance that reported ticket revenues were fairly stated.

Mr. Abhi, a new audit manager, just received the assignment to be manager on the 2006 audit. He had worked previously on the Great Champs prior-year audits as a staff auditor. When he learned that he would be managing the current-year engagement, he immediately thought back to all the hours of detailed testing of ticket sales he had performed in earlier years. One some of his other clients Mr. Abhi had been successful at redesigning the audit plans to make better use of analytical procedures as substantive tests. He is beginning to wonder if there was a more efficient way to gather substantive evidence related to ticket revenues on this audit engagement also.

In his first meeting with the management of Great Champs for the 2006 audit, Mr. Abhi learned that the Great Champs now use an outside company, M/s. Chicklets, to operate ticket gates for home games. The terms of the contract required M/s. Chicklets to collect ticket stubs so that they could later report total tickets collected per game. Although M/s. Chicklets did not break down the total ticket sales into the various price categories, Mr. Abhi thought there might be a way to develop an analytical procedure using the independently generated total ticket numbers and data from prior audits. To investigate this possibility, he asked a staff person to gather some information related to reported sales. The information that the staff person gathered from the records of the client, M/s. Chicklets and prior-year working papers is as follows :

2006 Park Attendance	
Total park attendance	5,45,459
2006 Number of Games	
Weekday games	44
Weekend games	29

Information from prior-year audit working papers indicate that average per-game attendance for weekend games was 27% higher than average per-game attendance for weekday games.

2006 Per-Game Ticket Prices	
Club seats	Rs. 300
Box seats	Rs. 200

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<sup>Ψ</sup> Adapted from a case study published in Auditing Cases: Buckless, Beasley, Glover, Prawitt (2000 edition), Prentice Hall, pg. 133.

## Background Material for Audit Training Workshops and Seminars

General seats :     Adult :                      Rs. 150  
                              Child :                      Rs. 75

Sales Mix	Weekday	Weekend
Club seats	30%	25%
Box seats	40%	30%
General Seats		
Adults	15%	25%
Child	15%	20%

Comparison of 2005 ticket prices to 2006 ticket prices reveals an average increase of 12% between the two years.

Information from prior-year audit working papers shows that sales mix has remained fairly constant over the past several years.

2006 Promotion : Number of Games

Weekday    7

Weekend    10

Information from prior-year audit working papers shows that attendance generally increases by 10 percent when there is a promotion (e.g., free football cap, poster, or special entertainment).

### Queries to the Readers

- i) Using the information provided, what expectation for ticket revenue for the year 2006 fiscal year should be developed by Mr. Abhi?
- ii) How close would the Great Champs reported ticket revenue have to be to your expectation for you to consider reported ticket revenue reasonable or fairly stated?
- iii) If reported ticket revenues are outside the "reasonable range" what could explain the difference?
- iv) If the engagement team decides to use analytical procedures for the Great Champs audit then how will the audit plan differ from prior years?

## CASE STUDY – 9

### M/s. Eduk IT International Ltd.

#### Accounting Systems and Internal Controls<sup>∞</sup>

Eduk IT International Ltd. runs four private colleges which provide education and training for people in the information technology industry. Its two-year course includes training in data processing, multimedia, animation, etc. M/s. Tick Tack & Co. are conducting the interim audit for the year ended 30<sup>th</sup> June 2005. The tangible fixed assets of each college are recorded in an asset register which is maintained at each college location by the respective college manager. The system operates as described below:

- In order to obtain new assets, a purchase requisition form is completed and approved by the manager at each college.
- The requisition is sent to the head office, where the purchases officer checks the requisition for approval and completes the purchase order for the new asset.
- Assets costing more than Rs. 50,000, are approved by the head of the Accounts Department. All assets over Rs. 2,00,000 require Board of Directors' approval.
- The purchase order is then sent to the supplier and a copy is sent to the central store at the location of the head office.
- The asset is received by the central store where the receiving clerk checks that all the asset details agree with those on the goods received note and the copy of the purchase order. The receiving clerk then issues the asset with its computer-generated sequential barcode number. This barcode is fixed to the asset and written on the goods received note and the supplier invoice.
- The relevant college manager inputs the new asset details into the asset register using a copy of the purchase order, the original requisition and the asset's barcode.
- For disposal or write-off of an asset, an asset disposal write-off form is completed by the relevant college manager, signed and sent to the head office. Disposals and write-offs are approved by the head of the Accounts Department. A copy of the form is filed at the head office and the approved original returned to the college manager for action. The college manager then updates the fixed asset register for the subsequent disposals/write-off.
- The asset register is maintained on tailored fixed assets accounting software systems, known as FAST and reconciled to the general ledger by each college manager monthly.
- The FAST system calculates depreciation automatically each month using the rate input by the college manager at the time the asset was added to the register.

#### Queries to the Readers

- i) Identify five internal control strengths in the above case on which the auditor can place reliance.
- ii) What tests of control should be designed to evaluate the effectiveness of each of the controls identified.

<sup>∞</sup> Adapted from the case study published in Modern Auditing, Graham W Cosserat, (second edition), John Wiley & Sons, pg. 252.

## **CASE STUDY – 10**

### **M/s. Fluffy Fresh & Co.**

#### **Auditing in an IT Driven Environment<sup>3</sup>**

Fluffy Fresh & Co. is a one-location bakery whose focus is specialty cookies with unique flavorings and ingredients for holidays and special occasions. The bakery only ships cookies that have been baked within the last 24 hours. In 2005, approximately 75% of the market for the Company's product was local and 25% national. The owner, Ms. Baker, noted that local market demand was relatively stable, and she expected demand from the national market to increase exponentially. Her goal for 2006 was to increase national market share. The company's order entry system consists of national and local customers placing order using the bakery's toll-free or local number and providing credit card, address, and other relevant order information. To ensure accuracy, the operator repeats the order to the customer, who has the option of receiving a fax confirmation. Orders are sequentially numbered and entered into personal computers by 12 data-entry operators. The personal computers are connected to a local area network (LAN).

After an order is entered, the computer system generates a production request for the 15 bakers working in three shifts and a mailing label. Four packers per shift pick and package the appropriate cookies and place mailing labels on decorative boxes, which are shipped by carriers that guarantee a maximum three-day delivery. The company accepts order 24 hours a day, seven days a week. Each mailing label contains a bar code that is scanned to update the outstanding orders file. Information on filled orders is automatically deleted from the system. For quality control, an inspector periodically compares the packed goods with the order. In 2005, Ms. Baker hired a consultant and developed an electronic storefront on the Internet. The website provides a catalogue of available cookie shapes, flavors, and styles and allows customers to place orders online as well as by telephone. The online customer completes an order form and provides the same information requested in a telephone order. The company sends the customer an e-mail confirmation when the order is filled that provides information on the expected delivery date. Orders received at the electronic storefront are captured on a file that is used as input to the existing order-entry system. Ms. Baker hired Mr. Shaw, a local college student majoring in information technology, to help develop the website.

By the end of 2006, national sales had increased beyond expectations and approximately 80% of all sales (national and local) were received *via* the Internet. The business experienced overall cost efficiencies, with no increase in the number of order-takers. Mr. Shaw was working four hours each weekday and was responsible for maintaining the LAN and all of the programming for processing customer orders, preparing production requests, printing mailing labels, and transmitting credit card charges to the company's bank. He also served as the weekend computer operator for nightly updating of files, printing reports and preparing backup. A LAN supervisor was also appointed who performed these duties during the week. Each weekend, Mr. Shaw would take the backup disk home with him so the company always had a current copy of its files off-site.

After some customer complaints about not receiving shipments, the packers started recording the number of shipments made during each shift on a summary sheet. The bookkeeper was responsible for comparing the number of shipments with the weekly sales summary report and investigating any differences. However, Mr. Shaw found that the bookkeeper frequently forgot to make the comparison, so he did it himself. Once Mr. Shaw completed his graduation, Ms. Baker hired him full time to write programs for an inventory control system and a system to automatically reconcile the credit card settlement report from the bank with the company's sales records. After these

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<sup>3</sup> Adapted from the CPA Journal, April 2000, AICPA.

projects were done, the owner had him develop programs to order supplies automatically by sending electronic data interchange records to the three baking ingredients suppliers and the decorative box supplier.

Ms. Baker believed that, due to the implementation of the electronic storefront and the increasing international exposure provided by the company's website, sales would increase significantly in the ensuing years. She wanted to construct new and larger production facilities to accommodate the expected demand. Ms. Baker contacted a local community bank that agreed to fund the expansion if the company could provide audited financial statements. She engaged M/s. KJ & Associates, a firm which had been performing tax services for the company for several years, to conduct an audit. The audit manager assigned the task noted that Fluffy Fresh & Co. sales system had evolved into one in which significant information was transmitted, processed, maintained, and accessed electronically.

**Queries to the Readers**

In this situation, what audit planning should be done and how the internal control environment should be evaluated for assessing risks arising due to IT driven environment?

## **CASE STUDY – 11**

### **M/s. Excel Electronics Technologies Ltd.**

#### **Inflated Inventories<sup>⊕</sup>**

Excel Electronics Technologies Ltd. (EET) is operating 25 electronics outlets in different parts in India. The company has reported significant increase in sales and overall profit earnings since it became public limited company in 2002. The company raised Rs. 50 crores through its first public issue which was oversubscribed about 60 times. According to Bhaskaran, the company's founder and chairman and one of the principal shareholders, EET's success may be attributed to rapid expansion of its retail showrooms combines with media blitz through sponsoring tele-serials. Bhaskaran always pointed out this fact with pride that though the EET has been operating in high tech area faced with a strong threat of product obsolescence and severe competition but it faced these challenges very boldly by entering into tie-ups with leaders in the electronics field and marketing the latest technology. EET reported consistent performance during last five years and earned profits of Rs. 10-12 crores every year. The share price also touched an high of Rs. 450 last year which plummeted back to Rs. 225 during the current year. In a takeover bid, Sloans Instruments International Inc. successfully took charge of EET. Shortly thereafter, in early 2007, the new management discovered that prior financial statements were incorrect and perhaps fraudulent.

In conducting fresh audit of EET, Pixley & Co., Chartered Accountants, discovered that instead of Rs. 12 crores profit during 2006-07 the company had actually incurred a loss of Rs. 15 crores during the same period. The auditors noted that the loss included certain items which should have been charged to prior years but it could not be reasonably ascertained the years to which specific charges could have been applied. The audit also revealed that inventories were inflated by Rs. 12 crore and sundry creditors were understand by approximately Rs. 2 crores.

The value of inventories was overstated by fabricating inventory stock sheets for non-existent inventory. This was done by (1) including goods in inventories which had already been recorded as purchase returns and were awaiting dispatch to vendors; and (2) by including unrecorded inventories in stores prior to physical inventory counts and auditor's observation of such counts. Thus, in fact the purchases had not been recorded but the goods were included in the closing stock. Sales were also inflated by including in a given outlet's sale those goods that were dispatched to other outlets. Even the manner of valuation of inventories was also a contributing factor on account of variation in selling prices at different points of time in the year as also substantial difference between export selling prices and domestic selling prices.

A study of internal control procedures in this area reveled that, as a matter of general policy, all the outlets located in different regions were dispatched goods from a central warehouse but, in exceptional cases, goods could be dispatched from an outlet having surplus stocks to an outlet in the same region. Sales at different outlets are made for payment by cash, by cheque or on hire-purchase term. Receipts are banked by Branch Manager of each outlet. A weekly statement is prepared by Branch Manager showing sales by cash and cheque and against hire-purchase including installments received and payments made for wages, etc. The procedure also envisages stock-taking by personnel from head-office on a yearly basis and reconciliation with the data held at the head-office. Seasonal discounts are offered by all outlets as per the uniform policy laid down by the head-office. The valuation of stocks at outlets is done at current selling prices but at the head-office level, it is reduced by normal profit margin. EET is also required to meet an export obligation to the extent of 25% of its production during the year.

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<sup>⊕</sup> Adapted from Case Study contributed by Mr. Vijay Kapur published in The Chartered Accountant, January 1998, page 64.



A detailed report submitted by the auditors to the management also noted that the sales growth at new outlets was a key success indicator emphasized during public issue.

**Queries to the Readers**

- i) What were the specific weaknesses in the internal control procedures to be overcome to improve the procedure?
- ii) Whether the method of valuation of stocks is proper, particularly in view of the fact that prices of certain electronic items varied greatly from month to month?
- iii) What procedures might the auditors have applied that would have enabled them to detect the fraud?
- iv) What should be auditor's responsibility for detecting the EET's fraud?

## **CASE STUDY – 12**

### **M/s Heritage Export Ltd.**

#### **Detecting Fraud<sup>7</sup>**

A late evening news item on a TV network reported that the Central Bureau of Investigation (CBI) had unearthed a rich haul of selected art works of renowned artists. This caused great anxiety to Navroz, a Chartered Accountant and Senior Partner in M&N Associates. According to the show, some of the biggest international art dealers in India, acting in close connivance with a gang of smugglers, had been smuggling original artworks abroad. The next morning, the newspapers carried elaborate details of art dealers conspiring with smugglers. A list of such artworks, some of them going back to the 19<sup>th</sup> Century, which had been smuggled out of the country, was also given. The report also made it clear that there was a possibility that the original paintings missing from the stocks of these dealers might have been substituted by forgeries. Navroz felt even more disturbed on learning this, since his firm's list of clients included a good number of art dealers and antique exporters. In particular, Heritage Export Ltd. (HEL) is a fairly big international art dealer of repute, which specialised in impressionistic paintings.

As soon as Navroz reached his office, he noticed that the atmosphere was rather tense. Natasha, his private secretary, informed him that Sudhakaran has been anxiously waiting to see him for the last one hour. Sudhakaran is a qualified chartered accountant who had been working with M&N Associate for about five years and had developed an expertise in conducting the audit of art dealers and exporters apart from rendering investment advice to clients in procuring antique items and paintings. He closely followed the trends in the international market for such items, and was a frequent visitor to art exhibitions and auctions. He also subscribed to catalogues and specialist art magazines. Sudhakaran had been the principal audit supervisor of the annual audit of HEL for the last two years.

Sudhakaran informed Navroz that early in the morning, he received information that Paul Christopher, managing director, HEL, has been questioned by the CBI in connection with the smuggling. After going through the various press reports, it seemed probable that some of the classic works belonging to HEL had been missing for quite some time. But a perusal of audit files for the previous year showed that they were still in the possession of HEL and had been so shown in the financial statements. The situations seemed to be quite serious. In case the value of stocks reflected in HEL's financial statements was not backed by original paintings in their possession, the continuance of HEL as a going concern would be in doubt. Navroz told Sudhakaran to go to HEL's corporate office and acquire a complete schedule of paintings, giving all details including title of the works, artist's name, period, location, distinctive features, cost, value and other sundry information. Any representations made by the management in the past should also be scrutinised carefully once again. Sudhakaran left for HEL's office accompanied by two assistants.

Two days later, Sudhakaran reported to Navroz that the total stock of impressionistic paintings would have been valued at Rs. 60 crore. The total turnover of HEL for the current year was around Rs. 150 crore. During the previous accounting years, the value of the paintings had been included in the financial statements on the basis of a certificate given by the management. In addition, the assessment of value was certified by Murtaza Ali, an eminent artist and consultant to HEL. Despite persistent enquiries expressing grave doubt about the originality of such paintings, the HEL management maintained that all paintings in their possession were the originals and the same had also been certified by a highly-respected person in the world of art. After discussing the matter at some length, Navroz decided that it would be appropriate to commission an independent specialist to determine the authenticity of the paintings. Accordingly, it was decided to approach Wilson & Christ (W&C), a firm of international fame, to take up this special assignment. Navroz got in touch with Christopher to work out the details of scope of work and consultancy fees. But to his surprise, there was lot of resistance to the appointment of W&C. Christopher argued incessantly that the

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<sup>7</sup> Adapted from Case Study contributed by Mr. Vijay Kapur published in The Chartered Accountant, February 1998, pages 30-31.

situation was not alarming, since this aspect has been verified and certified by renowned experts in the field, and moreover, the fees of W&C were likely to be very high. Despite this, Navroz decided to go ahead with the appointment of W&C on his own. W&C informed M&N Associates that their charges would be worked out on the basis of a percentage of the value of the stocks and audit fees, subject to the fact that the total fees would not be less than 50 per cent of audit fees. Traveling expenses would be charged on an actual basis.

W&C were informed about their scope of work and the fact that their findings would have significant support for verification and valuation of paintings being shown in the financial statements. The report of W&C revealed that it was almost certain that Rs. 10 crore worth of stock was definitely authentic, about Rs. 15 crore worth of stock was definitely forged, and there was considerable doubt about the remaining stock. In their report, W&C explained the objective and scope of their work. A complete description of material and assumptions used in arriving at such conclusions were also given. They also clarified that on certain stocks it was difficult for them to comment since they could not physically verify them.

W&C's report was quite disturbing. Both Navroz and Sudhakaran debated the issue at length but could not reach a consensus on how to deal with the situation.

**Queries to the Readers**

- i) Should M&N Associates accept at face value the report issued by Wilson & Christ?
- ii) Whether M&N Associates should refer to Wilson & Christ's report in their audit report?
- iii) What course of action should be taken with regard to the nature of the doubts which had been expressed by Wilson & Christ?
- iv) Whether another specialist be appointed or what further additional procedures should be performed by M&N Associates under the circumstances?
- v) Who should bear the consultancy fees charges by W&C and in what proportion? In case HEL refuses to pay, would sharing a part of audit fees with W&C be in order?

## **CASE STUDY – 13**

### **Konark Pvt. Ltd.**

#### **The Expectation Gap<sup>√</sup>**

It was a fine morning when S.K. Parnami, managing director of Konark Pvt. Ltd. met Arun Dale, senior partner of his company's auditors Dale & Associates (DA), at the Royal Golf Club. As conversation picked up, Parnami told Dale about his plans to expand Konark's ceramic and melamine potteries business, and about the way he would raise money for that. He would raise a term loan from a financial institution and negotiate with his bankers for renewal of overdraft facilities. But while all this was fine, what worried Parnami was the fall in net profits for the current year over the previous year, despite both turnover and gross profits increasing considerably.

Parnami, while expressing his general displeasure over the state of affairs in his company, said that, in his view, appointment of "independent auditors" during the last three years would have solved much of his problems. That would have ensured the company's resources were utilised efficiently, and no manipulation or misappropriations were possible in the management of financial affairs. In Parnami's opinion, one of the primary tasks of auditors was to ensure minimisation of tax liability, but in Konark's case, its tax liability had gone up over the period. Parnami also felt that the audit fees were quite high and disproportionate to the benefits derived from having the financial statements audited. Further, he said the auditors had not even bothered to look at the stocks in the 10 depots of the company.

A little astonished, Dale explained to Parnami the objectives of audit and the professional responsibilities of auditors. He also emphasised that it was the responsibility of the management to prevent and detect frauds and errors by maintaining an adequate and efficient system of internal control in the company. However, before leaving, Dale told Parnami that he would like to make a presentation to him on auditor's duties and responsibilities sometime the following week.

Later in the afternoon, Dale reached his office and began skimming the papers on Konark. He noted that Konark was initially established as a partnership firm about 10 years back. It was incorporated as a private limited company after about seven years, and since then DA had been its auditors. Konark, with two manufacturing units at Mirzapur and Bulandshahar in Uttar Pradesh, had a workforce of 225. While physical distribution of finished products was handled by 10 retain depots mainly in the northern and central areas of the country, each of the depots was headed by a storekeeper-cum-accountant. On an average, 80 or 90 daily-wage workers were employed at the manufacturing locations, while contract labour was engaged at the depots.

Since conversion to a company, Konark's turnover had gone up from an initial Rs. 1.5 crore to about Rs. 6 crore in 1996-97. Its net profits had also risen consistently throughout (from Rs. 20 lakh to Rs. 1 crore) until the previous year. In 1996-97, however, the net profits fell, while sundry debtors went up considerably. Looking at the papers, Dale did feel that there was something amiss somewhere. He summoned K. Sundreshan, partner-in-charge of the audit, to understand first-hand the affairs of Konark. During the course of discussion, Sundreshan made the following submission:

- While Konark's major shareholder was S.K. Parnami, the company was controlled mainly by R.K. Singh, chief accountant, who was married to Parnami's eldest daughter.
- During preliminary audit, Konark's internal control was found to be very weak in respect of salaries at both the manufacturing units, but no major errors had been detected.

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<sup>√</sup> Adapted from Case Study contributed by Mr. Vijay Kapur published in The Chartered Accountant, October 1997, pages 30-31.

- Sale of wood from plantations in the periphery of certain depots was booked through petty cash.
- No proper explanation was given for certain expenses booked as entertainment expenses. While no proper receipts were available, Singh had said the auditors should not bother about the entertainment expenses since Konark was a private limited company, and it was, more or less, a family affair.
- No reconciliation had ever been done with reference to the total quantity of items manufactured, items sold, and stock-in-hand. The explanation given was that reconciliation was not possible since there were too many items with different colours and designs. Moreover, it was not possible to count and value the stocks at the end of the year since staff was limited.
- One of the audit clerks had overheard a customer telling the accountant that he had already made the payment in cash to Singh. It was suspected that Singh had not deposited the amount subsequently.

After considering Sundreshan's submission, Dale felt some frauds may have been perpetrated by a few officials at Konark in collusion with the accountant. This would have ultimately led to the fall in net profits. Subsequently, as he had promised, Dale made a presentation to Parnami on the roles and responsibilities of auditors and those of the management. He also indicated the possible impact of Sundreshan's revelations on the accounts of the company.

At the end of the presentation, Parnami simply nodded his head, almost in disbelief. Apparently, he was still not quite convinced about the whole affair.

**Queries to the Readers**

- i) What are the role and responsibility of the auditors in detecting frauds and errors, and the contribution of audit to the efficient management of the business affairs of a company?

## CASE STUDY – 14

### Gamma Surgical Equipment

#### Planning the Audit↔

Gamma Surgical Equipment (GSE), a New Delhi-based company, is a distributor of surgical equipment. It is the principal distributor for British Laboratories in the northern region where it has a market-share of 30 per cent. For the accounting year 2006-07, the annual sales of GSE were about Rs. 20 crore, and its net income Rs. 1.80 crore. GSE's income figure also included a substantial income of about Rs. 50 lakh from investments, both long-term as well as current. R. Krish and Co., Chartered Accountants, have been auditing the financial statements of GSE for the past three years. As a matter of policy, the firm has a well-established practice of rotating the partner-in-charge of audit every three years so that the quality of audit is maintained. Pursuant to this policy, V.S. Narayan, CA, a partner of the firm was given the charge of GSE audit for the current accounting period for the first time. While going through the previous year's audit working papers, Narayan noted that the overall performance of GSE had been quite impressive and its markets share had gone up steadily over a period of time.

A close review of the organization chart showed that marketing was the dominant activity of the company, and a major part of the workforce comprised sales personnel in all, there are eight sales executives representing different territories in the region headed by a sales manager who are responsible not only for booking orders and ensuring delivery of goods to hospitals in far-flung villages and remote areas, but also for follow-up of incollectible amount. As against this, Narayan felt that a host of functions were being performed by a single individual and, practically, there was no adequate segregation of duties as far as staff functions were concerned. There was also no separate dispatch department, and the mail including cheques was distributed directly to the officer to whom it was addressed.

The following day, Narayan reached GSE's corporate office to commence the audit for the year. Since debtors constituted a significant aspect of the business, Narayan decided to concentrate on the sales cycle. He observed that there were three persons working in the accounts section whose duties had been allocated. S.K. Pai, accounts officer and overall in-charge of the accounts section, dealt with sales from the receipt of orders to the collection and recording of cash from debtors. Sonam, accounts executive, dealt with all purchases and expected payments including entries in the cashbook. Prachi, accounts clerk, maintained the petty cashbook and dealt with preparation and payment of wages. The preliminary review revealed that the total debtors outstanding at the end of the year as per the ageing schedule were as follows:

- i) Outstanding debts for over six months:

Considered good	Rs. 6 crore
Considered doubtful	Rs. 2 lakh
- ii) Other debts considered good Rs. 17 crore  
(Outstanding for less than six months)

Narayan was perplexed as to how the debtors considered good could exceed the annual turnover by about Rs. 3 crore. He wondered that even if sales of the last six months were counted on an average basis, the excess of debtors over sales would be about Rs. 8 crore. As per analysis of the past trends in debtors expressed as percentage of total sales, no cyclical fluctuations were noticeable and GSE did not belong to the category of a seasonal industry.

Further, while reviewing investment operations, Narayan noted that R.V. Manan had been working as manager (investments) for the last five years. The company had authorized Manan to open accounts with various brokers in

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↔ Adapted from Case Study contributed by Mr. Vijay Kapur published in The Chartered Accountant, December 1997, pages 26-27.

his own name. To provide maximum flexibility, all purchases and sales investments were authorised by Manan. Broker's advices and other correspondence from brokers, including cheques for sale proceeds, were directly mailed to Manan. The cheques were drawn in favour of R.V. Manan C/o GSE A/c. The investment ledger was maintained by Manan but the general ledger was maintained by Pai.

Narayan noted, to his dismay, that the procedure offered considerable scope for defalcation of sums received from brokers, particularly in view of the fact that cheques were received directly by Manan. It was quite likely that he might not have passed on broker's advices to Pai for recording in the general ledger. During his two day stay at GSE, Narayan felt that both Manan and Pai had been maintaining quite a luxurious lifestyle that did not quite match their monthly salary and perks. He was stunned to learn that both had been planning their next vacation abroad and planned to spend about Rs. 5 lakh. Narayan brought all these facts to the notice of the managing director (MD). However, there was lukewarm response from the MD since he felt that given the number of persons working in the accounts section, he was able to supervise the activities more closely.

With regard to the above, Narayan concluded that the internal control system was quite weak and, thus, called for detailed substantive audit procedures and periodic surprise checks. He was, however, unable to lay down a concrete plan of action on certain issues regarding the course of action to be followed under the circumstances.

**Queries to the Readers**

- i) Whether to inform the board of directors about the weaknesses in the internal control system on an immediate basis.
- ii) How the division of duties should be restructured, given the number of employees working in the company, with regard to cost-benefit analysis, and whether the same should be carried out by the auditors themselves.
- iii) The type of substantive audit procedures that should be performed to assess that sundry debtors and investments are reflected properly in all respects.
- iv) Whether auditors can be held liable for not detecting defalcation, if any, perpetuated and concealed by the top management.

## **CASE STUDY – 15**

### **ABC Limited**

#### **Relying Upon the Work of an Internal Auditor**

ABC Limited, a listed company with a turnover of over Rs. 100 crore. It is mainly involved in manufacture / trading of office automation products. The manufacturing facility and corporate office are based in the same location. It has sales / branch offices across the country. The company has an internal audit department comprising of three personnel including the IA head who is professionally qualified and has a number of years experience in the industry / company. The other members of the team are graduates with a number of years in the company. The IA head reports independently to the Managing Director and is also present in the audit committees.

The company is facing high blockage of funds in current assets mainly certain category of stock, certain debtors and certain loans and advances (to group companies).

The above balances from the statutory auditors' perspective are high risk and involve judgement regarding reliability, analysis of contractual terms etc. The company may have high exposure in them in terms of sticky balances which may be overstated.

The internal auditor's have covered the following areas as part of their annual audit programme-cash and bank balances, payroll, purchase-payable cycle. However it is seen that the specific balances which are considered risky by the statutory auditors have not been covered by the internal audit team although they are material also from the company's perspective.

In view of the above what implications are there in the statutory auditor's scope of reliance of the internal audit work, evaluation of internal audit work. What implications are there in CARO reporting?

*Source: Anonymous*



## CASE STUDY – 16

### Going Concern Audit Report

You are the manager responsible for performing hot reviews on audit files where there is a potential disagreement between your firm and the client regarding a material issue. You are reviewing the going concern section of the audit file of Sunshine Ltd, a client with considerable cash flow difficulties, and other, less significant operational indicators of going concern problems. The working papers indicate that Sunshine Ltd is currently trying to raise finance to fund operating cash flows, and state that if the finance is not received, there is significant doubt over the going concern status of the company. The working papers conclude that the going concern assumption is appropriate, but it is recommended that the financial statements should contain a note explaining the cash flow problems faced by the company, along with a description of the finance being sought, and an evaluation of the going concern status of the company. The directors do not wish to include the note in the financial statements.

Identify and discuss the implications for the audit report if:

- (i) the directors refuse to give the disclosure note.
- (ii) the directors agree to give the disclosure note.

### Suggested Response

- i) The Directors refuse to give the disclosure note:

The audit report should contain a qualified or an adverse opinion due to the disagreement. The auditors need to make a decision as to the significance of the non-disclosure of the uncertainty surrounding going concern assumption. If it is decided that without the note the financial statements are not fairly presented, and could be considered misleading, an adverse opinion should be expressed.

- ii) The Directors agree to give the disclosure note:

If the directors agree to give the disclosure note, it should be reviewed by the auditors to ensure that it is sufficiently detailed. In evaluating the adequacy of the disclosure in the note, the auditor should consider whether the disclosure explicitly draws the reader's attention to the possibility that the entity may not be able to continue as a going concern in the foreseeable future. The note should include a description of conditions giving rise to significant doubt, and the directors' plans to deal with the conditions. If the disclosure is considered adequate, then the opinion should not be qualified. The auditors should, however, consider adding an emphasis of matter paragraph to highlight the existence of the material uncertainties, and to draw attention to the note to the financial statements. The emphasis of matter paragraph should firstly contain a brief description of the uncertainties, and also refer explicitly to the note to the financial statements where the situation has been fully described. The emphasis of matter paragraph should re-iterate that the audit opinion is not qualified. However, it could be the case that a note has been given in the financial statements, but that the details are inadequate and do not fully explain the significant uncertainties affecting the going concern status of the company. In this situation the auditors should express a qualified opinion. The auditor, however, may also consider expressing an adverse opinion, if it is warranted under the circumstances based on the Auditor's professional judgment.

*Source: Implementation Guide to Standard on Auditing (SA) 570, Going Concern.*

## **CASE STUDY – 17**

### **Going Concern Audit Report**

XYZ Inc. is a manufacturer of televisions. The domestic market for electronic goods is currently not doing well, and therefore many entities in this business are switching to exports. As per the audited financial statements for the year ended March 31, 20XX, the entity had net losses of Rs.120 million. At March 31, 20XX, its current assets aggregate to Rs.1,200 million and the current liabilities aggregate to Rs.1,500 million. Due to expected favorable change in the government policies for the electronic industry, the entity is projecting profits in the coming years. Furthermore, the shareholders of the entity have arranged alternative additional sources of finance for its expansion plans and to support its working capital needs in the next 12 months.

#### **Required:**

Should XYZ Inc. prepare its financial statements under the going concern assumption?

#### **Suggested Solution**

In this case, the two factors that raise doubts about the entity's ability to continue as a going concern are:

- The net loss for the year amounting to Rs.120 million.
- The working capital deficiency (current liability of Rs.1,500 million Less: current assets of Rs.1,200 million) of Rs.300 million existing at the balance sheet date.

However, there are two mitigating factors:

- The arrangements made by the shareholders to fund the entity's expansion and working capital needs; and
- Projected future profitability due to expected favourable changes in government policies for the industry the entity is operating in.

Based on these sets of factors, it may be possible for the management of the entity to argue that the going concern assumption is appropriate and that any other basis of presentation of financial statements would be unreasonable at the moment. However, if matters deteriorate further instead of improving, then in the future another detailed assessment would be needed to ascertain whether the going concern assumption is still valid and accordingly suitable disclosure may be made in the financial statements and the same shall be considered by the auditor *vis a vis* need to give Emphasis of Matter Paragraph or Qualified or Adverse Opinion, as the case may be.

*Source: Implementation Guide to Standard on Auditing (SA) 570, Going Concern.*

## CASE STUDY - 18

### Determination of Provision (Form and Content of Documentation)

The client is a software company. During the audit of the accounts for the year ended 31<sup>st</sup> March 2012, a difference of opinion pertaining to provision for doubtful debts arose. The client had provided Rs. 10 lakhs as provision for doubtful receivables. He is of the opinion that this is sufficient as most of the receivables are from group companies. The auditor challenged this because as per his estimate, it should have been at least Rs. 60 lakhs. After many meetings and arguments, both parties agreed that a provision of Rs. 40 lakhs was appropriate. The audit working papers do not have any record of how the provision was determined. The auditor says that once he was satisfied about the adequacy of provision, he is not required to keep any record on his file.

Is the opinion right?

### Analysis and conclusion

As per Para 8 of SA 230, the auditor should prepare audit documentation regarding "Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions."

All significant matters arising during the course of the audit need to be documented. Specifically, those pertaining to provisions and estimates where professional judgment is necessary to arrive at a conclusion, should be documented. Some examples of such situations are provision for doubtful debts, useful life of unique technical assets, provision for warranty, etc.

Hence, in the above situation, the auditor and the client have discussed and argued, considering various scenarios, before arriving at a conclusion on the provision for doubtful debts. Issues debated and discussed at the meetings should be documented. The auditor should also have sufficient evidence to support his conclusion which may include breakup of the doubtful debts, subsequent realization, past history of repayments, etc.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*

## **CASE STUDY - 19**

### **Documentation of Wage Settlement (Oral Communication)**

The client has entered into a retrospective wage settlement agreement during the current financial year. The related wage arrears amount to Rs. 100 crores which is above the relevant materiality levels. Necessary adjustments were made in the books of accounts. Consequently, provision for gratuity has also increased significantly. The same has been provided in the books of accounts.

The auditor is of the opinion that, since all the facts of the case, the subsequent decisions and the adjustment in the books have already been orally communicated to those charged with governance; the same need not be documented.

Is this opinion correct?

### **Analysis and conclusion**

As per Para 10 of SA 230, "The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place."

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

Going by the facts, the case in question is an exceptional item which is to be considered as a significant matter. Hence, though the management/those charged with governance is/are already aware of the issue and its resolution by way of oral discussions, the same will need to be documented. Generally the same may be communicated through the audit committee/ Board Meeting presentation.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*

## CASE STUDY - 20

### Cross Referencing Risk and Audit Program

The audit team, after due discussions, identified and documented the significant risks pertaining to the organization. The team also had a pre-determined standard audit program for every area of balance sheet and profit and loss.

The audit procedures were performed as per the audit program and the same was documented.

However, risk and the program were not cross referenced. The team is of the opinion that the same need not be done.

### Analysis and Conclusion

As per SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", an auditor needs to discuss amongst the team members, understand the entity and its environments, assess the significant risks of the organization and understand the relevant controls in the entity to mitigate such risks. Risks are identified at the financial statement and the assertion level.

As per para 29 of SA 330, "The Auditor's Responses to Assessed Risks", the Overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed and the linkage of those procedures with the assessed risks at the assertion level should be documented.

In the given case, the audit team has identified the risks and the procedures. However, the procedures have not been linked with the assessed risks. Hence, the documentation is not complete.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*

## **CASE STUDY – 21**

### **Documentation of Responses to Assertions**

Every account balance in the books of accounts needs to be audited based on certain assertions. These include completeness, accuracy, valuation, etc.

The auditor was auditing the accounts of a hotel. Revenue comprising primarily of room revenue and revenue from food and beverages is an assumed risk. While determining the assertions of revenue, the most important assertion identified was “completeness”. Checks pertaining to cut off, etc was done to verify the same. However, the same was not explicitly documented.

### **Analysis and Conclusion**

As per SA 330: The Auditor’s Responses to Assessed Risks, the following need to be documented:

- The results of the audit procedures, including the conclusions where these are not otherwise clear.
- The form and extent of audit documentation is a matter of professional judgment, and is influenced by:
  - nature, size and complexity of the entity and its internal control,
  - availability of information, and
  - audit methodology and technology used in the audit.

In the given case, though the risks have been assessed and assertions identified, documentation is not complete if the audit checks in response to assessed risks and conclusion thereof have not been documented.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*

## CASE STUDY - 22

### Revisions of Work Papers

The audit team, during the finalization of the audit of a client in the hotel industry, had several revisions in the financial statements. Consequently, the related working papers also underwent numerous changes.

The audit manager is of the opinion that the old papers can be destroyed wherever there were revisions and it is enough to preserve the final version. However, the audit team is of the opinion that all revisions need to be filed for traceability.

Which opinion is right?

### Analysis and Conclusion

As per Para A22 of SA 230, "The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if they are administrative in nature. Examples of such changes include: Deleting or discarding superseded documentation."

Hence, old papers which have been revised may be deleted or discarded.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*

## CASE STUDY - 23

### Audit of Inventory (Comprehensiveness and Relevance)

During the audit of inventory of a manufacturing company, a working paper had the following details pertaining to finished stock:

Item	Quantity	Rate (Rs.)	Value (Rs.)
A	36,042.80	42.51	15,32,179
B	3,250.00	165.22	5,36,965
C	1,176.50	146.99	1,72,938
D	82.00	2,482.19	2,03,540
E	64.00	1,740.52	1,11,393

As a reviewer identify the missing details.

#### Analysis and Conclusion:

As per Para 9(a), "In documenting the nature, timing and extent of audit procedures performed, the auditor shall record the identifying characteristics of the specific items or matters tested."

The auditor is expected to record all such information which enables an "experienced auditor" to understand the work done and conclusions reached without the help of the engagement team.

As per Para 6(c), an experienced auditor is "An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:

- i. Audit processes;
- ii. SAs and applicable legal and regulatory requirements;
- iii. The business environment in which the entity operates; and
- iv. Auditing and financial reporting issues relevant to the entity's industry.

Keeping in mind the above, the following essential details are missing in the working paper:

- Unit of Measurement
- Previous year comparative figures
- NRV vs Cost comparison not detailed
- Cost formulae – Current year Vs Previous year
- Excluded costs
- Absorption of fixed overheads
- Quantity reconciliation
- Reference to physical verification paper

The working paper can be called complete only when the above details are incorporated.

Source: *Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*



## CASE STUDY - 24

### Assembly of Final File

The audit team completed the field work and finalization of the audit. Financials and audit report were signed on 10<sup>th</sup> July 2012. Due to statutory and tax audit pressure, the team was reallocated to another assignment before closure of the audit file. The team attended to the closure of the file after the tax audit season, i.e. 30<sup>th</sup> September 2012.

Is this in compliance with the requirements of the standard?

### Analysis and Conclusion

As per Para 14 of SA 230, "The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report."

Para 74 of SQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files. Para 75 of SQC 1 says "An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report."

Hence, the file needs to be completed by 10<sup>th</sup> September 2012.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*

## **CASE STUDY - 25**

### **The Devil Called “Microsoft Excel” (Form and Content of Documentation)**

Working for 2 hours to make a 33MB excel file to a mail friendly size of 886 KB and ensuring that relevant information is not compromised, the auditor was thoroughly dejected trying to fix the problem, without knowing where the problem was.

The auditor was reviewing a report, where significant issues were documented in a word document and related annexures in a spreadsheet. The size of the annexure was 33MB for just 68 sheets. Teams had taken screen shots of ERP sample pages to explain a point (Very good from evidence perspective but not from file size management point of view).

Where is the real problem here?

### **Analysis and Conclusion**

After working out permutations and combinations, the problem was successfully identified!

- i. Complete dump of transactions for a period as taken from the ERP was pasted in the spreadsheet with few annexures running to 10000 lines!
- ii. On the annexures, filters were applied to explain the problems. However, the complete data was sitting in the annexure without relevance. E.g. The observation reported delay in collection over 5 days from due date and the annexure contained the complete debtors ledger dump with at least 30 columns (many of those columns may not be relevant in context) with appropriate filters applied!

Solution -

- i. Remove unwanted columns, unwanted rows.
- ii. Reduce the image sizes when you copy screen shots into a file.

Documentation in soft copy is good provided a proper trade off is made between Required details and file size.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*

## CASE STUDY - 26

### Preference Share Holders Redemption (Documentation)

Preference shares issued by A Ltd. in October xx05 are due for redemption on xx10. Preference shares have not been redeemed on due date and negotiations between the parties have not concluded as on audit report date.

The auditor has made a comment on Preference share redemption in Audit report without qualifying audit opinion but has not documented the same in the working papers. Is this correct?

### Analysis and Conclusion

Preference share redemption is a significant event that will have an impact on cash flows of the company and has been included in "emphasis of matter" paragraph in the audit report. As per para A8 of SA 230, auditor has to document such matters (information on negotiation between preference shareholders and the company) in the working papers.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*

## **CASE STUDY - 27**

### **Change in Risk Assessment and Audit Procedures**

A Ltd. Auditors had not considered "Fixed assets" as significant risk area at the Planning stage. During FY 2012, A Ltd. had written off fixed assets with WDV of Rs.10 lacs as these assets could not be traced by management. On further inquiry, auditors identified that fixed assets register was not properly updated and critical information such as quantity and serial numbers were not available in fixed asset register. Auditors revised their audit approach and considered "Fixed assets" as significant risk area and modified their audit procedures pertaining to fixed assets verification.

Should auditors document the reason for considering fixed assets as "significant risk" in working papers and the reason for change in audit procedures in working papers?

### **Analysis and Conclusion**

As per para A8 of SA 230, where risk assessment is revised and audit procedures are modified, then such changes need to be considered as a significant matter and documented in audit working papers. As a result, the reasons for considering Fixed assets as significant risk and all observations and procedures pertaining to fixed assets needs to be documented in the working papers.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*

## CASE STUDY - 28

### Acceptance of Salary Escalation Assumption

Management of A Ltd. expects future salary escalation to be about 8% for purpose of computing gratuity liability and leave encashment liability as per actuarial valuation, whereas weighted average salary increase for FY 2012 was about 16% and 17% for FY 2011. Auditors questioned the management on reasonableness of the salary escalation assumption used for computation of the liability.

Management expects the salary escalation to be less compared to previous years as salary level of all employees are in line with market. Management further provided salary increment expected to be given for all employees on payroll as on balance sheet date. Weighted average salary increase computed based on forecast data given by management is 8%.

Auditors accepted the 8% salary escalation rate but did not document the data and explanation given by the management in working papers. Is this correct?

### Analysis and Conclusion

Please refer para A9 in SA 230. As salary escalation rate is a significant matter that requires professional judgment, it is critical to document the reason for accepting 8% salary escalation rate in the working papers.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*

## **CASE STUDY – 29**

### **Purposeful Documentation**

A firm XYZ was carrying out a government audit. In a government audit, a supplementary report is required to be submitted to the CAG. On review of the report, it was found that for a query requiring the auditor's comments on legal cases, an ageing analysis of the cases had been performed.

Is the same sufficient documentation?

### **Analysis and Conclusion**

Documentation must be purposeful.

In the above case, while the auditor had analysed the ageing of the legal cases, information such as the purpose of the case, the amount involved, etc. had not been highlighted and hence becomes insufficient.

Documentation must be done with a purpose and all data does not become information useful in audits.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*

## CASE STUDY – 30

### Contents of Documentation

While reviewing a work paper on “pre-paid expenses” an auditor noticed that the schedule prepared by the audit team gave the opening balance, debits to the account, credits to the account and closing balance.

Is the same sufficient documentation?

### Analysis and Conclusion

Audit documentation highlights the audit performed by the team. The above documentation process would indicate that the team has taken a short cut to perform the audit.

A pre-paid expense schedule should clearly state, in respect of significant items:

1. Name of item;
2. Total amount paid,
3. Period to which it relates,
4. The pre-paid amount as on Balance Sheet date,
5. Period for which prepayment was done; and
6. The pre-paid amount on the same date of the previous year

Auditor should ensure that proper schedules are obtained from client so as to prepare sufficient work papers. Extracts from ledger by themselves are not adequate audit documentation.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*

## **CASE STUDY – 31**

### **Documentation should be after a Lot of Thought and Application of Mind, and done Logically and Cogently:**

On reviewing an audit report, an experienced auditor observed that godown rent cost had increased in the audit period and the reason stated for the same was "Increase in rates or increase in kgs stored".

Does the same constitute proper documentation?

### **Analysis and Conclusion**

The use of the word "or" does not make the observation conclusive.

What the writer wanted to convey was probably that in some cases rent is paid on per kg basis and in some cases as fixed rent. Both have increased.

However use of the word 'or' makes it looks like a multiple choice question, requiring the reader/reviewer to take his pick.

Part explanation is not correct.

For example, let us say that there an increase in salaries on account of new recruitments and also decrease as some people have left. Auditor should ensure both aspects are covered in explanation. You can't just use a part explanation because that sufficiently explains the variation.

Do not leave something on 'materiality' ground if there is a genuine reason which needs to be explained. This happens when salaries of two departments are there (for both underlying agreement being same and the increase on a/c of the new agreement is 25%) and one (admin. dept) has 25% increase and another (sales dept.) 3% increase, you need to explain both variations as otherwise the real reason why it is 13% will not come out;

Explanations must be with figures and not just facts.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*



## CASE STUDY- 32

### Complete Work Papers

When doing an analytical review, the following was observed by an auditor:

*Lease rent: The lease rent has reduced as no. of employees has reduced*

### Analysis and Conclusion

Audit documentation must be complete.

Work papers must be such that a qualified person with no previous knowledge of the reviewed company should be able to go through the file himself and review it.

In the above case, upon enquiry, it was understood that in a particular division computers were hired for all employees and as the no. of employees in that division had come down, the no. of computers hired had also come down.

However, the same was not properly highlighted through the work paper.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation.*

## CASE STUDY – 33

### Documentation in the Eyes of a Peer Reviewer

The following points were highlighted by a reviewer during the peer review of an audit firm and the auditor's responses to the same.

S.No.	Reviewer	Auditor
1.	Cut off reviews are not documented under revenue	No cut off is applicable in this company.
2.	Going concern – next year projections are not attached or documented	Projected sales are not provided to us.
3.	IT controls are not documented	Company uses Tally which has no controls
4.	Revenue not considered as key /significant/ fraud risk.(in a bank)	No income allocated to us in the Joint auditors' area /responsibilities.
5.	PAR not in file. (Preliminary analytical review)	PAR not relevant as no changes are made to financials during the audit.

### Analysis and Conclusion

Documentation is an essential part of the audit. As per the SA on Audit documentation, an experienced auditor should be able to understand the work papers even without the engagement team being present. The above review points pertain to insufficient documentation and may be handled as follows:

- Cut off:** There is no company where cut off is not applicable for revenue. In a manufacturing company it could mean dispatches not billed in the right period; in a software company, this could mean revenue of current year postponed to next year or vice versa.
- Going concern:** Looking at next one year projections is essential. If the Company has no projections/budget etc the next year projections needs to be discussed at least orally with CFO, etc.
- IT controls:** Precautions taken if the software does not have controls, has to be documented. E.g. Serial no. control over vouchers, Reconciliation of MIS with company accounts, TB signed by CFO periodically, copy of Tally taken on CD, etc.
- Joint audit:** If key branches are audited, revenue is certainly covered and needs to be documented as a risk.

**Preliminary analytical review:** This is mandatory. In case there is no change in the figures, one can mention the same in the final analytical review.

*Source: Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation..*

# Technical Posers

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## Technical Poser – 1

The client had provided Rs. 10 lakhs as provision for doubtful receivables. The auditor challenged this because as per his estimate, it should have been at least Rs. 60 lakhs. After many meetings and arguments, both parties agreed that a provision of Rs. 40 lakhs was appropriate. The audit working papers do not have any record of how the provision was determined. The auditor says that once he was satisfied about the adequacy of provision, he is not required to keep any record on his file.

*Is the auditor's argument valid?*

## Technical Poser – 2

When testing cash and bank balances, the cashier provided the auditor a bank confirmation of Rs. 2,50,00,000 on the official letterhead of the Bank. This was duly tallied with the bank statement and filed among the audit working papers. Next year it was discovered that both, the bank statement and the confirmation, were forged and the actual bank balance was only Rs. 1,50,000.

*Is there any failure on the part of the auditor in carrying out the audit?*

## Technical Poser – 3

The statutory auditor of a nationalised bank held discussion with the internal auditor and obtained a program of internal audit coverage made during the year. Based on this, the statutory auditor decided not to include areas covered by internal audit in his own audit program, as he relied on the work of the internal auditor.

*Is the statutory auditor justified in his action?*

## Technical Poser – 4

When asked for planning documentation for the audit of a listed company, the auditor produces two-page document called "Audit Plan". This contains a table giving the various account balances to be tested, the randomly selected months for which vouching is to be done, and some details of finalisation work like stock-take.

*Would you consider document appropriate?*

## Technical Poser – 5

For determining the liability for gratuity, the client produces a report obtained from a reputed independent actuary. On examination of the assumptions made in the actuary's report, the auditor notices that the rate of return on gratuity trust investments assumed is 10%. The auditor knows that the current return on it is no more than 6%.

*Can the auditor challenge the actuary's report?*

## Technical Poser – 6

Audit of a distillery is being done at the head office in Mumbai. The company has a sales outlet for army personnel on the Indo-Pak border in Kashmir. The auditor relied on the written representation of the company's management that

## **Background Material for Audit Training Workshops and Seminars**

stock worth Rs. 2 crores lying at the godown near Srinagar was physically verified by the local storekeeper, without performing any other audit procedures. It was later found that no such godown existed.

*On what counts would the auditor be lacking in this case?*

### **Technical Poser – 7**

A number of material account receivable balances from certain related parties are outstanding for more than five years. The parties do not respond to balance confirmation requests. The management assures the auditor that all the parties are sound and the money will be recovered. Audited financial statements of one of the parties are shown to the auditor as proof of its solvency. Taking these financial statements on record as evidence, the auditor agrees that no provision for doubtful debts need be made.

*Is the auditor's decision appropriate?*

### **Technical Poser – 8**

Provision was made in the books on account of translation loss in respect of a foreign subsidiary that was consolidated. Prior to signing the financial statements, the exchange rate became favourable. The management urged the auditor to reverse the charge to income in view of evidence of rate correction provided by the subsequent event.

*Should the auditor agree?*

### **Technical Poser - 9**

Newspaper reports allege that the promoter-managing director of a company had committed an excise duty fraud in that company's subsidiary. The company's auditor checked excise duty workings of the holding company that he audited and concluded that no such fraud appeared to have been committed in the auditee company.

*Were the auditor's procedures adequate?*

### **Technical Poser – 10**

Last year's auditor's report was qualified as regards short provision for receivables. This year, the provision is adequate. The auditor, therefore, dropped the qualification altogether from his current year's auditor's report.

*Is the auditor justified in dropping the qualification from the current year's audit report?*

### **Technical Poser - 11**

A private limited company has a board of directors but no audit committee. The auditor, by and large, deals with the company's financial controller. All audit issues were discussed with the controller, the financial statements finalised, and the auditor's report issued.

*Would this be a violation of Standards on Auditing?*

**Technical Poser – 12**

The auditor was told by the financial controller that arrangement for him to attend the annual stock-take of the company at an outstation location, carrying significant value of stock, could not be made consequently, the auditor did not attend the stock-take.

*What would be the impact of the inability of the auditor to attend the stock take on the audit opinion?*

**Technical Poser – 13**

When the audit team visited the client to perform substantive audit of debtors the client produced ledger accounts of customers and debtor's confirmation letters in respect of the ten largest debtors. One of the debtors was more than five years old, but had confirmed his balance. The audit manager verified the confirmations with the ledger balances and found them to be in order.

*Did the manager perform adequate work to obtain sufficient appropriate audit evidence?*